# Market Commentary

PORTLAND INVESTMENT COUNSEL®

March 2, 2015

## News Highlights

### Financial Sector

Ares Capital reported 4Q14 results that beat consensus. Net investment income came in at $0.42/share and above consensus of $0.39/share, with the beat driven by higher other income and lower total opex. Book value per share closed the quarter up $0.11/sh q/q to $16.82. While net originations were relatively flat during the quarter and negative thus far in 1Q, we suspect ARCC took advantage of market volatility and optimized its portfolio by selling lower yielding first lien assets in favor of higher yielding second liens at more attractive prices.

Originations: ARCC originated roughly $1,390MM of assets during 4Q relative to repayments and exits of $1,269MM. Of the capital deployed in 4Q, ~51% were in first lien and 28% were in second lien securities. Thus far in 1Q, ARCC has originated $171MM of investments and had repayments and exits of $597MM, although the yield on new investments was ~10%, while yield on investments exited was 7.8%. Portfolio Mix and Yield: The portfolio was 41% first lien and 21% second lien compared to 46% first lien and 17% second lien the prior quarter. Overall yield on debt and income producing securities increased ~20bps q/q to 10.1% from 9.9% the prior quarter. Balance Sheet and Leverage: Leverage of 0.74x debt to equity, up from prior quarter of 0.70x debt to equity, and slightly higher than the broader BDC space average of ~0.70x. However, ARCC issued new unsecured notes ($600MM) in November at ~3.875% due in 2020, while it plans to redeems existing unsecured notes ($144MM) due in 2020 that bears interest at 7.0%.

CIBC reported adjusted cash EPS of $2.36 in Q1/15, which were above consensus expectations of $2.27 per share. Similar to Royal Bank and National Bank, the beat in the quarter was due to Capital Markets, which saw record trading revenues in almost all categories. Retail and Business Banking also had a strong quarter with adjusted earnings of $618 million due to solid growth in CIBC-branded products, lower loan losses, partially offset by lower Net Interest Margin (down 4 bps to 2.50%) due to the sale of a portion of its credit card portfolio to TD. Wealth Management had an in-line quarter due to higher fee-based earnings coupled with the contribution from the Atlantic Trust acquisition. Finally, asset quality was strong with the Provisions for Credit Losses ratio declining 2 bps to 0.28%. Capital was strong with a Core Equity Tier 1 ratio of 10.3%. The Basel III leverage ratio was 3.8%. The dividend was increased again this quarter – up 3% to $1.06 per share.

HSBC has set aside $550 million more to cover potential fines for alleged manipulation of foreign exchange markets and warned it could face a $500 million bill to compensate U.S. customers sold debt protection products. HSBC said in its annual report on Monday it had paid restitution to some U.S. customers in connection to debt protection and other products offered before May 2012. It said additional remediation for this issue “may lie in a range from zero to an amount up to $500 million.” (Source:Reuters)

Lloyds Banking Group: Underlying Profit Before Tax for 4Q 2014 was £1782m, -3%/£63m vs consensus. Both Net Interest Income and other income were disappointing albeit some of the NII/Net Interest Margin miss is accounted for by a one-off in Q4 (c£60m). Lower income was largely offset by better impairment charges. Statutory Profit Before Tax was £148m (consensus £1001m) with provisions for Principal Protection Insurance and other provisions comprising the difference. Core Equity Tier 1 capital ratio was stronger at 12.8% (cons 12.1%) and a dividend of 0.75p has been declared for 4Q14. 2015 guidance is for (1) Net Interest Margin of 2.55% (consensus 2.47%), (2) other income stable at £6.6bn (consensus £6746m), and (3) impairment charges of 0.30%. Additionally, the group has disclosed a 2.1% Pillar 2A CET1 requirement and so is guiding its go-to Core Equity Tier 1 ratio to 12% (from 11%). We think the stronger capital position will outweigh a weaker P&L, for now.

National Bank reported adjusted EPS of $1.14, which was ahead of the consensus estimate of $1.12 with better-than-expected contribution from Financial Markets (very strong trading offsetting “lower investment banking fees mostly in the Energy sector”). P&C Banking results were a bit below expectations due to lower but still positive operating leverage, and Wealth Management was largely in line. Credit remains solid with a total bank Provision for Credit Losses ratio of 20 bps and the bank continues to highlight a target range of 20-30 bps over the next two quarters. The Core Equity Tier1 ratio was 9.3%, higher by about 7 bps sequentially.

Royal Bank of Canada reported cash EPS of $1.67, which was above consensus estimates of $1.59 with better-than-expected contribution from Capital Markets (trading as well as advisory and underwriting) and Investor and Treasury Services, and resilient Canadian Banking results. Credit remains solid with total bank Provision for Credit Losses ratio of 24 bps. The Core Equity Tier 1 ratio was 9.6%, lower by about 30 bps sequentially, reflecting volume growth as well as FX impact on Risk Weighted Assets. The bank increased its quarterly dividend by about 3% to $0.77.

Standard Chartered: Peter Sands, current Group CEO, to step down from the Board in June 2015. Bill Winters to be appointed as Group CEO. Bill Winters spent 26 years at JP Morgan. He was Head of European Fixed Income and in 2004 became Co-CEO of JPM Investment Bank until 2009. According to press articles, Mr Winters – who received a lot of credit for strong risk management at JPM during the Global Financial Crisis - was seen as a potential successor for the Group CEO position. Mr Winters was also speculated as a candidate for the CEO position of Barclays and UBS. Instead Mr Winters set up Renshaw Bay – an independent asset management firm. Mr Winters was a member of the Independent Commission on Banking in the UK, contributing to changes made post-financial crisis to the UK banking framework and standards. Sir John Peace, Chairman, to step down during 2016. StanChart has not made any mention of his potential successor. Jaspal Bindra, CEO for the Asian business, to step down from the Board after 16 years with StanChart. Three long standing directors will step down - Ruth Markland, Paul Skinner and Oliver Stocken - and two new directors will join the board - Gay Huey Evans and Jasmine Whitbread. Intent to reduce the Board size to 14 Directors in due course. Standard Chartered is in a difficult position due many structural issues such as the comparatively high cost base as a result of running too many sub-scale businesses in too many markets after a top-line growth-driven expansion in the past we believe. The new regulatory environment puts a big question mark over the viability of sub-scale multinational banking businesses, in our view.

Toronto Dominion Banks: Core EPS of $1.12, up 6% YoY, in-line with consensus. As expected TD raised the quarterly dividend to $0.51, an increase of 9% QoQ and YoY and implying a 45.5% payout ratio. The star performer was US P&C Banking, where on a USD basis the segment printed $457m, up 15% YoY. As TD indicated last quarter Net Interest Margin rebounded with a 6bp QoQ increase, and loan growth was a strong 3% QoQ. Staying with US P&C, operating leverage was a solid +1.5%, as expenses were down an impressive 3% YoY. On a C$ basis earnings in US P&C were up a sizable 26% YoY. Earnings in Canadian P&C came in at $1,117m, up 6% YoY. However, the 'beat' was entirely driven by Provisions for Credit Losses, which we were surprised to see decline $60m Quarter on Quarter. The Pre Tax Pre Provision trend was less impressive, with the -1.7% operating leverage. NIM was down 3bp QoQ, and loan growth was limited to 0.5% QoQ. Trends in market-sensitive revenue were less robust than peers, with these streams up just 2% YoY. Wholesale earnings were in-line (trading revenue of $380m), while pure Wealth earnings were flattish QoQ and YoY. Total Provisions for Credit Losses of $362m were decently below both our $409m and the $390m in net charge-offs. TD ended Q1 with the Core Equity Tier 1 ratio at 9.45%, up a skinny 2bp QoQ., The US strength this quarter is a welcome development.

## Canadian Dividend Payers

Northland Power – issued, on a bought deal basis, 13,750,000 of common shares at a price of $16.00 per Common Share, representing $220,000,000 of gross proceeds. Concurrently with the closing of the bought deal offering, in satisfaction of pre-emptive rights, Northland will issue 3,125,000 Common Shares to Northland Power Holdings Inc. (NPHI), on a private placement basis at the same price per Common Share being offered to the public pursuant to the Offering for gross proceeds of about $50,000,000. The company intends to use proceeds of Offering, net of underwriters' fees, and proceeds of Private Placement to fund a portion of Northland's investments in the Nordsee One project and the Grand Bend wind project in Ontario, to replenish working capital and for general corporate purposes

Northland Power Inc., an international producer of wind, solar and thermal power, was recognized by three prominent international publications for its achievements in 2014. The awards were presented at various events throughout the month of February. Project Finance International, a leading source of global project finance news and information, awarded the Gemini project "Power Deal of the Year" for Europe. Northland is the majority owner of the 600 MW offshore wind project located off the coast of the Netherlands. Investor Relations Magazine, a global publication originally launched by the Economist Group, awarded Northland's Paul Bradley "Best Investor Relations (Canada) by a Chief Financial Officer, mid-cap (a company with a market capitalization between $2 and $10 billion)" at their annual awards dinner in Toronto. Infrastructure Journal and Project Finance Magazine (IJ Global), a source for in-depth news, insight and analysis on all aspects of global infrastructure finance presented the Gemini project with two awards at their annual awards ceremony in London: "Wind Deal of the Year" for Europe as well as "Overall Winner" for Europe and Africa.

## Activist-influenced Companies

Hertz Global Holdings – reported 2014 fourth quarter operating results and updated the status of fleet strategy and cost reduction initiatives. It also announced that the financial statement restatement is ongoing. Hertz doubled its cost savings goal run rate to $200 million. It expects to finalize the fleet transformation announced in November, about one month ahead of original mid-year target. It is also accelerating the used car sales, resulting in more moderate fleet growth in 2015 compared to its preliminary plan. The company remains committed to the spin-off of its equipment rental business and is continuing to advance the plans. It expects 2014 consolidated corporate EBITDA at the lower end of the $1.30 billion to $1.45 billion range. Q4 consolidated revenues were $2.55 billion versus $2.56 billion last year, while total U.S. car rental revenue was $1.5 billion in the 2014 fourth quarter, in line with the 2013 fourth quarter. The company guided for 2015 revenue growth to be negatively impacted by approximately 3% versus 2014. Hertz said it expects profits for 2011, 2012 and 2013 will be reduced more than expected due to an ongoing restatement of results. The restatement would reduce GAAP pre-tax income for 2011, 2012 and 2013 by about $153 million, up from its previous estimate of about $138 million. Hertz had said in June that it would restate results for 2011 to fix some accounting errors and, in November, expanded the restatement to include financial reports for 2012 and 2013. All in, it looked like a spring cleaning exercise by the new CEO, John Tague, former chief operating officer of United Airlines, ahead of the restructuring efforts.

## Global Dividend Payers

BHP Billiton underlying earnings dropped 31% cent to $5.4 billion in the last six months of 2014 from $US7.7 billion in the same period a year earlier, driven down by steep falls in oil and iron ore prices. The result, which was better than analysts expected, confirms that BHP is one of the most resilient companies on the share market when the prices of its products fall. The world's largest mining group increased its first-half dividend by 5% per cent to $0.62. BHP has not cut its dividend since 1988.

CEO Mackenzie said the company would be selective about investments to boost growth, which he said was the company's third priority behind maintaining an A credit rating and ensuring dividends do not fall. BHP plans to cut capital spending by $3.8 billion by the end of 2015-16 to conserve cash. BHP has made significant progress on iron ore production costs, cutting cash costs 29% to nearly $S20 a tonne. About $2 billion of the cuts will come from BHP's onshore shale gas business in the United States. After the planned $15 billion spin-off South32, which is on track for June, BHP plans to maintain dividend payments at at least the same level, so any dividends from South32 will be additional returns to shareholders.

Pearson – British publisher forecast a return to earnings growth after two years of restructuring, helped by improved fortunes in North America where falls in college enrolments have started to ease. Pearson, the world leader in educational publishing, beat forecasts for several years around the turn of the decade, before embarking on a restructuring programme to increase its focus on the faster growth areas of digital services and emerging markets to complement its core U.S. education division. The group now expects significant earnings growth in 2015, its first increase since 2011, and to then build on that momentum in the years ahead, Chief Executive John Fallon said. Pearson, the 171-year-old company which also owns the Financial Times newspaper, reported adjusted earnings per share of 66.7 pence in 2014. That was marginally better than a forecast of 66 pence given in January and the company reiterated a forecast of 75-80 pence EPS in 2015. Looking at its different geographical divisions, North America, worth 61% of group revenue, posted a 5% rise in underlying adjusted operating profit. Within its important U.S. Higher Education unit, total college enrolments fell 1.3% percent, a slight decrease on the 1.9% drop recorded in 2013. The group also said Coram Williams, CFO of its Penguin Random House book joint venture, would take over as chief finance officer from August 1, replacing Robin Freestone.

Rentokil Initial – British outsourcing firm said it was looking to Latin America and Asia for further growth in the year ahead, after strong demand for its pest control services led to a 58.4% rise in full-year pretax profit. Chief Executive Andy Ransom said he planned to spend around £50 million on acquisitions this year in the two emerging market regions, as well as in North America and Britain, but added this figure could be higher. The company, which generates around 90% of its revenue outside Britain, completed 30 deals in the past year, 23 of which were either in its two main emerging markets or in Britain and North America, spending £68 million. Ransom said the group had made strong progress overall but cautioned that some parts of Europe remained challenging for the group. The company, which offers services from pest control to work wear supply, posted a full-year pretax profit of £163.2 million for the year ended Dec. 31. It said it would pay a final dividend of 1.82 pence per share to give a total for the year of 2.59p, up 12%.

## Economic Conditions

U.S. real GDP growth was revised down to 2.2% annualized in the final quarter of last year (from 2.6%) but this wasn't as bad as expected. While business inventories were scaled back (now adding just a scant 0.1 ppts to growth instead of 0.8 ppts previously) and the trade deficit expanded more than the BEA initial assumed (due to a massive 10.1% surge in imports), business investment was revised sharply higher, suggesting little adverse impact from the downdraft in the energy sector. Nonresidential investment rose 4.8% (versus 1.9% previously) following consecutive gains averaging above 9% in the prior two quarters. Nonresidential structures jumped 5.0%, while equipment spending was revised to a slight gain, and spending on intellectual property products (such as software) soared 10.9%--the most in 14 years. State and local government spending was also bumped up to 2.0%, though a 12.4% dive in federal defense outlays still carved 0.6 ppts from GDP growth. Exports were revised higher to 3.2%, not bad considering the strong dollar and soft global climate. Personal consumption growth was shaved a tad to 4.2%, still the strongest in four years.

U.S. home resales fell sharply to their lowest level in nine months in January amid a shortage of properties on the market, a setback that could temper expectations for an acceleration in housing activity this year. The National Association of Realtors said last Monday existing home sales declined 4.9% to an annual rate of 4.82 million units, the lowest level since last April. Reuters

India Budget: The Govt. has tried to be realistic in its assumptions on tax collection, which has also left limited scope to increase capex. Budgeted capex for FY16 is up 25% YoY, for a 20bps improvement to 1.7% of GDP. This may be lower than what we saw during the previous bull cycle, but looks reasonable in the context of the current fiscal situation. Spending on rail and road infrastructure is now budgeted at ~30% of total capex, considerably higher than the ~17% in FY07. To fund this increase, the Finance Minister proposes additional instruments such as tax-free bonds. The evident attempt to set policy direction with a timeline to implement GST, direct tax reforms, direct benefit transfers to cut subsidies, a new bankruptcy code, measures to curb black money, GAAR clarification, monetary policy reforms and social inclusion all augur well for a broad-based improvement in the economy.

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## Financial Conditions

US Federal Reserve policymakers remain determined to signal that although Quantitative Easing has stopped, the stimulus remains via keeping rates at present low until mid 2015. The US 2 year/10 year treasury spread is now 1.38% and the UK's 2 year/10 year treasury spread is 1.20% - 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 their costs of capital. It seems the top tier 6-9 investment banks will continue to command their market and possibly increase their share – as barriers to entry for newcomers have in our view been raised.

Influenced by the withdrawal of quantitative easing, the US 30 year mortgage market rate has increased to 3.80% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to give priority to incentivising home ownership. Existing US housing inventory is at 5.1 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, a more promising economic recovery, job creation, and low prices are finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in a more normal range of 4-7 months.

The VIX (volatility index) is 13.69 (compares to a post-recession low of 10.7 achieved in early June) 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 currently offers 6 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

**Private/Alternative Products**

Portland also currently offers 4 private/alternative products:

- Portland Focused Plus Fund LP
- Portland Private Income Fund
- Portland GEEREF LP
- Portland Advantage Plus Funds

**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

Sources: Thomson Reuters, Bloomberg, BMO, Macquarie, Credit Suisse

Source:Thomson Reuters, Bloomberg, BMO, Macquarie, Credit Suisse



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