News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. September 24, 2018

Owner Operated Companies

Northland Power Inc. (NPI) and James Temerty its founder and circa 1/3rd owner hosted its Investor Day in Toronto last week. We attended and came away with confidence in the company's ability to execute on its current secured growth program and management provided a bit more colour on its longer-term growth strategy. Management also maintained its 2018 estimated EBITDA (adjusted) guidance of $860 million - $930 million and FCF per share guidance continues to be $1.70-$2.00.

During the Investor Day, management provided a bit more colour around the potential earnings power of the company once Deutsche Bucht enters service in Q4 2019 as well as the potential contribution from Hai Long in 2026. Once Deutsche Bucht enters service NPI forecasts the EBITDA (adjusted) will increase approximately 30% over 2018 estimated guidance suggesting 2020 estimated EBITDA (adjusted) of approximately $1,118 - $1,209 million. Post-2020, should NPI successfully secure Power Purchase Agreements (PPA) for the Hai Long project, management forecasts another approximately 30% growth in EBITDA (adjusted) over 2020 estimates suggesting 2026 estimated EBITDA (adjusted) of approximately $1,376 - $1,488 million. The 2026 estimate forecast suggests EBITDA (adjusted) contribution from Hai Long of approximately $258 - $279 million. At the current exchange rate (TWD/CAD = 0.042) this would suggest 2026 estimated EBITDA (adjusted) of approximately NT$6,143 - NT$6,643 million. There could be upside to management's forecast for Hai Long based on the current forward curve; however, this could be impacted depending on how management layers in hedging to the program. Looking forward to growth beyond Deutsche Bucht and Hai Long, NPI will pursue opportunities in Eastern Europe, Japan, Korea, Latin America, and Mexico. In support of this effort, management is introducing a new enterprise risk team to address various risk and currency exposures as the portfolio grows and diversifies.

Energy Sector

Nothing signifcant to report.

Financial Sector

HSBC Holdings PLC is planning to increase its wealth-management staff in Asia as Chief Executive Officer John Flint bets on growth in the region. The bank plans to add more than 1,300 positions, split roughly between retail and private banking, by 2022, according to the heads of the two divisions, which between them currently employ just over 32,000 people in the region. The bulk of the hires, some of which could be internal, will be in Hong Kong and Singapore. The wealth strategy is part of Flint's plan to grow HSBC by expanding in Asian markets including Greater China and Southeast Asia. The CEO, promoted in February, said in June that HSBC will pour as much as $17 billion by 2020 into expanding the region's business and improving technology. The bank aims to grow revenue from Asia by at least $1 billion during the same period. (Source: Bloomberg).

JPMorgan Chase & Co. is setting up a programme using money from the U.K.'s apprenticeship levy to fund MBA studies by its executives and run courses for U.K. school leavers aspiring to be bankers. The financial services apprenticeship programme, in partnership with the University of Exeter's business school, is also the first time a company has teamed up with one of the Russell Group of British Universities to deliver on-the-job training. "We have no doubt that this partnership will help us attract even stronger candidates to our programmes," Phillip Paige, executive director and U.K. early years lead at JPMorgan, said. The courses will be funded from the U.K.'s apprenticeship levy, a pot of money companies and public sector bodies with payrolls greater than £3 million must set aside for government-approved workplace training schemes. (Source: Financial Times).

Royal Bank of Scotland Group PLC (RBS) has begun discussions with regulators about launching a special share buyback to speed up its privatization after the completion of Bank of England stress tests in December. Katie Murray, RBS' deputy finance director, told investors that "we are in the process of working through with the [Prudential Regulation Authority] how we might do that, what's the timing of that." RBS' Chief Executive and Chairman have both previously said the bank was interested in a directed buyback, which would allow it to buy shares directly from the government rather than through the open market. However, Ms. Murray's comments were the first sign the bank has begun taking concrete steps toward securing regulatory approval. The PRA is the part of the Bank of England which supervises the country's largest banks and insurers (Source: Financial Times).

Visa Inc., Mastercard Inc., and a number of U.S. banks last week agreed to pay $6.2 billion to settle a long-running lawsuit brought by merchants over the fees they pay when they accept card payments. Visa and Mastercard previously reached a $7.25 billion settlement with the merchants in the case, but that deal was thrown out by a federal appeals court in 2016 and the U.S. Supreme Court last year refused to revive it. The deal had been the largest all-cash U.S. antitrust settlement, although its value shrank to $5.7 billion after roughly 8,000 retailers opted out. The lawsuit, brought on behalf of about 12 million retailers and dating back more than a decade, accuses the credit card companies of violating federal antitrust laws by forcing merchants to pay swipe fees and prohibiting them from directing consumers toward other methods of payment. The card issuers named in the class-action lawsuit include **JPMorgan Chase & Co., Citigroup Inc. and Bank of America Corporation.** (Source: Reuters).

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Barrick Gold Corporation (ABX) and Randgold Resources Ltd. (GOLD) Merger - $18.3 billion All-Stock, No Premium Mega-Merger: Barrick Gold and Randgold Resources have reached an agreement on terms of a recommended share-for-share merger (a “no premium merger of equals”), whereby each GOLD Shareholder will receive 6.1280 New Barrick Shares for each Randgold Share -- following completion of the merger, ABX shareholders will own approximately 66.6% and GOLD shareholders will own approximately 33.4% of the New Barrick Group on a fully-diluted basis – both Boards believe the merger will create an industry-leading gold company with the greatest concentration of Tier One Gold Assets in the industry, the lowest total cash cost position among Sr. Gold Peers, and a diversified asset portfolio positioned for growth in many of the world’s most prolific gold districts -- based on the 2017 financial results for both companies, the New Barrick Group would have generated aggregate Revenue of approximately $9.7 billion and aggregate adjusted EBITDA of approximately $4.7 billion – the merger is expected to close by Q1 2019 -- following completion of the merger, John L. Thornton, Executive Chairman of Barrick, will become Executive Chairman of the New Barrick Group -- Mark Bristow, CEO of Randgold, will become President/CEO of the New Barrick Group.

GEA Group AG has appointed Stefan Klebert as the new CEO, who will succeed the current CEO Jürg Oleas on February 18. Mr. Klebert served as the CEO of **Schuler Group** from 2010 to April this year, and has worked with **thyssenkrupp AG** from 2004 to 2009. He will join the company’s Executive Board with effect from November 15, 2018.

Nestlé SA announced the strategic review of Gerber Life Insurance Company in February. It found an agreement with Western & Southern Financial Group, Inc. for total consideration of USD $1.55 billion. Gerber Life had sales of USD $856 million in 2017 with statutory capital and surplus of USD $285 million (as of June 30). As analysts had assumed a selling price of up to USD $1 billion, which was already quite aggressive assuming margin of around 5%, with a multiple of 15x (in line with Life Insurance) Nestlé have achieved a very attractive exit price in our view and this follows the highly attractive price negotiated for the U.S. confectionery business (sold to Ferrero earlier this year). Since the beginning of 2017, acquisitions had clearly higher return on invested capital (ROICs) than disposals, indicating that Nestlé was able to negotiate attractive prices, both for disposals and acquisitions. Based on transaction prices, companies divested had a ROIC of 1.9% vs acquired companies at 3.6%. We expect Nestlé to further divest non-strategic, underperforming assets like Skin Health (and Herta? ice cream in the U.S.? frozen food in the U.S.?). **Nestlé** announced it is exploring strategic options for its Skin Health unit (the old Galderma S.A.). Nestlé acquired 50% of Galderma’s equity it did not own in 2014 for €3.1 billion (paid for with L’Oréal SA shares), implying a notional value of €6.2 billion (or 3x sales). The review is expected to complete by the middle of next year. Since the acquisition, L’Oréal’s share price is up approximately 60% and Galderma’s profits have halved; significantly impacted by its prescription products going ‘off-patent’. The company has disclosed last year’s sales of the business at SFr 2.7 billion and some analysts’ estimate EBIT margin of between 8-9%. Nestlé took a goodwill impairment charge of SFr 2.8 billion last year. While a sale of the business will not be growth accretive (grew high single digits in the first half), we estimate it could add over 20bps to group EBIT margin. Assuming a transaction multiple of 1x sales a deal would be slightly earnings dilutive. This closes the chapter on a disappointing transaction for Nestlé shareholders, although to be fair it predates Schneider’s arrival and the review demonstrates his willingness to grasp the nettle.

The Walt Disney Company - After the 3rd round of bidding, Comcast Corp. has likely won the fight for Sky PLC with a high bid of £17.28/ share, handily topping Twenty-First Century Fox Inc.’s Disney-backed final bid of £15.67/ share in sealed bidding – a difference of $2.2 billion on the 61% free float. This places the total value for Sky shares at £29.7 billion, or $38.8 billion at today’s rates. The board still has to make a recommendation once the official offer documents are produced, and shareholders will still have to vote, but with a significant margin between the 2 offers, we expect the high Comcast bid to be accepted. We have long believed that we there was a strong possibility Disney would have Fox bid up the price Comcast would have to pay for Sky, potentially in order to sell Fox’s 39% stake to Comcast at this higher price in order to reduce the cost of the larger Fox acquisition, and this now appears more likely, especially if Disney can gain Comcast’s share in Hulu, LLC. CNBC reported after the auction that a source familiar with Comcast’s strategy expects talks to begin now between Comcast and Disney around selling the Fox stake along with Comcast selling its 30% stake in Hulu, valued at $2.4 billion in the Disney/Fox merger filings. This is likely the best outcome that Disney investors could have hoped for – Sky was not necessarily considered key to Disney’s long-term success while control of Hulu, given its growing influence in SVOD and live OTT TV, is viewed as more crucial to combatting Netflix, Amazon Prime, and cord-cutting. With a £17.28 bid for Sky shares, its estimated Disney’s interest would be worth $15.1 billion, and if sold back to Comcast, could bring year 2 and 3 accretion on the Fox deal. Both companies will have to produce official offer documents on or before September 27th and submit these to the Sky Board. The Board will then make a recommendation to shareholders, who will then have until October 11th to vote in favor of one offer or the other.

Economic Conditions

Canada's consumer price index fell 0.1% (not seasonally adjusted) in August, taking the year-on-year inflation rate down to a consensus-matching 2.8%. In seasonally adjusted terms, Consumer Price Index (CPI) rose 0.1% thanks to increases in seven of the eight broad categories –only clothing/footwear prices bucked the uptrend by staying flat. The Bank of Canada's preferred core measures on a year/year basis were as follows: CPI-trim (2.2%), CPI-median (2.1%) and CPI-common (2.0%), the latter being slightly higher than what was expected by consensus.

Canadian retail sales rose a consensus-matching 0.3% in July. Sales were up in 8 of the 11 subsectors, but the 1.4% decline for autos/parts dealers was a major drag on overall sales. Excluding autos, sales rose a consensus-topping 0.9% thanks to gains for sellers of gasoline, furniture, sporting goods, building materials, miscellaneous items, electronics, clothing, and food/beverages, which dwarfed decreases for sellers of general merchandise and health/personal care products. However, higher prices were responsible for the overall sales increase because in real terms retail sales actually fell 0.1%.

The U.K. inflation rate unexpectedly rose in August to 2.7%, the highest level in six months. Economists had expected a CPI rate of 2.4%. The pound rose after the data was released by the Office for National Statistics (ONS). Wages are still rising more than inflation, with data last week showing wages, excluding bonuses, grew by 2.9% in the three months to July. Rising prices for recreational goods, transport and clothing drove the rise. In July, CPI was 2.5%, which had been the first jump in the index since November. Mike Hardie, head of inflation at the ONS, said: "Consumers paid more for theatre shows, sea fares and new season autumn clothing last month." However, mobile phone charges, and furniture and household goods had a downward effect on inflation." (Source: BBC).

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 0.26% and the U.K.'s 2 year/10 year treasury spread is 0.76% - 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 4.65% (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 12.42 (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 bodes well for quality equities.

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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
- ITM AG Investment 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

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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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