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. March 14, 2016

Energy Sector

Crescent Point Energy Corporation (CPG) – announced its fourth quarter and full year 2015 results, as well as its re-calibrated 2016 capital program and further reduction in its dividend payout. Below we're listing some of the key points from last week's announcement as well as our related views. As we have been expecting, CPG announced a dividend cut, though the magnitude (70%) of the cut was larger than our expectations, to $0.03/month ($0.36/year) from $0.10/month ($1.20/year). From our recent discussions with management, in the context of its strategic change, the company's preferred cash flow uses include (1) preserving the balance sheet, (2) growing production per share (organically or through M&A) and (3) paying a dividend (in that order). The management also mentioned a target 15% payout ratio for the dividend (relative to its funds from operations (FFO)), which we took as a through-cycle target (to avoid variability), but which the management seems to be taking rather literally. For 2016, CPG targets a 97% total payout ratio (including capex) and 21% dividend payout ratio, while for 2017 it targets a 96% total payout ratio and a 16% dividend payout ratio. According to company's disclosure and our own calculations for 2016, CPG is likely to generate $1,275 million of FFO (compared to 2015's $1,938 million and 2014's $2,408) based on a $35/bbl WTI (West Texas Intermediate crude oil benchmark) average for the year. For each $1 increase in WTI, CPG expects to generate about $30 million in additional FFO (i.e. additional $300 million in a $45 WTI environment). Average production for 2016 is expected to be 165,000 barrels of oil per day (boed), up 1% on 2015. For 2017, CPG is likely to generate $1,175 million of FFO based on a $45/bbl WTI average for the year. For each $1 increase in WTI, CPG expects to generate about $60 million in additional FFO (i.e. additional $600 million in a $55 WTI environment). Average production for 2017 is expected to remain flat at 165,000 boed. The increased leverage in 2017 in all likelihood comes from the thinning out of the hedges. CPG achieved record production at 176k boed in average for Q4 and is currently producing at a 177k boed rate. CPG has substantially finished drilling and completing for the first half of the year as it shifted $100 million of its capital budget into H2, when it plans to spend $525 million. The revised budget for the year is, at $950 million, at the lower end of the previous guidance. 85% will be spent on drilling and completions with 15% on infrastructure. The company's waterfloods (the method in the oil industry where water is injected into the reservoir, usually to increase pressure and thereby stimulate production) program has performed better than expected and is slated to accelerate, leading to a reduction in the company's corporate decline rate to 28% in 2016 from 35% in 2011. New completion fluids used in Viewfield Bakken improved initial 90 day production (IP90) by 50%. This and the waterfloods outperformance allowed the company to shift $100 million of its capital program into the second half of 2016. CPG saw improvements in drilling and completion costs, down 30% in 2015 due to savings and efficiency improvements. It took another 4% to 5% of costs out in the first quarter so far and expects to realize and overall 10% reduction in costs in 2016. Cashflow netback for the quarter was $34.17 (including $11.69 from hedges) while for 2015 was $36.19 (including $10.76 from hedges). CPG has 39% of oil hedged at C$80/bbl in 2016 and 9% of 2017 oil exposure at C$76. It monetized about 40% of its 2017 and 2018 hedges earlier in the year. CPG added 65 million boe in proven and probable (2P) reserves compared to 2014; 4.5 million boe was due to waterfloods. Including the reserves from acquisitions over 2015, CPG reported a total 2P reserves level of 935.7 million boe (a 16% increase). CPG took an impairment charge of $589 million (after-tax), equivalent to 3% of its total assets, due to lower commodity prices. CPG had $4.3 billion of debt at the end of the year, equivalent to 2.2x its FFO. It maintains $1.4 billion of credit capacity, which is unsecured and not subject to redetermination based on reserves. All in, we see the results as mildly positive, while the increase in reserves and the reduction in its capital program and its dividend are also likely to be viewed as positive by long term investors.

U.S. land rig count fell 13 units to 450, led by horizontal oil (-10), vertical oil (-4), horizontal gas (-4), partially offset by gains in directional oil (+4) and vertical gas (+1), while directional gas remained flat week/week. Total horizontal land rig count has declined 73% since the peak in November 2014 and has declined 32% QTD quarter/quarter.

U.S. horizontal oil land rigs decreased by 10 to 301 and down 25% over the last 7 weeks led by the Permian (-6), "Other" (-4), Eagle Ford (-2), Williston (-1), partially offset by Granite Wash (+2) and Mississippian (+1), while DJ-Niobrara and Woodford remained flat. This is the eleventh consecutive week of declines for horizontal oil land rigs.

U.S. offshore rig count increased by 2 units to 26, and is down 52% since June 2014.

Canadian rig count was down 31 rigs and remains 56% off the level this time last year.

BHI international rig count down 27 rigs month/month in February and down 257 year/year.

Int'l land rigs averaged 1,018 in February with land rigs down 10 and offshore rigs down 17 month/month, led by Asia Pac (-11), Latin America (-6), Africa (-6), Middle East (-3), and Europe (-1).

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Financial Sector

BNP Paribas SA offered a glimmer of hope for Europe's battered bank capital market last week when it issued the first subordinated bond in the single currency since mid-January, though prospects for Additional Tier 1 issuance remain gloomy. The €750 million long 10-year Tier 2 transaction for the lender attracted 1.8 billion of demand, enabling the issuer to price the trade 13bp tighter than initial price thoughts. (Source: Reuters)

HSBC Holdings plc - HSBC winning approval to start a credit-card business in China's $1 trillion market offers Chief Executive Officer Stuart Gulliver added flexibility in his push into the nation's retail banking and wealth-management industries, Bloomberg reports. The approval from Chinese authorities came as HSBC ended a card venture with Bank of Communications Co., the bank's Asia-Pacific head Peter Wong said in a weekend interview, paving the way for the U.K. company to join Citigroup Inc. and Bank of East Asia Ltd. as the only foreign credit-card issuers on the mainland. Wong didn't say when HSBC won the nod from regulators, or provide any specifics on how the business will be rolled out.

Prudential plc - 2015 IFRS operating profit of £4,007 million was 20% ahead of consensus of £3,634 million. However, excluding a one-off positive item associated with changes to asset allocations in the UK due to regulatory Solvency II considerations, the result was rather broadly in-line. Asian new business profit of £1,490 million was well ahead (+8%) of consensus of £1,380 million and up 28% year over year (y/y), a good result given currency headwinds in 2H15. This was, however, concentrated in Hong Kong cross-border sales. Management reiterated that 70% of this business has annual premiums below US$5000, implying that on a monthly basis government imposed foreign exchange limits per transaction for individuals are not impacted. The other key markets of Malaysia, Singapore and Indonesia came in below expectation, with guidance still cautious on the latter. There was a one-off operating profit boost (£339 million on IFRS basis), leading management to declare a 10p special dividend. Traditionally for its Asian operations, growth has been more a function of the industrial process of expanding distribution capacity and tapping the large store of local consumer liquidity. The ordinary dividend was up 5% year/year to 38.78p. The IFRS operating earnings per share of 125.8p included a c10% boost from one-off factors, but if stripped out, it's estimated the dividend was covered 2.9x. This is well ahead of the management target of 2x cover medium term, implying material future upgrades as we move towards achievement of the 2017 sales and cash targets. Management stated that good progress was being made towards these. The capital generation of £3.1 billion was 9% ahead of expectation and up 18% y/y. The year-end solvency II coverage ratio was 193% and in-line with the half year.

Royal Bank of Scotland plc (RBS) is cutting its face-to-face advice service and slashing 550 jobs in another move to reduce costs, as more customers turn to digital "robo-advisers". The state-backed bank is cutting 220 investment advice positions and scaling back its service to only those customers with at least £250,000 to invest — more than double the current £100,000 threshold. RBS is also removing 200 protection advice jobs. (Source: Financial Times).

Depositors at some of the largest U.S. banks are finally going to get the chance to do something quick and simple: send money to another person's account instantaneously by mobile phone. Big banks including **JPMorgan Chase & Company, Bank of America Corporation, Wells Fargo & Company** and **U.S. Bancorp** are starting to plug into a system they jointly own, called clearXchange, which will allow each others' customers to transfer money in a flash when they split a dinner check, rent payment or vacation bill. "What we are doing now is delivering payments in real time, which is what our customers have asked for," Mary Harman, managing director for payments at Bank of America, said in an interview. The bank is one of two that have started rolling out the system to customers. (Source: Reuters).

Mario Draghi, president of European Central Bank (ECB) has come to the aid of bank-debt investors. The riskiest type of bank bonds rose after the ECB said it will start paying lenders to borrow from a four-year funding program. The bank-financing move "provides funding certainty at an attractive price in an environment of increasing volatility, and also an environment of large upcoming bank-bond redemptions," Draghi said last Thursday. (Source: Bloomberg).

Activist Influenced Companies

Pershing Square Holdings Ltd. – Valeant Pharmaceuticals International Inc., under scrutiny for its accounting and business practices, said it had given shareholder Pershing Square Capital Management a seat on its board and added two additional directors. Stephen Fraidin, a veteran Wall Street lawyer who is vice chairman at William Ackman's Pershing Square, has joined the board, along with Fred Eshelman and Thomas Ross, Valeant said. Anders Lonner has stepped down as a director, the company said on Wednesday.

Canadian Dividend Payers

Distinct Infrastructure Group, via the acquisition line financed by Crown Capital Fund IV, has announced the acquisition of Mega Diesel Excavating Ltd. for $2.5 million. Established in 2003, Mega is an Edmonton-based company providing hydro vac, vacuum truck and excavating services throughout Edmonton and the surrounding area and is described by Joe Lanni, Co-CEO of Distinct as a "complimentary business that will allow Distinct to offer additional services to our existing client base and expand our hydrovacing capacity in Western Canada".

Global Dividend Payers

AT&T Inc. – At least three major U.S. companies, AT&T, Starwood Hotels & Resorts Worldwide Inc. and Marriott International Inc., are seeking to complete deals in Cuba as President Barack Obama prepares to visit Havana. The flurry of deal-making could help Obama use his historic March 20-22 trip to showcase what he sees as the benefits of Washington's diplomatic opening with the former Cold War foe after decades of hostility. It will be the first visit to Cuba by a U.S. president in nearly 90 years. However, the longstanding U.S. economic embargo continues to limit efforts by American companies to do business on the communist-ruled island. AT&T is trying to complete a mobile communications agreement with Cuba's state telecoms monopoly Etecsa, while Starwood is also weighing an announcement, according to the source, who was briefed by administration and company officials.

Economic Conditions

U.S. – Consumer credit expanded by $10.5 billion in the U.S. in January, significantly lower than the consensus expectations of $17.0 billion, a welcome respite for those worrying about increased signs of a bubble in vehicles finance.

Canada – Canadian economy lost 2,300 jobs in February, against expectations for a 9,000 jobs gain in the month, driven by a roughly 52,000 positions drop in full-time employment, mostly in the public sector, hospitality and other services, while job gains in construction and manufacturing helped offset the weakness. The headline rate of unemployment inched higher to 7.3% from 7.2% in January. Capacity utilization in Canada disappointed in the last quarter of 2015, down to 81.1% compared to expectations for an 81.6% flat reading.

On the Canadian housing front, building permits were down a larger than expected 9.8% in January, while house starts of 212,600 units annualized were a lot stronger than forecasted in the month of February. New housing prices, meanwhile, inched higher by 0.1% in January, mildly below the expected 0.2% rate of growth.

Italy - Italy's 2016 budget is at risk of breaking European Union fiscal rules even if Rome is granted all possible fiscal leeway by the European Commission, euro zone finance ministers said in a joint statement last Monday. Italy has the second largest debt in the European Union after Greece and is running an expansionary budget in 2016 in a bid to revive sluggish growth. This puts Rome at odds with EU fiscal rules which require significant cuts in public debt for countries with excessive indebtedness and corrections to reduce the structural deficit. Stretching the rules, Rome asked for nearly €10bn of further deficit spending in 2016 and urged the Commission, which monitors euro zone national budget plans, to grant it flexibility allowed by the rules. The Commission will decide in May on Italy's request. But euro zone finance ministers made clear in a joint statement on Monday that "even if the maximum potential additional flexibility is granted, the risk of a significant deviation (from EU budget rules) may remain." To be in line with EU rules, Italy may be forced to find additional revenue to plug its fiscal gap this year.

China - Beijing reported February exports fell 25.4% Year/Year in dollar terms while imports declined 13.8%. The fall in exports is the worst one-month contraction since 2009.

Financial Conditions

European Central Bank Announcement: The Governing Council of the ECB last week took the following monetary policy decisions:

(1) The interest rate on the main refinancing operations of the Eurosystem will be decreased by 5 basis points to 0.00%, starting from the operation to be settled on March 16, 2016.

(2) The interest rate on the marginal lending facility will be decreased by 5 basis points to 0.25%, with effect from March 16, 2016.

(3) The interest rate on the deposit facility will be decreased by 10 basis points to -0.40%, with effect from March 16, 2016.

(4) The monthly purchases under the asset purchase programme will be expanded to €80 billion starting in April.

(5) Investment grade euro-denominated bonds issued by non-bank corporations established in the euro area will be included in the list of assets that are eligible for regular purchases.

(6) A new series of four targeted longer-term refinancing operations (TLTRO II), each with a maturity of four years, will be launched, starting in June 2016. Borrowing conditions in these operations can be as low as the interest rate on the deposit facility.

The market has initially liked the additional Quantitative Easing measures laid out by ECB head Mario Draghi as he delivered on balance we believe more than the market expected with a cut to the refinance rate, marginal lending facility but meeting expectation of the in focus deposit rate, but introduced new TLTRO's effectively allowing banks to be paid to take up funding to lend to the economy, which is essentially seen as a cheap carry, and buying non financial corporate bonds. The cheap funding should help the periphery banks who have been taking up most TLTRO cash and are the largest lenders to the SME sector and all banks that are the real lenders to the economy.

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The Bank of England said it will offer extra liquidity to the financial system around the U.K.'s European Union referendum in order to improve the availability of funds to banks. The move is understood to be a precautionary measure to help ensure the continued smooth functioning of sterling markets rather than in response to specific concerns about liquidity stress around the referendum. (Source: Bloomberg). Bank of England - Governor Carney says impact on London depends on renegotiation of relationship on Brexit (Britain to exit EU). He notes impact on City of London is dependent on factors such as frameworks agreed, 'passport' regime for banks. He highlights importance of mutual recognition arrangement; whether it mirrors current arrangements in place. Carney says logical to expect some institutions would make different arrangements, have contingency plans. Would expect some degree of loss of business for City of London.

Reserve Bank of New Zealand has cut its lending rates for the fifth time since June last year to a record low of 2.25%. The bank said the 25 basis point cut was due to global growth worries and weaker demand from China - an important trade partner. The central bank signalled it could cut rates further to help boost growth.

The U.S. 2 year/10 year treasury spread is now 1.00% and the UK's 2 year/10 year treasury spread is 1.00% - 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 U.S. 30 year mortgage market rate has increased to 3.68% (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 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 16.50 (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 Focused Plus Fund
- 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.

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