News Highlights

Owners. Operators. And Insightful Investors.

Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. February 22, 2016

Energy Sector

Baytex Energy Corporation (BTE) – Marathon Oil Corporation (MRO), (BTE's operating partner in the Eagle Ford oil field) has announced their 4th quarter 2015 results and revealed their capital program for 2016. The announcement was very much in-line with BTE's expectations, as per our discussion with the company's management a couple of weeks ago. Key highlights:

- MRO reduced their capex by more than 50% to $1.4 billion in 2016, with the net result of a 6% to 8% reduction in its production, adjusted for the planned $750 million to $1 billion in divestitures for 2016.
- MRO is to allocate the bulk of its North American caped to Eagle Ford's acreage that the company shares with BTE, as expected.
- MRO is reducing the number of rigs in Eagle Ford to 5 from 7 over the course of the first quarter and will hold steady afterwards.
- MRO is targeting 130 to 140 of gross wells, implying 35 to 40 net wells for BTE; cost per well has continued to decrease to an estimated $5.5 million per well in average for MRO's acreage in Eagle Ford and likely closer to $5 million currently. Above figures imply that BTE should be able to fit its capex commitments in the $225 to $250 million range, as expected, in which case the company would avoid breaking its 5.25x Senior Debt/TTM EBITDA covenant until later in the year (i.e. late Q3 or Q4); however, the expectation continues to be that the company will announce the securitization of its current bank credit facilities in the first half of the year, unless crude oil prices improve significantly in the short term.

US land rig count fell 27 units to 487, led by horizontal oil (-17), vertical oil (-9), directional oil (-1), while horizontal gas, vertical gas, and directional gas were all flat week/week. Total horizontal land rig count has declined 70% since the peak in November 2014.

US horizontal oil land rigs decreased by 17 to 331 and down 18% over the last 4 weeks led by the Permian (-4), Eagle Ford (-4), Williston (-3), DJ-Niobrara (-2), Mississippian (-2), Granite Wash (-1), and Woodford (-1). This is the eighth consecutive week of declines for horizontal oil land rigs. Additionally, vertical oil rigs were down 2 in the Permian.

US offshore rig count remained flat at 25 and is down 54% over the last 18 months.

Canadian rig count was down 16 rigs and remains 43% off the level this time last year.

Financial Sector

Barclays plc reportedly evaluating the sale of its unit in Egypt as part of previously announced restructuring. It's understood it could fetch in excess of $500 million. Separately, Bloomberg reports that leading the agenda at the Board meeting at the UK bank were the options for its Barclays Africa Group unit. Other issues to be discussed include the ring-fencing of the UK bank. Any decisions could be announced with full year results on 1-Mar. Tom King, the head of Barclays investment bank is leaving the bank in two weeks, the Financial Times reports.

Berkshire Hathaway Inc. – Standard & Poor's left its "AA" credit ratings for Warren Buffett's Berkshire unchanged, saying the company's growing diversification and "modest" financial risks meant a downgrade was not necessary. Berkshire had been put on review for a possible downgrade on Aug. 11, on concern about Buffett's decision to deploy a large amount of cash toward last month's $32 billion acquisition of industrial parts maker Precision Castparts Corporation. But S&P analyst Laline Carvalho said Berkshire's "consistently strong" operating profitability and "exceptional" liquidity, plus the significant cash flow from its roughly 90 operating units, justify the "AA" rating, S&P's third highest. S&P also affirmed Berkshire's "A-1+" short-term credit ratings, the highest possible, and its ratings for several insurance units, including Geico and General Re Corporation. It also raised its ratings for Berkshire's BNSF railroad. The agency also said it now analyzes Berkshire as a "corporate conglomerate" rather than as an "insurance holding company," reflecting the growing importance of non-insurance businesses. It has a "stable" outlook for Berkshire's ratings. In recent years, Omaha, Nebraska-based Berkshire has diversified through big purchases such as Precision Castparts, BNSF, chemical company Lubrizol and Nevada utility NV Energy. It also owns nearly 27% of Kraft Heinz Company which was created last year when Kraft Foods Group and H.J. Heinz Co. merged. Berkshire bought about half of Heinz in 2013. Buffett has said that excluding Kraft Heinz, Berkshire owns 10 companies large enough to be in the Fortune 500 if they were independent. While insurance units now account for only about a quarter of overall results, they help Buffett fund acquisitions and investments by providing large amounts of "float," or the amount of premiums held before claims are paid. Insurance float totaled $86.2 billion as of Sept. 30. Berkshire ended September with $66.26 billion of cash. Buffett has said he would spend $23 billion on Precision Castparts and finance the rest. He prefers keeping a large cushion for big insurance claims. Berkshire held "triple-A" grades from all three major U.S. credit rating agencies as recently as 2009.

HSBC Holdings plc – Reporting for 4th Quarter 2015 - Underlying Profit Before Tax of US$1.9 billion was –US$1.7 billion/47% vs. consensus, with the difference mainly accounted for by US $1.1 billion lower income and US$0.7 billion higher impairment. There was then a net –US $2.8billion of additional 'one-offs' to leave reported Profit Before Tax at –US$0.9 billion. Underlying income was -US$1.1 billion/8% vs. consensus at US$12.9 billion, largely driven by Global Markets (-US$0.7 billion vs. estimates) and an undisclosed amount of hedge ineffectiveness in 'Other'. Costs were in line. The impairment charge was US$1.6 billion, +US$1.0 billion Quarter on Quarter with Oil & Gas accounting for around half the difference, while Non Performing Loans were -5% Half year on Half year. The Core Equity Tier 1 ratio was +0.1% Quarter on Quarter at 11.9% (cons 11.9%). Tangible Net Asset Value (TNAV) was US$7.48, leaving the stock at about 0.86times 4Q 2015 TNAV. The dividend for 4Q 2015 was US$0.21 with US$0.10 declared for 1Q 2016, with the reported payout ratio at 78% for 2015. While offers were received, the Turkish business will now be retained and restructured. Separately, after investors complained that top managers' pay at HSBC looked high compared to rival banks, the bank cut the awards from 50% of executives' base salaries to 30%. The change is expected to be announced on today, the Financial Times reports. In addition, CEO Stuart Gulliver had his pension allowance reduced by £250,000 last year in a move aimed at appeasing big investors. HSBC will disclose today that a cash sum handed to Stuart Gulliver in 2015 in lieu of a pension was cut from £625,000 to £375,000.

Element Financial Corporation will be splitting into two public companies. The new businesses will be: 1) Element Fleet Management, with ~$19.5 billion in assets, led by Brad Nullmeyer, current President of Element; and 2) Element Commercial Asset Management, with ~$7 billion in assets, led by Steve Hudson, current CEO of Element. Separation is expected to be completed before the end of 2016. Management explain the rationale for separation is to surface value. Operating Fleet as a standalone business will provide investors with pure-play exposure to Element's leading Fleet business (37% market share in U.S., 44% in Canada). The split also has the potential to improve credit ratings of Fleet, lower funding costs and increase leverage. Management outlined intentions to replicate its Aviation fund structure for its C&V and Rail businesses, moving the business to an advisory model. This would be expected to result in a more efficient use of its balance sheet and release capital.

European banks began selling bonds again last Monday after weeks of limited access to funding, when market turmoil compounded the worst start to a year for new sales since 2003. ING Groep NV and Nordea Bank AB last Monday both launched senior unsecured bank bonds, which financial institutions use to fund the loans they make to the wider economy. (Source: Financial Times).

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Barrick Gold Corporation (ABX) reported a strong quarter and good end to 2015. 4th quarter 2015 earnings beat on costs and gold sales: ABX reported adjusted EPS of $0.08 vs. consensus of $0.06. The beat was primarily as a result of better than expected cash costs (7% lower) and slightly higher gold sales volumes than pre-released production. Pre-released production was 1.62 Moz (and 138 Mlbs copper), however gold sales volumes were 1% higher than production (1.64 Moz sold). Looking to 2016, ABX seems to be maintaining a strategy focused on debt and cost reductions guiding to another $2 billion "at least" in deleveraging while bringing operating costs lower than 2015 levels. We expect ABX will be able to achieve both objectives. With just over $3 billion in cash and our expectation the company will be able to generate free cash flow in 2016, we believe the company will be able to beat its $2 billion debt reduction target (decreases Net Debt/forward year Earnings Before Interest Tax and Depreciation from 2.8x now to 2.6x at year end 2016 at $1,100/oz gold). 2016 guidance includes production of 5 – 5.5 Moz at cash costs of $550–$590/oz versus expectations of 5.57 Moz at cash costs of $588/oz. Capex guidance is $1.35-1.65 billion, in-line with expectation of $1.5 billion.

Global Dividend Payers

AT&T Inc. announced it would invest about $10 billion in its global business solutions division, as it seeks to boost the unit that offers services such as wireless connectivity, cloud storage and security to companies. Last month, AT&T said it expects its overall capital expenditure in 2016 to total $22 billion. For the quarter ended Dec. 31, 2015, the company said revenue in its business solutions unit fell 2.7% from a year ago to $18.2 billion, driven in part by lower equipment revenue and pressure from foreign exchange rates. AT&T also announced would partner with chipmaker Intel Corp to test the functionality of drones on its high-speed LTE wireless network. AT&T will work with Intel to examine the efficiency of drones on its LTE network at higher altitudes and potential interference with airwaves related to areas such as video streaming and flight information. Intel has been aggressively investing in drone technology in recent years. With the U.S. wireless market over-saturated, AT&T is betting on growth from the "Internet of Things", or web-connected machines and gadgets from cars, home appliances to drones, a new battleground for the company and rivals ranging from Verizon Communications Inc to Amazon.com Inc. AT&T's LTE network can help bring wireless connectivity to industries such as logistics, agriculture, construction and insurance. At Mobile World Congress in

Barcelona this week, Intel has set up an "Intel Drone Zone" to demonstrate its drone technology over AT&T's wireless network.

Deere & Company reported Q1 2016 Earnings per Share of 80c vs. 67c estimates and $1.12 a year ago. Operating margins of 4% in Agriculture & Turf are at their lowest level since 2009. However, Deere's management lowered their full year 2016 net income guide by $100 million, to $1.3 billion. Several larger components of the guide reduction include a $25 million reduction in credit sub-income and lower underlying sales in Construction & Forestry (Down 9% vs. Down 4% old forecast, currency neutral).

Nestlé SA - Full Year 15 sales declined by 3% to CHF 88.8 billion; organic sales growth was 4.2% (consensus 4.2%) of which price was 2.0% (2.1%). FX was negative 7.4%. 2015 was negatively impacted by the Maggi recall in India (approx. 40bp) and revised revenue recognition at Galderma (approx. 15bp). There were noteworthy performances from; Water (organic growth of 7%), Beverages (5%), Confectionery (6%), Petfood (6%) and Nutrition ex Galderma (+6%). Developed markets grew by 1.9% and Emerging Markets by 7.0% (of which it's estimated over half was price). Trading Operating margin decreased by 20bp (+10bp at constant FX) to 15.1% (consensus 15.4%), reflecting a 160bp increase in gross margin (which includes margin accretion from Galderma), more than offset by higher marketing investment. Ex volatile items the decline was 40bps, and 80bps in H2. Underling Earnings Per Share (using Nestlé's definition which excludes restructuring costs) fell by 4% to SFr 3.31 (consensus SFr 3.32). The dividend was increased by 2% to CHF 2.25. Net debt increased by CHF 3.1 billion to CHF 15.4 billion which reflected free cash flow of CHF 9.9 billion helped by a further improvement in working capital offset by CHF 6.4 billion of share purchases. Management are guiding for org sales growth "in-line with 2015 but with softer pricing" (consensus is 4.7%) and an improvement in underlying EPS. There is no mention of a share buyback.

Economic Conditions

US – The US inflation, as measured by changes in the consumer price index (CPI) accelerated in January, to more healthy levels, at 1.4% year-on-year, compared to expectations for a 1.3% reading and December's 0.7% rate. Energy prices were down by 2.8% in the month, while food prices were flat. The core CPI reading (which excludes the effects of food and energy prices) was one notch higher in January, to 2.2%.

US industrial production rose much more than expected with the 0.8% jump more than doubling consensus and the largest monthly gain since November 2014. The increase helps soften the pain of the downward revision to December - now coming in at -0.7% (originally pegged at -0.4%). In any event, of the three components to production - utilities experienced the biggest jump (+5.4%, largest since February 2007) with manufacturing, up 0.5% (most since November 2014) while mining actually managed to stay unchanged (after dropping for four straight months). But even excluding utilities, industrial production rose a solid 0.4%. In other words, the support was broadly based. More activity boosted the capacity utilization rate 0.7% to a 3-month high of 77.1%, and manufacturing by 0.3% to 76.8%. Still far from inflation-threatening levels and a good sign assuming it is maintained.

US housing starts fell 3.8% in January. New-home construction fell in January for a second straight month, as the housing market entered the new year with slowing momentum. US housing starts fell 3.8% from a month earlier to a seasonally adjusted annual rate of 1.099 million in January, the Commerce Department said on Wednesday, the lowest rate since October. (Source: Business Spectator)

Canada – Inflation accelerated in Canada, to a 2.0% rate of change from the prior year, exceeding the consensus expectations calling for a more muted 1.7% reading in the month. The core inflation reading (which excludes the effects of eight most volatile price series, including food and energy) was also right on Bank of Canada's inflation target of 2.0%, one notch higher than December's value and the consensus expectations.

Retail sales in Canada were softer than expected in December, down 2.2% against expectations for a 0.6% retreat. The core reading, which excludes auto sales, was also weak, down 1.6%, offsetting November's gains. Likely some of the effects are due to the pulling forward of holiday sales due to Black Friday's promotions in November.

The UK will hold a referendum on its 43-year membership of the EU on Thurs. June 23rd. The UK Prime Minister called the referendum, a manifesto commitment, after what he says is his successful renegotiation of the terms of membership in four areas of Social benefits & free movement, Sovereignty, Economic Governance and Competitiveness. He will now lead his party in campaigning to remain in the EU, as will the leaders of most other major political parties, much of big business and the trade unions. But politicians across all parties, including six cabinet ministers and the relatively popular Mayor of London will campaign to leave, supported by wide swathes of the population.

UK Unemployment fell by 60,000 between October and December to 1.69 million, according to the Office for National Statistics. The rate of unemployment was unchanged from a month ago at 5.1%, maintaining a decade-low rate. More than 31.4 million people are in work, the highest figure since records.

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Financial Conditions

The US 2 year/10 year treasury spread is now 0.99% and the UK's 2 year/10 year treasury spread is 1.05% - 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.

Influenced by the withdrawal of quantitative easing, the US 30 year mortgage market rate has increased to 3.65% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing US housing inventory is at 5.2 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 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 20.09 (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 Investment Counsel Inc. currently offers 7 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

Private/Alternative Products

Portland also currently offers private/alternative products:

- Portland Focused Plus Fund LP
- Portland Private Income Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund

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.

@PortlandCounsel Portland Investment Counsel Inc. Portland Investment Counsel Inc.

Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

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