News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. April 2, 2018

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Owner Operated Companies

Brookfield Property Partners L.P. said it would acquire the 66% of GGP Inc. that it does not already own in a cash-and-stock deal that values GGP, one of the largest owners and operators of U.S. shopping centers, at about $15.3 billion. The deal comes as many malls struggle to retain tenants amid the brick-and-mortar retail sector's downturn. The acquisition will strengthen Brookfield Property's negotiating power with retailers and allow it to repurpose some GGP properties. "Having Brookfield's expertise in offices, hotels and multi-family residential properties will allow the combined company to draw more value from the GGP mall assets," Brookfield Property Chief Executive Brian Kingston told Reuters in an interview. The agreement comes four months after a special board committee of GGP rejected a $14.8 billion cash-and-stock offer from Brookfield Property as inadequate. Brookfield Property, which is also a major owner of U.S. office properties, is currently GGP's largest shareholder with a 34% stake. Under Brookfield Property's latest offer GGP shareholders can elect to receive $23.50 in cash per share, or either one Brookfield unit or one newly created share that trades as a real estate investment trust (REIT). The complex deal structure is the result of a compromise between Brookfield Property, which wanted to continue to trade as a publicly listed partnership, and GGP's special committee, which wanted GGP shareholders to continue to own a REIT security, if they so choose. The cash consideration in the deal was increased by $1.85 billion to $9.25 billion. Instead of a 50/50 split under Brookfield Property's previous offer, cash now represents 61% of the total deal. With about 127 "Class A" high-end mall properties, mostly in the U.S., GGP's tenants include carmaker Tesla, Inc., jeweler Tiffany & Company and retailer Macy's, Inc. In 2016, Rouse Properties Inc., another U.S. mall owner, rejected an offer by Brookfield Property, its largest shareholder. It eventually agreed to a sweetened $2.8 billion offer.

Walgreens Boots Alliance, Inc. reported quarterly profit and sales beat analysts' estimates for the second quarter of its fiscal 2018, helped by higher prescription volumes. Like other drugstore chains, Walgreens is seeing a drop in customer visits to its retail stores, where it sells over-the-counter drugs and cosmetics, as some purchases have now shifted online. To offset sales losses at retail - its front-end business - the company has focused on boosting sales through its prescription only pharmacy business by signing partnerships with pharmacy benefit managers such as Prime Therapeutics that has given it more than 20 million additional customers. Walgreens is also pulling non-profitable items off shelves at its front-end stores and promoting store-brands to boost margins. The efforts came at a cost - same-store sales at its retail stores fell 2.7% in the quarter. Same-store sales at its pharmacies rose 5.1%. Walgreens filled 9.1% more prescriptions in the quarter. Deerfield, Illinois-based Walgreens lifted its full-year adjusted EPS forecast to between $5.85 and $6.05 from between $5.45 and $5.70. Analysts were estimating $5.78 EPS for the year. The raise in forecast reflects a $350 million tax benefit for fiscal year 2018, an increase of about $150 million from the company's previous estimate. Excluding items, Walgreens earned $1.73 per share. Net sales rose 12% to $33.02 billion. Analysts on average were expecting a profit of $1.55 per share on revenue of $32.19 billion.

Energy Sector

U.S. Rigs – U.S. energy companies past week cut oil rigs for the first time in three weeks even as crude prices hover near three-year highs. Drillers cut seven oil rigs in the week to March 29, bringing the total count down to 797, as reported by General Electric's Baker Hughes energy services firm. Energy companies have been steadily increasing spending since mid-2016 when crude prices began recovering from a two-year crash.

Financial Sector

The Toronto-Dominion Bank - The Financial Post reported last Thursday that the chief executive of TD said that recent rumblings of protectionism are "troubling" given the need to update the North American Free Trade Agreement (NAFTA). Bharat Masrani told the annual meeting of the bank's shareholders that the lender's performance in the first quarter made him feel "optimistic" about the year ahead. "But there are risks on the horizon," Masrani said during his speech in Toronto. "As just one example, trade wars are top-of-mind nowadays." He specifically raised the ongoing negotiations around NAFTA, a trade deal Masrani said has been "very positive." However, he added that Canada, Mexico and the United States have undergone changes driven by technology and evolving customer preferences since the trade deal was implemented about 25 years ago. "As a result, there is a need to modernize this trade agreement, but not eliminate it," Masrani said. "That's why the rhetoric and recent moves toward protectionism is so troublesome. My hope is that the merits of this partnership prevail — so we can look for ways to make NAFTA even better — even stronger — for each country." Masrani told reporters after the shareholder meeting that the situation has generated "concern" among the bank's commercial customers. "Folks are worried," he said. "It's critical that this gets sorted and that we move on." The shareholder meeting also followed a long-awaited report by the Financial Consumer Agency of Canada (FCAC) on the sales practices of the country's biggest banks. After months of work, the consumer watchdog found the "Big Six" lenders had a very sales-focused culture that could be increasing the risk of "mis-selling" financial products to customers. The FCAC said they did not find any widespread abuses, but did say they were investigating an undisclosed number of alleged breaches of consumer protection rules. "I'm satisfied with the review that we did and I can categorically say that we did not come across widespread misuse or mis-selling or unethical behaviour at the bank," Masrani told reporters.

Activist Influenced Companies

Pershing Square Holdings, Ltd. – Bill Ackman has stepped out of Nike, Inc. The billionaire investor's hedge fund Pershing Square Capital Management reportedly earned roughly $100 million in profit when it cashed out of its 0.71% stake in the sportswear company recently. Two months ago, the activist investor told clients that Pershing Square had taken a rare passive stake in Nike at the end of 2017, when the stock was trading at around $53 a share and that the bet had already earned them a roughly 30% gain. Ackman, a passionate tennis player, is often photographed on courts wearing Nike apparel ranging from shoes to shirts to wrist bands. In January, Ackman told his investors that he was making changes to return the prominent firm to its glory days by shrinking his team, becoming more involved in the investment process again and leaving the marketing to someone else. The firm generated compound returns of 21% a year net of fees over 11 years from its launch to the end of 2014. Then it lost money in 2015, 2016, and 2017. So far, he has largely stuck to his plans to keep a lower profile. There was no big announcement that he had exited Herbalife International and there was not much fanfare around the Nike investment either. Shareholders of the U.K. - listed company will vote April 24 on a planned $300 million tender offer, which could help to reduce the discount to net asset value the company trades at. "While the overall record is satisfactory for early investors, it has been disappointing for Pershing Square investors who invested in recent years," Ackman said in his annual letter to investors, included in the company's annual report released Monday. "2017 should have been a stronger year for Pershing Square." Pershing Square's portfolio traded at a 21% discount to its net asset value last week, with catalysts that should contribute to value recognition, according to Ackman. The investment firm's ability to generate ideas is "intact and productive," he said in the letter.

Dividend Payers

Novartis AG has agreed with Glaxo SmithKline PLC (GSK) to sell its 36.5% stake in the over the counter consumer health joint venture (OTC JV) to GSK for US$13 billion. Novartis will use the proceeds to "grow its core business, drive shareholder returns, and execute value creating bolt-on acquisitions". GSK has agreed to pay US$13 billion cash for the Novartis OTC JV stake. The valuation was agreed by both parties. The 4 directors of the JV (out of 11) that Novartis had appointed will step down when the transaction is complete. The deal is subject to GSK shareholder approval. Completion expected in Q2 2018, subject to necessary approvals. After great efforts put into the integration of the JV, operations seemed to be starting to bear fruit with accelerating growth and margins, but at a multiple of 19 times last year's operating profits, the deal does seem to be at the upper end of comparable businesses in our view. Now we expect Novartis to add to its pipeline, as patent expirations will weigh on growth again as of 2019. We would now, not be surprised to see larger acquisitions.

Walmart Inc. - The Wall Street Journal reported that Walmart is in preliminary talks to buy Humana Inc. There are currently two pending large-scale transactions involving health insurers – so clearly the industry is consolidating: CVS Pharmacy's acquisition of Aetna Inc., and Cigna's planned purchase of Express Scripts Holding Company. These follow the failed Anthem, Inc./Cigna and Aetna/Humana mergers in 2017 – the latter is particularly important since Humana was involved as the target. Humana is among the top 5 largest health insurers in the country and its Pharmacy Benefits Manager – Humana Pharmacy Solutions - is also among the largest – filling an estimated 439 million prescriptions in 2017 (per Humana April 2017 Investor Day). Unlike other large managed care organizations (MCOs), Humana derives the vast majority its members from Medicare through Medicare Advantage (MA) or Medicare Part D (PDP). At its 2017 Investor Day, Humana indicated that its MA market share was 19% and its PDP market share was 25%. The company expected MA enrollment to grow at a 6% compound annual growth rate from 2017-2022 due to: 1) growth in the senior population, 2) MA is a more holistic approach and allows seniors to better manage their costs than fee-for-service (FFS) Medicare, and 3) younger seniors are opting into MA over FFS Medicare at an increasing rate. Barclays PLC's analysts' estimate that Walmart filled 70-75 million of Humana Pharmacy Solutions, Inc.'s prescriptions in 2017. This is based on the following assumptions: 1) ~60% retail penetration at Humana (mail penetration projected to be 39% per 2017 investor day deck) and 2) Barclays' estimate that Walmart is filling 25-30% of Humana's retail prescriptions given the heavy co-branding (well above its ~5% national average market share of total dispensed pharmacy revenue).

Economic Conditions

U.S. Personal spending rose 0.2% for a second straight month in February, while volumes were flat after a downwardly revised 0.2% decline in January. Even with a (likely) sharp rebound in March, consumer spending looks to slow to around 1.5% in Q1 from 4.0% in Q4. It's another soft start for the economy this year, after averaging 3.0% in the past three quarters. Inflation is starting to flicker. Core prices rose 0.2% after an even larger advance in January, lifting the annual rate to 1.6%. More ominously, the three-month rate hit a cycle high 2.8%, while the six-month metric rose to six-year highs of 2.3%. This suggests the yearly core rate will reach the Fed's target by the summer.

U.S. The Institute for Supply Management's (ISM) Purchasing Managers Index (PMI) survey, a leading indicator of business activity, came in on the softer side in the month March. The 59.3 points reading, while still indicating future expansion (numbers over 50 have that meaning) it fell short of the expectations for a 60.0 points print and a 1.5 points drop from February's 60.8 points level.

U.S. consumer sentiment, as measured by both the Conference Board, down to 127.7 points in March from 130.8 in February, and by the University of Michigan, down to 101.4 points in March from 102.0 in February, seems to have softened from previous near record high levels. The latter composite index is showing continued strength in its "expectations" component, though "current conditions" has dragged the overall index lower.

U.S. pending home sales, a leading indicator of existing home sales, advanced a robust 3.1% in February, ahead of the expectations, purporting strong demand. At the same time, the Case Shiller Home Price Index for the 20 U.S. metropolitan area shows a 6.4% increase in year/year home prices for January, ahead of the expectations.

Canada – Canadian economy surprisingly contracted in the month of January, by 0.1%. The drag on the economy has chiefly been the mining and oil and gas sector, down 2.7%, with large unscheduled maintenance shutdown in the country's oil sands operations taking place during the month. The real estate sector was also a detractor in the month, as the more stringent regulations kicked in.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .49% and the U.K.'s 2 year/10 year treasury spread is .53% - 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 4.44% (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 3.4 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 20.98 (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 Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen 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.

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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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