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. July 23, 2018

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Owner Operated Companies

Alphabet Inc. – European antitrust regulators fined Google €4.34 billion ($5 billion) and ordered it to stop using its popular Android mobile operating system to block rivals, a ruling which the U.S. technology company said it would appeal. It represents just over two weeks of revenue for Google parent Alphabet and would scarcely dent the company's cash reserves of $102.9 billion. But, it could add to trade tensions between Brussels and Washington. European Commission President Jean-Claude Juncker is due to meet U.S. President Donald Trump at the White House next Wednesday in an effort to avert Trump's threatened new tariffs on cars made in the European Union as the president looks to reduce the U.S. trade deficit. Alphabet, which is scheduled to report financial results on Monday, said it would set aside money to pay the fine, which would cut its second-quarter profit by about $5 billion. Google's Android system, which Google lets device makers use for free, runs about 80% of the world's smartphones. According to the E.U., Google's behaviour dates back to 2011 and includes forcing manufacturers to pre-install Google Search and its Chrome browser together with its Google Play app store on their Android devices, paying them to pre-install only Google Search and blocking them from using rival Android systems. Google Chief Executive Sundar Pichai warned that Android may not remain free as a result of the E.U. ruling or it may shift to a tightly controlled distribution model like rival Apple Inc.

Danaher Corporation said it would spin off its dental unit into a publicly traded company, as the medical equipment maker seeks to revitalize a struggling business. The unit provides dental tools such as prosthetics, infection prevention products and implants. The dental unit spinoff will be tax-free to Danaher shareholders and is expected to be completed in the second half of 2019. Amir Aghdaei, who is currently responsible for the dental business, will become the CEO of the new company, Danaher said. The company also reported better-than-expected quarterly profit for the second quarter. Revenue rose 10.4% to $4.98 billion in the second quarter, above the consensus estimates of $4.92 billion. Excluding items, the company reported profit of $1.15 per share, above expectations of $0.95 per share. The company reported annual sales of $18.33 billion for 2017.

Energy Sector

Baytex Energy Corp. and Raging River Exploration Inc. have filed a joint management information circular and proxy statement for their respective special meetings of shareholders to be held in connection with the proposed strategic combination of Baytex and Raging River. The board of directors of Raging River unanimously recommends that Raging River shareholders vote in favour of the arrangement. The board of directors of Baytex unanimously recommends that Baytex shareholders vote in favour of the issuance resolution. Both shareholder meetings are scheduled for August 21st.

Financial Sector

Berkshire Hathaway Inc. last week announced that it has changed its policy on share buybacks to a level at which Chairman Warren Buffett and Vice Chairman Charlie Munger believe the repurchase price is below the intrinsic value of Berkshire's share price, conservatively valued. Until now, there was a maximum valuation of 1.20x book value for share repurchases. In May 2018, Mr. Buffett signaled this threshold might be raised to perhaps 1.3x, so last week's result offers much greater flexibility than earlier anticipated. We also believe it reflects Berkshire's growing cash pile of $109 billion (implying around $85 billion of deployable cash based on $20 billion of minimum cash and pending bolt-on acquisitions) as of Q1 2018, as well as a lack of opportunities to acquire large companies at attractive valuations. We now believe Berkshire could have the ability to repurchase tens-of-billions of dollars of its shares over time. Even so, we think investors should temper their expectations regarding initial share repurchase activity based on management's usual conservatism. We still believe Berkshire is unlikely to pay a regular shareholder dividend while Mr. Buffett is Chairman. Based on Mr. Buffett's prior commentary, it is estimates Berkshire's current intrinsic value (conservatively valued) based on his methodology is approximately $338,740 per A share ($226 per B share), which would be around 17% above the current Berkshire share price. Mr. Buffett's historical methodology of estimating Berkshire's intrinsic value has been the sum of: 1) per share cash equivalents and investments (its estimated as $191,748 per equivalent A share as of Q1 2018 including the market value of The Kraft Heinz Company common shares); and 2) a multiple of pre-tax earnings from its operating businesses including insurance underwriting income (its estimated as a value of $146,992 per A share equivalent based on 2019 estimates $14,699 pre-tax earnings per equivalent A share and a pre-tax price/earningof 10x).

Fifth Third Bancorp puts operating EPS at $0.63 ($0.56 excluding reserve release) and consensus was $0.57. A loan-loss reserve release added $0.07 and a tax benefit added $0.02, driving the beat. Net interest income, commercial loans growth, consumer loan growth and fee income all came in below its guidance, while expenses were also lower than anticipated. Operating revenues increased 5% year/year and rose 2% linked quarter. Net interest income rose 3% to $1.024 billion (guided to $1.025-$1.030 billion) reflecting higher short-term market rates, a higher day count and growth in middle market Commercial & Industrial loans. Its net interest margin rose

3bps to 3.21% (guided to 3.21%-3.23%). Its net interest margin reflected market rates (+5bps), growth in higher yielding commercial loans (+1bp), day count (-2bps) and commercial deposit balance shift to interest bearing accounts (-1bp). Its yield on interest-earning assets increased 16bps to 3.98% with loans up 19bps. Its Non-Performing Assets ratio improved 3bps to 0.52%. Its reserve/loan ratio dropped 7bps to 1.17%. Tangible book increased 1.4% to $18.30 (trading at 1.7x). Its ROTE was 14.6%. Its CET 1 ratio was 10.91%, up 9bps. Average diluted shares declined by 1.1%. The bank said it expects to execute open market share repurchases associated with up to $500 million of its repurchase plan. Looking at its Q3 2018 outlook, it is pointing to net interest income, net interest margin and loan growth below consensus while expenses are expected to be higher than anticipated. Still, fee income is expected to be better than projected. For its 2018 outlook, it lowered its expectations for net interest income, consumer loan growth, net interest margin and is no longer guiding to lower-end of its expense forecast. While it lowered its 2018 tax rate expectations, its longer-term forecast is modestly higher.

The Goldman Sachs Group Inc. reported Q2 2018 EPS of $5.98. Consensus was $4.66. Provisions for litigation and regulatory proceedings were $148 million ($0.30), up from $44 million in Q1. Revenues increased 19% year/year and declined 6% sequentially to $9.4 billion (highest Q2 in 9 years). Relative to Q2 2017, each business grew with Investment Bank fees up 18% (equity underwriting), Institutional & Corporate up 17% (FICC), Investing & Lending (I&L) up 23% (debt securities & loans) and Investment Management (IM) up 20% (incentive fees). ROE was 12.8%, while ROTE was 13.5%. Tangible Book Value increased 4.3% to $183.78 (trading at 1.3x). Goldman Sachs also announced President and COO David Solomon will succeed Lloyd Blankfein as CEO on October 1, 2018 and Chairman at year-end. While this timing has never been publicly certain, this move has been widely anticipated post the departure of Goldman Sach's then co-president, co-COO Harvey Schwartz in mid-March.

Morgan Stanley reported Q2 2018 EPS of $1.30. Excluding an intermittent net discrete tax benefit of $88 million related to new information pertaining to resolution of multi-jurisdiction tax examinations, EPS was closer to $1.25 and consensus was $1.11. Relative to consensus, Institutional Securities Group (ISG) revenues exceeded expectations, while Wealth Management and Investment Management were a tad light. Within ISG, Fixed Income, Currency and Commodities(FICC), Equities, and Investment Banking all exceeded forecasts. Relative to peers, based on year/year growth rates, Morgan Stanley outperformed in Investment Bank fees and FICC and was in-line in Equities. Revenues increased 12% year/year and fell 4% linked quarter to $10.6 billion (consensus $10.1 billion). While revenues in Institutional Securities (+20% with IB +20% and trading +18%), Wealth Management (+4%) and Investment Management (also +4%) all increased on a year/year basis, all three main business units saw revenues decline from Q1 2018's level. Relative to Q2 2017, revenues increased in Americas (+13%) and Europe, Middle East and Africa (EMEA) (+14%) but lagged in Asia (+1%). Tangible book increased 3.4% to $35.19 (trading at 1.4x). Excluding the tax benefit, it posted an ROE of 12.5% and ROTE of 14.3% (medium-term target of 11.5% to 14.5%). Its CET 1 ratio was 15.8%, up 30bps. During the quarter, Morgan Stanley repurchased $1.25 billion of its common stock or 24 million shares. Average diluted shares declined by 1.3%. Compared to the prior quarter, deposits increased 8%, while assets grew 2% (still Risk Weighted Assets declined 1%).

Nordea Bank AB - Total revenues amounted to €2,541 million compared to consensus at €2,587 million. Net interest income was 1-2% better and amounted to €1,073 million compared to our forecast of €1,049 million and consensus at €1,065 million. Lending margins were negative in the quarters but at least volumes have bottomed and started to increase. The CEO comments that it sees signs that the business momentum is improving in some of the core market. Further that although Nordea expects modest growth in for the remainder of the year it is unlikely that repeating revenues will reach the 2017 level (consensus is already lower) but that net profit will increase (also already in estimates). In Q1 Nordea stated that it will be challenging to meet fiscal year guidance. Commissions amounted to €800 million compared to consensus at €799 million. Lending related commissions are positive but negative with outflow of assets under management (AUM) of €5.7 billion where the other banks have reported inflows. Trading income was weak at €260 million compared consensus at €337 million. Nordea comments that it was an unfavorable trading environment. Costs came in at €1,154 million compared to consensus at €1,222 million and was the positive deviation. Nordea has previously guided for a cost base of around €4.9 billion in 2018 before it could start to gradually come down to about €4.2 billion in cash costs in 2021. That guidance was reiterated. Nordea reported loan losses of 10bps in the quarter compared consensus forecast of 9bps but still comfortable ahead of the long-term historical average of 16bps. Loan losses mainly stem from collective provisions on Russian exposures and underlying asset quality remains very strong. Nordeareported a CET 1 ratio of 19.9% compared to consensus at 19.9%. This equals a buffer of 240bps compared to the Q4 capital requirement. Overall, the report should, in our view, be a relief in Nordea that Net interest income and commissions hold up and costs are better than forecasted.

State Street Corporation reported Q2 2018 EPS of $2.05, excluding $0.17 of repositioning charge related to organizational realignment. Expenses include a $77 million repositioning charge related to organizational changes and management streamlining, consisting of $61 million of compensation and employee benefits and $16 million of occupancy costs. Consensus was $2.01. Greater than expected net interest margin expansion and controlled cost were able to more than offset lower than expected fee income (servicing and securities lending). Revenues rose 7.7% year/year to $3.0 billion (Net Interest Income +14.6%, fee income +5.5%), while expenses increased

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a lower 6.3%. It posted a ROE of 14.7% and ROTE of 21.1%. Its CET 1 ratio was 11.3%. State Street did not repurchase any share during the quarter and does not anticipate repurchasing any common stock for the remainder of the year. Average diluted shares declined 0.6%. Its loan loss provision was $2 million, compared to nil last quarter. **State Street announced the acquisition of privately held Burlington, MA-based Charles River Development (CRD)**, a provider of investment management front office tools and solutions, for $2.6 billion in cash. CRD provides solutions that automate front and middle office investment management functions across asset classes on a single platform for the institutional, wealth, asset owner and alternative market segments. Its clients include 49 of the top 100 asset managers that in aggregate have more than $25 billion in AUM. It has offices in North America, Europe and the Asia-Pacific region (745 employees). Last year, CRD generated $311 million in revenues and $149 million in operating income. State Street is paying 8.4x and 17.5x, respectively. State Street said it is paying 18.2x estimated 2018 net income and 13.9x estimated 2018 net income including only 2021 cost synergies. The purchase price is expected to be financed through the suspension of $950 million of share repurchases in Q2 2018 and during the remainder of 2018, and the remainder of the purchase price through the issuance of equity (two-thirds common, one-third preferred). The company said the acquisition is expected to be accretive to EPS in 2020, excluding acquisition and restructuring costs and based on anticipated revenue growth and cost synergies. Revenue synergies expected to contribute $80 million of EBIT, while cost synergies contribute $60 million of EBITDA. State Street calculates an internal rate of return at 14% with anticipated cost synergies only (over 20% with revenue and cost synergies). It also noted total acquisition & restructuring costs estimated at $200 million through 2021, identifiable intangibles of $800-900 million to be amortized over 10 years, and tax basis step-up associated with the transaction provides positive cash benefits with an estimated present value of $345 million over a period of 15 years. The purchase is expected to close in Q4 2018.

Activist Influenced Companies

Pershing Square Holdings, Ltd. – India's UPL Corporation Limited announced it would buy the agrochemicals business of Platform Specialty Products Corporation for $4.2 billion in cash. The deal is part of chemicals maker Platform's plan to separate Arysta LifeScience and its performance solutions businesses. Platform will rename itself as Element Solutions Inc. following the deal's close, and use the sale proceeds to pay down debt. Arysta was acquired by Platform Specialty Products in 2015. At 14% shareholding, Pershing Square, is, by far, the largest owner of Platform Specialty Products.

Dividend Payers

BHP Billiton PLC delivered a strong end to their fiscal year 2018 results with output beating estimates for all divisions apart from thermal coal (3% of 2018 EBITDA). Guidance for 2019 is in line/ahead of expectations across the business, with the exception of copper (3% below adjusting for sale of Cerro Colorado) due to lower grades at Escondida, and thermal coal (about 10% below estimates). Combined these could reduce 2019 EBITDA by approximately 2%. Other positives to draw from the report were that unit cost guidance is expected to be achieved at the major assets given the strong volume performance in Q4 (this had been a key area of concern), petroleum capex came in at $1.6 billion vs. guidance of $1.9 billion implying some modest upside to cash flow, the Permian fields delivered record output with positive implications for sale value, and U.S. onshore bids have been received and sale completion is targeted by the end of 2018. Negatives include iron ore realized price 1% below estimates and met coal 2% below in 2nd half 2018.

Novartis AG - Group sales grew to USD$13.16 billion (+7.5% year/year in USD, 5% in constant currency, cc), beating consensus by 1.5%. Core operating profit amounted to USD$3.54 billion (+9.5% year/year), beating consensus by 2.4%. Core operating margin was 26.9%, up 49bps year/year. Core EPS of USD$1.29 beat consensus by 3.2%. The main beat stems from Innovative Medicines that posted sales growth of 9.8% year/year and core operating profit grew 14.3%. Main contributors were Cosentyx that grew 43%, Entresto 117% and the oncology franchise that posted 10% year/year sales growth. Performance at Sandoz continues to suffer from ongoing strong price erosion in the U.S. (-9%); ex-U.S. performance remains intact (+5%). These results are roughly in-line with estimates. Alcon sales were about in-line with estimates and core operating profit was slightly better. Group outlook for 2018 remains unchanged, however sales guidance for Alcon is revised upwards to mid-single digit growth while Sandoz is revised downwards to low-single digit decline. In our view the Q2 2018 results are convincing, particularly for Innovative medicines that beat on sales growth and profitability. Most importantly, Cosentyx, the company's most important growth driver, could grow again after missing estimates in Q1 2018. This growth was driven by strong underlying demand and enhanced access to earlier lines of treatment. Moreover, also Entresto could convince with its higher-than-anticipated growth rate, the drug should now head for blockbuster status in 2018. During Q2 Novartis announced its intention for a 100% spinoff of the Alcon division.

South32 Ltd. delivered a decent set of Q4 production numbers, finishing the year with all assets meeting or beating guidance apart from the two alumina refineries (5% below). The two problem assets Illawarra and Cannington both had a decent Q4 with coal production +7% quarter/quarter and silver production +18% quarter/quarter respectively. There was no update to 2019 production guidance. Realised pricing was stronger than we forecast for met coal and in line for alumina and manganese. Raw material cost pressures were flagged in aluminium smelting, and unit costs will be slightly higher than guidance in SA coal (higher washing costs) and nickel (royalties).

Economic Conditions

Canada's consumer price index rose 0.1% (not seasonally adjusted) in June, allowing the year/year inflation rate to climb three ticks from 2.2% to 2.5%, i.e. well above the 2.3% expected by consensus. In seasonally adjusted terms, CPI rose 0.1%, thanks to increases in six of the eight broad categories - only household ops/furnishings and recreation/reading defied the trend by dropping slightly. Excluding food and energy, CPI rose 0.2% (not seasonally adjusted), pushing up the year-on-year print one tick to 1.8%. On an annual basis, the CPI-trim and CPI-median both stand at 2.0%, while CPI-common is at 1.9%. The uptick in prices is consistent in our view with an economy with no remaining slack.

Canadian retail sales rose 2.0% in May, more than erasing the prior month's decline. Sales were up in 8 of the 11 subsectors, including a 3.7% jump for autos/parts dealers. Excluding autos, sales still rose a solid 1.4% as gains for sellers of gasoline, sporting goods, building materials (+5.4%), clothing, general merchandise, and miscellaneous items dwarfed decreases for sellers of food/beverage. Sales of health/personal care products, furniture, and electronics were roughly flat. In real terms, overall retail sales rose 2%.

U.S. housing starts plunged 12.3% to a 1.173 million annual rate in June from a downwardly revised level in May. Both singles and multiples fell sharply (-9.1% and -19.8%), and all four major geographical regions posted declines. Some pullback was expected given a spike in multiple starts (notably in the Midwest) the prior month, but the decline was about six times larger than the market expected, and takes total starts to a nine-month low. No special weather events were at play. While the six-month average level of 1.29 million extends a seven-year upward trend, it's apparent that residential construction is plateauing, likely in the face of higher interest rates and prices in our view. Also, building permits slid for a third straight month, by 2.2% to 1.273 million in June, though singles managed to eke out a small gain.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .30% and the U.K.'s 2 year/10 year treasury spread is .50% - 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. Also, the narrowing gap between yields on the two-year and 10-year Treasuries is of concern given its historical track record that when shorter term rates exceed longer dated ones, such inversion is usually an early warning of an economic slowdown.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.52% (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 4.0 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 13.28 (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.

And Finally .... JPMorgan Chase & Co. has made a strategic investment in Volley.com, a San Francisco-based startup that uses artificial intelligence to help large enterprises automatically generate training content for employees, the companies said on Tuesday. JPMorgan's investment comes as banks increasingly look to use artificial intelligence to make better use of the growing amount of data that they hold across a variety of business lines, ranging from trading to compliance. The startup is developing software that can process data from disparate sources to create quizzes and other corporate training material such as cyber security or compliance courses.
Its technology can help large companies, including banks, save money and time when creating educational content for employees, Volley founder and chief technology officer Carson Kahn said in an interview. (Source: Reuters)

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:

- Bay & Scollard Development Trust
- 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 www.portlandic.com/prices

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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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