News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. January 22, 2018

Owner Operated Companies

Alphabet Inc. – Google recently signed a patent licensing deal with Tencent Holdings Limited in an attempt to find ways to grow in China, the second largest economy, where many of its products have been discontinued. The cross licensing deal with Chinese social media and gaming firm, Tencent, will allow the companies to come together and create new technologies and it covers a wide range of products. Google has entered into similar agreements before with companies like Samsung Electronics Co., Ltd. LG Electronics Inc. and Cisco Systems, Inc.

Linamar Corporation – will reportedly receive $99 million in funding to support the expansion of advanced manufacturing technology through the opening of a new research and development centre in Ontario. The federal government is providing a $49 million grant toward what it says is a $750 million total investment. The grant is the first to come out of the Strategic Innovation Fund, a $1.26 billion program that will provide repayable and non-repayable contributions to companies in the hopes of spurring innovation. Ottawa says that the new funding will help create 1,500 new jobs in Canada while "maintaining" about 8,000 more by "supporting advanced manufacturing processes." Ontario is providing Linamar with a grant of up to $50 million through its Jobs and Prosperity Fund, as part of a project with overall costs of up to $500 million.

Energy Sector

BP PLC, announced last week that it is to take an additional $1.7 billion charge with its Q4 numbers relating to Deepwater Horizon class action settlement. In turn this results in a $1 billion increase in the cash outflow for 2018 to $3 billion from the previously assumed $2 billion which is still lower than the $5-5.5 billion cash outflow for 2017. Mechanically the $1.7 billion impact translates through to 6p/share, although given that it does appear there is still some uncertainty as to the final claims it is possible the market will assume there will be additional liabilities. Whilst disappointing in the short term, we do not see this news as changing the investment case that we expect it to become increasingly evident over the coming 12 months that BP can deliver a material and sustained improvement in free cash flow. Project start-ups already delivered at the end of 2017 should drive this improvement, with 2018 start-ups adding to the momentum towards year-end. In the downstream, growth is set to come from a differentiated offering in both retail and lubricants and is still, for us, an under-appreciated part of the BP business model. There will doubtless be bumps in the road over the coming five years and assuming flawless delivery is unreasonable for any oil company, yet the direction of travel is attractive for BP, in our view.

Financial Sector

Shareholders will be the biggest winners from the new tax law, Bank of America Corporation said as it announced its highest annual profit since 2006. Despite an upfront $2.9 billion tax-related accounting hit, executives told investors to expect higher dividends and share buybacks on the back of Washington's sweeping reforms. Bank of America is handing lower-paid staff a $1,000 bonus. (Source: Financial Times). **Bank of America** reported Q4 2017 EPS of $0.20. Excluding a $2.9 billion ($0.27) charge for the Tax Cuts & Job Act, EPS was $0.47 and consensus was $0.45. Its tax charge included a $946 million pretax valuation adjustment on renewable energy investments, which was offset by the tax benefit from repricing the related deferred tax liability and a $1.9 billion income tax expense related primarily to the repricing of deferred tax assets and deferred tax liabilities. Revenues increased 2% year/year and declined 6% linked quarter to $20.4 billion. Still, excluding the Tax Act, revenues were closer to $21.4 billion (consensus: $21.5 billion), up 7% year/year but 2% below Q3 2017. Tangible book declined 1.3% linked quarter to $16.96 (trading at 1.8x). Ex. Tax Act impact, it posted an ROE of 7.8% and ROTE of 10.9%. Its CET 1 ratio declined 40bps to 11.5%. Its average share count declined 1.2%. Net interest income increased 3%, driven by growth in loans, deposits and securities as well as higher interest rates. Its net interest margin increased 3bps to 2.39%. Fee income fell from the prior quarter, though included some tax noise. Looking at its major line items, card income (+$126 million) and investment & brokerage services (+$96 million) increased, while trading (-$684 million), mortgage (-$62 million), investment banking (-$59 million) and service charge (-$13 million) declined. Expenses declined 1% on both a year/year and linked quarter basis. Looking ahead, Q1 2018 expenses are expected to include $0.4 billion for seasonally elevated payroll tax costs relative to Q4 2017. Ex. Tax Act impact, its efficiency (cost/income) ratio was 62%. Its Non Performing Assets ratio declined 2bps to 0.73%. Its loan loss provision increased $167 million to $1.0 billion, driven primarily by Steinhoff International. This provision was $236 million less than net charge-offs ($66 million release in Q3 2017). The reserve release was driven by continued improvements in consumer real estate and energy exposures. Its reserve/loan ratio declined 4bps to 1.12%.

Citigroup Inc.'s Q4 2017 EPS was a net loss of $7.15. Reported results included a one-time, non-cash charge of $22 billion ($8.43), comprised of $19 billion related to the re-measurement of its Deferred Tax Allowance arising from a lower U.S. corporate tax rate and shift to a territorial tax regime and $3 billion related to the deemed repatriation of unremitted earnings of foreign subsidiaries. Excluding the impact of tax reform, it was $1.28. Results also included a combined net benefit of $0.08, recorded in Corporate/Other, related to discrete items that resulted in a lower-than-expected tax rate, as well as a one-time loss in discontinued operations. **Excluding this item, EPS was $1.20. Consensus was $1.19.** Revenues increased 1% year/year and declined 5% from Q3 2017 to $17.3 billion. Relative to a year ago, revenues increased in Asia (+9%), Latin America (+6%) and North America (+2%) and declined in Europe/Middle East / Asia (-8%). Corporate/other had revenues of $746 million, up from $509 million in the prior quarter. Its Q4 2017 ROTE ex. Deferred Tax Allowance was 8.9%. Tangible book declined 12% to $60.40 (1.3x), reflecting the tax charges. Its CET 1 ratio was 12.3%, down from 13.0% in Q3 2017, driven by the return of capital and the impact of Tax Reform (a reduction of $6 billion of CET 1 Capital or 40bps). During Q4 2017, Citi repurchased 74 million shares, compared to 81 million in the prior quarter. Average diluted shares declined by 3%. **Global Consumer Banking** revenues increased 6% year/year and little changed with Q3 2017 at $8.4 billion. **North America Consumer Banking saw credit card growth with** North American revenues rising 2% year/year. Branded cards revenues increased 1% year/year, with continued growth in core portfolios. **International Consumer Banking** revenues (constant dollar) rose 7% year/year. **Institutional Clients Group** revenues slipped 1% year/year and fell 12% from Q3 2017 to $8.1 billion. Total trading revenues declined 19% to $2.9 billion. Excluding an episodic loss in derivatives of $130 million related to a single client event (Steinhoff International related we believe), trading revenues would have declined 16% (guided to a high-teens decline). Fixed Income, Currency & Commodities fell 18% year/year to $2.4 billion, reflecting continued low volatility, as well as the comparison to a more robust trading environment in Q4 2016 (U.S. elections). **Net interest income** declined 2%. Its reported net interest margin declined 9bps to 2.63. Expenses were little changed year/year and declined 1% from Q3 2017. Its 2017 and Q4 2017 efficiency (cost/income) ratios were 58%. Excluding the impact of Tax Reform, its effective tax rate was 24.9% in Q4 2017, compared to 31.1% last quarter. Its reserve/loan ratio declined 4bps to 1.87%.

The Goldman Sachs Group Inc. reported a sharp drop in trading revenue that renewed questions about its ability to revive a moribund profit driver or find business to replace it. The Wall Street bank posted its first quarterly loss in six years due to huge but anticipated one-time tax charges. While its adjusted profit beat analyst expectations, Goldman struggled more than rivals during a widespread trading slowdown. Low volatility has crimped trading revenue across Wall Street for years, but Goldman has borne the brunt of that slump due to the type of customers it caters to, and because it had been more reliant on trading than other banks. (Source: Reuters). **Goldman Sachs** posted a Q4 2017 loss of $5.51. Results included $4.4 billion of income tax expense related to Tax Legislation ($3.32 billion due to the repatriation tax and $1.08 billion due to the effects of the implementation of the territorial tax system and the re-measurement of its U.S. Deferred Tax Allowance). Excluding tax legislation, EPS was $5.68 and consensus was $4.90. Net provisions for litigation and regulatory proceedings were $9 million, down from $18 million last quarter. Results also included a $127 million charitable contribution (comp was reduced to fund this). It contributed $114 million in Q4 2016. Total revenues decreased 4% year/year and declined 6% linked quarter to $7.83 billion (consensus: $7.86 billion). Relative to Q4 2016, investment banking fees jumped (+44%; driven by underwriting), while Institutional (+12%) and Investment Management (+4%) also advanced. Still, Institutional Client Services (trading) continued to be pressured, dropping 34%. By region, relative to a year ago, revenues increased in the Americas (+1%) but declined in Europe, Middle East & Africa (-16%) and Asia (-4%). Full-year ROE was 10.8%. In Q4 2017, tangible book fell 5% to $181.00 (trading at 1.4x). Its CET 1 ratio was 10.9%, down from 12.0% last quarter. Tax Legislation cost it 70bps. In Q4 2017, it repurchased 6.6 million shares for $1.59 billion. During Q3 2017, it repurchased a greater 9.6 million shares for $2.17 billion. To date, this represents 43% of its $8.7 billion regulatory allowance. Expenses declined 1% year/year and fell 12% sequentially to $4.7 billion. Its full-year compensation ratio was 37.0% compared with 38.1% for 2016.

Morgan Stanley reported Q4 2017 EPS of $0.29. Excluding the net discrete tax provision of $990 million ($0.55), EPS was $0.84 and consensus was $0.77. Its net discrete tax provision of $990 million was comprised of $1.2 billion net discrete tax provision as a result of the enactment of the Tax Act, primarily from the re-measurement of certain net Deferred Tax Allowances, partially offset by an $168 million net discrete tax benefit primarily associated with the re-measurement of reserves and related interest relating to the status of multi-year IRS tax examinations. Revenues increased 5% year/year and rose 3% linked quarter to $9.5 billion (consensus: $9.2 billion). Relative to a year ago, Institutional Securities (+3%) and Wealth Management (+4%) increased, while Investment Management declined (-6%). Tangible book declined 1% to $33.48 (trading at 1.7x). Its ROE (ex. the impact of net discrete tax provision) for Q4 2017 was 8.6%, while it was 9.4% for the full-year (target was 9-11%). Its 2017 ROTE was 10.8%. Its CET 1 ratio was 16.0% (-30bps). During the quarter, it repurchased $1.25 billion of its common stock or 25 million shares. In Q3 2017, it repurchased $1.25 billion of stock or 27 million shares. In all, it is at 50% of its $5.0 billion regulatory 2017 allowance. Average diluted shares declined by 1.2%. Expenses increased 4% year/year and rose 5% linked quarter. Its full-year compensation ratio was 45%, down from 46% last year. Its efficiency ratio was 74%. The effective tax rate was 31.4% excluding the impact of the net discrete tax provision. It was 28.1% in the prior quarter.

Activist Influenced Companies

Nomad Foods Limited announced it has entered into an agreement to acquire Green Isle Foods Ltd. ("Goodfella's Pizza") from a subsidiary of Boparan Holdings Ltd. for approximately €225 million on a debt free, cash free basis. Goodfella's Pizza manufactures and distributes a portfolio of leading branded and private label frozen pizzas in the United Kingdom and Ireland. The Goodfella's brand, which accounts for the majority of Goodfella's Pizza revenues, was founded in 1993 and holds number one and number two market share positions within the frozen pizza category in Ireland and the United Kingdom, respectively. The acquisition also includes the San Marco brand and two frozen pizza manufacturing facilities which provide a foundation for future expansion in the category. Noam Gottesman, Nomad Foods' Co-Chairman and Founder, commented, "We are pleased to announce the acquisition of Goodfella's Pizza. Over the past two years, Stefan and the team have successfully integrated two of Europe's largest frozen food businesses while strengthening the core product offering. With strong organic revenue growth momentum, the time is right to expand into new strategic categories such as pizza, which offer adjacent avenues for further growth and synergies. The Goodfella's Pizza brands and team broaden our product offering and customer reach, and solidify our market leadership within the United Kingdom and Ireland. We are pleased to welcome Goodfella's Pizza to the Nomad Foods portfolio." Nomad Foods expects the acquisition to be immediately accretive to adjusted EBITDA and adjusted earnings per share and, within two years post-closing, contribute approximately €150 million revenue, €22 to €25 million adjusted EBITDA and €0.08 to €0.09 adjusted earnings per share. The purchase price is expected to be funded through cash on hand and the transaction is expected to be completed in the first quarter of 2018, subject to certain closing conditions. In addition, Nomad Foods now expects 2017 adjusted EBITDA to be approximately €328 million versus the prior expectation of approximately €325 to €327 million and organic revenue growth of approximately 5% for the fourth quarter of 2017 versus prior guidance of approximately 3%. Nomad Foods will report three months ended December 31, 2017 and audited full year 2017 financial results in March 2018.

Pershing Square Holdings, Ltd. (PSH) – PSCM Acquisition Company (PSCMAC), the vehicle established by Bill Ackman for buying back Pershing Square shares, confirmed that it has agreed with PSH to increase the price range for PSCMAC's potential Dutch tender offer for up to $300 million of PSH's public shares from a 24% to 16% discount to net asset value (NAV) to a revised range of a 16% to 10% discount to NAV. The revised range, which represents an 8.1% to 15.8% premium to the average 22.3% discount to NAV at which PSH traded for the 120 calendar days prior to the initial announcement of the potential tender offer on January 3, 2018, has been agreed to after discussion between the Board of PSH and PSCMAC. Further announcements regarding the launch of the potential tender offer, which is subject to the receipt of relevant regulatory permissions, will be made by PSCMAC as soon as possible.

Dividend Payers

Barrick Gold Corporation - Consistent with management's messaging throughout the year, production for the back half of 2017 was weighted to the fourth quarter. Barrick announced 1,339koz and 5,323koz of attributable gold production for Q4 2017 and 2017, 8% higher than the prior quarter (Q3 2017). Copper production decreased from 115 million pounds (Mlb) in Q3 2017 to 99Mlb in the quarter. Overall, gold production was in line with expectations while copper production was modestly weaker than anticipated. Barrick had a modest inventory release (33koz) in the quarter driven by sales at Barrick Nevada and Turquoise Ridge. Turquoise Ridge had the weakest performance in Barrick's gold portfolio, missing expected production by 4% and coming in at the very low end of revised guidance. The "other mines" which include KGCM, Hemlo, Golden Sunlight, and Porgera, also came in at the low end of revised guidance for the year. Acacia (63.9% owned by Barrick) had previously released 2017 production. The African miner had a stronger-than-expected fourth quarter with production from Buzwagi coming in 18% higher than anticipated due to an increase in grade due to ore tonnes solely being mined from the main ore zones. This was offset by moderately weaker results from Acacia's other mines, North Mara and Bulyanhulu, with 2017 production 2% and 9% below estimations, respectively.

BHP Billiton PLC delivered a solid set of production numbers for Q2 fiscal year 2018. Production guidance was unchanged except for met coal, which was cut 7% due to geotechnical issues, and unit cost guidance of US$59/metric ton is under review (~3% EBITDA impact). Iron ore (34% of EBITDA) had a record Q2 with production up 11% quarter/quarter to 286 metric tonnes per annum (mtpa) runrate, close to the target of 290mtpa. Copper (27% of EBITDA) improved as the new concentrator at Escondida ramped up, offsetting weakness at Olympic Dam due to smelter maintenance. U.S. onshore oil production was flat but rig count will be reduced in 2nd half as BHP 'tailors plans to maximize value', resulting in $100 million lower capex. The dataroom will be opened to potential trade buyers by the end of March. Other financial guidance in advance of the 1st Half 2018 result included: $250-350 million impairment in underlying EBIT at Escondida, offset by $246 million copper provisional pricing benefit, reduced tax rate (below 32-37% range), and $100 million bond repurchase costs in net interest expense.

Nestlé SA has announced the sale of its U.S. confectionery business to Ferrero (private company) for SFr 2.8 billion (3.3x fiscal year 2017 sales). It is assumed this represents about 22x EBITDA. This compares to the 20x EBITA multiple that Reckitt Benckiser Group PLC received for its Foods business and the 10x EBITDA that Unilever received for its Spreads business. The portfolio of brands (Butterfinger, Crunch, SweetTarts, etc.) was registering a sales decline of c5%. To set this in context, the U.S. confectionery business reported sales of US$923 million in fiscal year 2016.

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Assuming a 7% sales drop last year, sales of US$860 million can be estimated for 2017. That would imply an Enterprise Value/sales of between 3.0x and 3.3x, a very high multiple compared to similar transactions: Russell Stover Candies, Inc. 3.3x, Cadbury 2.5x, Godiva Chocolatier 2.3x and failed bid for The Hershey Company by Mondelez International Inc. 3.5x. Considering Nestlé's U.S. confectionery sales performance in recent years, this represents a very high multiple in our view as all other brands were successful before they were acquired.

South32 Limited unveiled decent Q2 production numbers overnight, with most of the key assets delivering production in-line with consensus 1st half estimates. The only change to fiscal year 2018 guidance was an upgrade to South Africa manganese production, by 8% (+0.5% to EBITDA). Compared to 1st half 2018 estimates, the only material miss was Illawarra met coal sales (12% below but underlying production in line); while both South Africa and Australian manganese plus Cerro Matoso nickel were ahead of expectations (by 20%, 9% and 11% respectively). At Illawarra the ramp up of a single longwall at Appin mine in October has gone to plan so far (production +27% quarter/quarter), while at Cannington the new crusher chamber commissioning in March plus higher grades keep management comfortable with current guidance.

Economic Conditions

U.S. government shutdown will cause the release of any data compiled by the federal government to be postponed. Data from the Federal Reserve Board or the regional Federal Reserve banks will not be impacted, nor will private sector releases. The shutdown did not prevent the sixth round of NAFTA negotiations from starting in Montreal yesterday, and they run until next Monday (January 21-29). The effects of a government shutdown that began Saturday will kick in more forcefully today across the federal bureaucracy, as agencies begin implementing contingency plans to scale back operations and send workers home. The Senate is scheduled to vote at noon EST Monday whether to advance a measure that would reopen the government for three weeks.

U.S. industrial production doubled expectations with a 0.9% jump and November and October saw sizeable upward revisions. The main factor behind the surprise was found in utilities (always a wildcard), where the late-month freezing temperatures in various parts of the country pushed the industry up 5.6%.

U.S. housing starts retreated more than expected in December, sliding 8.2% to 1.192 million units annualized. The pullback was led by the less-volatile singles and was spread across the nation. Still, there is plenty of room for optimism. The decline was led by the South (14.2%) amid payback for the recent surge in construction to replace storm-damaged homes in Texas and Florida. Bad weather may also have played a role late in the month. Meantime, permits stayed elevated at 1.30 million, led by a surge in singles. Despite the soggy finish to the year, housing starts jumped 30% annualized in Q4 to their highest level in a decade. And, with the fewest number of single-family homes listed on record and homebuilder confidence even higher today than during the bubble, starts should ring in the new year in high style. Income should be no obstacle for sales, with initial jobless claims falling to their lowest level in nearly 45 years.

The U.K.'s inflation rate has fallen for the first time since June, mainly because of the impact of airfares. The inflation rate dipped to 3% in December, down from November's rate of 3.1% - a six-year high. The Office for National Statistics (ONS) said that while airfares rose last month, it had a smaller impact than at the same point in 2016. It added that a drop in the price of toys and games also contributed to December's fall. The ONS said it was too early to say whether this was the start of a longer-term reduction in the rate of inflation. The Bank of England has said it thinks inflation peaked at the end of 2017 and will fall back to its target of 2% this year. The rate had been rising over the past year, partly due to the fall in the value of the pound since the Brexit vote which has pushed up the cost of imported goods. (Source: BBC).

Financial Conditions

The Bank of Canada pushed forward with its third quarter-point interest rate since July, while cautioning it's in no rush to return borrowing costs to more normal levels as uncertainty around NAFTA talks cloud the outlook. Policy makers led by Governor Stephen Poloz increased the benchmark overnight rate to 1.25%, bringing it to the highest since the global recession. The move is a nod to a red-hot economy running up against capacity with a jobless rate at the lowest in more than four decades. At the same time, central bank officials repeated their dovish language about moving ahead cautiously and warned they expect the economy will require continued stimulus to remain at capacity. (Source: Bloomberg).

The U.S. 2 year/10 year treasury spread is now .58% and the U.K.'s 2 year/10 year treasury spread is .79% - meaning investment banks remain constrained from profiting from a steep yield curve and instead are seeking operational efficiencies, including job cuts and lower compensation, to maintain acceptable levels of profit, i.e. above costs of capital.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.04% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing U.S. housing inventory is at 3.9 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, economic recovery, job creation, and low prices are still supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now at the low end of a more normal range of 4-7 months.

The VIX (volatility index) is 11.17 (compares to a post-recession low of 9.52 achieved in early November) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

Mutual Funds

Portland Investment Counsel Inc. currently offers 8 Mutual Funds:

- Portland Advantage Fund
- Portland Canadian Balanced Fund
- Portland Canadian Focused Fund
- Portland Global Income Fund
- Portland Global Banks Fund
- Portland Global Dividend Fund
- Portland Value Fund
- Portland 15 of 15 Fund

Private/Alternative Products

Portland also currently manages the following private/alternative products:

- Portland Advantage Plus - Everest and McKinley Funds
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Private Growth Fund
- Portland Private Income Fund
- Portland Special Opportunities Fund
- Portland Value Plus Fund

Individual Discretionary Managed Account Models - SMA

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

We want to share our insights with you and welcome your feedback. Our website has the latest, as well as archived videos, company profiles, and press articles. Please visit us at www.portlandic.com.

Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'ROE' return on equity, 'ROTE' return on common equity.

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