News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. May 24, 2016

Energy Sector

US land rig count down 7 rigs week/week, Canada land up 1 rig.

U.S. land rig count fell 7 units to 375, led by vertical oil (-3), horizontal gas (-2), vertical gas (-2), while horizontal oil, directional oil, and directional gas remained flat week/week. Total horizontal land rig count has declined 77% since the peak in November 2014.

U.S. horizontal oil land rigs remained flat week/week at 248 as gains in the Permian (+2), Woodford (+2), and Granite Wash (+1) were offset by losses in Mississippian (-2), "Other" (-2), and Williston (-1), while Eagle Ford and DJ-Niobrara remained flat week/week. This is the first time in 21 weeks horizontal oil land rigs have not declined. Additionally, the Permian gained 2 vertical oil land rigs.

U.S. offshore rig count increased 2 units to 23, and is down 57% since June 2014.

Canadian rig count was up 1 rig and remains 56% off the level this time last year.

Financial Sector

Ares Capital Corporation announced yesterday the planned acquisition of American Capital, Ltd. (ACAS) for $3.43 billion or $14.95 per share. In total, ACAS shareholders will receive $4 billion, or $17.40 per share, consisting of $1.470 billion in cash and $1.682 billion of equity from Ares, $275 million in cash from Ares' external manager, Ares Management and $562 million from the sale of ACAS's American Capital Mortgage Management, a separate transaction. ACAS shareholders will receive a fixed exchange rate of 0.483 shares for every share of ARCC adding approx. 110.8 million shares to Ares' total share count. The deal is expected to close at year end. Adjusting for fully diluted shares, excluding the related mortgage manager divestiture, $212 million of deferred tax asset, and $197 million of "costs and expenses", ACAS' pro forma Net Asset Value at 3/31/2016 was $15.18; Ares' consideration of $13.75 per share represents 90.6% of the pro forma Net Asset Value or a little less than a 10% discount. Ares lined up $460 million of new credit facility commitments in connection with the transaction. Pro forma leverage is expected to be in a range of 0.65x-0.75x. Additional pro forma financial details are expected to be filed in a proxy statement by the end of June. Ares external manager Ares Management is contributing $1.20 per share in cash for the deal, leaving Ares' contribution to $13.75 per share ($7.34 stock and $6.41 cash). The Ares consideration is 90.6% of the pro forma NAV of ACAS, providing flexibility for purchase accounting asset marks when the deal is completed. Additionally, its external manager is waiving $100 million of management fee expense for 10 quarters following the deal. It is estimated the roughly $40 million of first year waiver would equate to around $0.09 per share or about 6% of 2016 core estimated Net Interest Income per share, providing a large portion of the up-front deal-related earnings accretion. The combination will significantly increase the size and scale of Ares Capital, add flexibility to its non-qualified assets (30% bucket), and improve its dividend coverage by rotating low- and non-yielding investments into higher yield investments. Management sees earnings accretion "north of 10%" in the first full year following the transaction. The deal discount to Ares' pro forma NAV at 3/31/2016 of $15.18 is a little under 10%, which should provide flexibility to write-down a portion of America Capital's pro forma $4.1 billion of investment assets. In addition to the financial benefits of enhanced earnings and dividend coverage, Ares' increased scale could drive large syndication opportunities (higher fee income), improve access to capital markets funding, and add flexibility. The equity raised in the transaction decreases Ares' proportion of non-qualified assets providing opportunity to grow and enhance returns. While there should be near-term NAV dilution, management expects the earn-back period to be about one year before becoming accretive to book value. The pro forma investment portfolio at 3/31/2016 would rise to $13.2 billion from $9.1 billion and increase diversification to 385 portfolio companies from 220. Ares' equity would rise to $7.0 billion from $5.2 billion based upon the stock issuance at the time of the announcement.

Barclays plc - South Africa's Public Investment Corporation may put together a group to take a controlling stake in Barclays Africa, The Financial Times reports.

BNP Paribas SA - Reuters reports BNP Paribas plans to cut its investment banking staff in Britain by around 5% in 2016. The article mentions BNP plans to axe 233 British jobs but will also be hiring 60 employees there - bringing the net headcount down to 3,105 in 2016 from 3,278 in 2015.

Berkshire Hathaway Inc. – The General Re Corp. unit of Warren Buffett's Berkshire Hathaway named longtime reinsurance executive Kara Raiguel as its new chief executive officer, replacing the retiring Tad Montross. Raiguel will report to Ajit Jain, who oversees Berkshire Hathaway Reinsurance Group and has long been viewed as a potential successor to Buffett at Berkshire itself. Montross had been chairman and CEO of Stamford, Connecticut-based General Re since 2008, and reported directly to Buffett. Berkshire paid about $16 billion for General Re in 1998 and after initial struggles the unit has performed better recently. Buffett nonetheless warned on April 30 at Berkshire's annual meeting that the industry will fare less well in the next decade as more investors enter the business and push prices down. In a memo, Jain agreed that the industry faces "serious headwinds." He said Raiguel's first priority in the next 90 days is to decide how best to add business without sacrificing underwriting discipline and business integrity. General Re and Berkshire Hathaway Reinsurance accounted for more than two-thirds of Berkshire's roughly $88 billion of float as of March 31.

Berkshire Hathaway revealed a more than US$1 billion stake in Apple Inc. in a rare foray into the technology sector, which Buffett has largely shunned apart from a poorly performing investment in IBM Corporation. Berkshire made its investment in the first quarter, before the iPhone maker in April reported its first quarterly revenue decline in 13 years. The investment was announced amid an increasing view among investors that Apple may deserve a lower valuation because its heady growth days may be over. However, Apple has a strong balance sheet and management, attributes long favored by Berkshire. Berkshire's largest technology bet has been Buffett's roughly $12.1 billion stake in IBM, an investment now more than $1.6 billion in the red. The Apple investment was made by one of Buffett's two stockpicking deputies, Todd Combs and Ted Weschler, his assistant said in an email to The Wall Street Journal. Combs and Weschler, who ran hedge funds before joining Berkshire, each invest about $9 billion and usually make smaller wagers, while Buffett, known as the Oracle of Omaha, makes bigger investments such as IBM. Investors said Combs may have been the Apple buyer. He invested in chipmaker Intel Corp for Berkshire in 2011.

Brookfield Asset Management Inc. – Brookfield Renewable Partners LP has closed the first mandatory tender offer for the remaining outstanding shares of Colombian company Isagen SA. Approximately 709 million shares were tendered to the consortium at a purchase price of Ps4,130 per share for a total consideration of Ps2,927 billion (US$976 million). Brookfield Renewable and its institutional partners now own approximately 83% of Isagen. The second mandatory tender offer is expected to commence in July 2016. Following the conclusion of the tender offers, Brookfield Renewable is expected to have invested an aggregate of approximately US$625 million in respect of the acquisition of Isagen shares, equivalent to an approximate 25% ownership.

HSBC Holdings plc is axing 840 IT jobs in the UK as part of restructuring and cost-cutting measures. The cuts mark the first major round of job losses under an overhaul that will remove 8,000 UK roles at the bank by the end of next year. (Source: Financial Times)

IGM Financial, Inc. – has closed a US$50 million investment in Personal Capital Corporation, a market-leading digital wealth advisor based in the U.S., with an agreement to invest an additional US$25 million in the next year for a total of $75 million. This would result in an initial 10% ownership stake increasing to 15% within 12 months, with the remaining interest owned by Personal Capital's management team and existing investors. Personal Capital's approach to wealth management - combining dedicated financial advisors with innovative customer-facing technology - is unique in the industry. Led by a market-leading and experienced team with a long track record in financial services, Personal Capital has been growing rapidly in the mass affluent and high net worth investor segments of the market, offering a unique, compelling and valuable proposition for its clients. "This opportunity will enable us to participate in the emerging digital wealth management industry in the United States," said Jeff Carney, President and Chief Executive Officer of IGM Financial. "As founder and CEO of Personal Capital, Bill Harris brings over 25 years of experience building financial technology, notably serving as CEO of Intuit and PayPal. Bill's proven leadership together with the depth of talent of his management team, their combined experience and innovative technology, makes this is an attractive investment for IGM Financial." Personal Capital will benefit from its relationship with one of Canada's premier personal financial services companies, particularly given IGM Financials expertise in financial advice and asset management, coupled with its deep understanding of its clients' needs.

IGM Financial has appointed Barry McInerney as the new president and CEO of Mackenzie Investments. Mr. McInerney has over 25 years of experience in the investment management business. He has held senior executive positions at several leading financial institutions in North America."It is an honour to lead Mackenzie Investments at this exciting time in its history and to further execute on the vision and strategies being pursued by the Mackenzie leadership team," said Mr. McInerney. Mr. McInerney succeeds Jeffrey R. Carney, who has been President and CEO of Mackenzie Investments and Co-President and CEO of IGM Financial, since 2013. Effective May 6, Mr. Carney has been appointed President and CEO of Investors Group and President and CEO of IGM Financial."Mr. McInerney brings a global perspective and experience to the Mackenzie Investments team," said Mr. Carney. "I look forward to working with him to build on Mackenzie's strong legacy and increasing marketplace momentum."

Sixteen of the world's largest banks including JPMorgan Chase & Co. and Citigroup Inc. must face antitrust lawsuits accusing them of hurting investors who bought securities tied to Libor by rigging an interest-rate benchmark. Bank of America Corporation, HSBC Holdings Plc, Barclays Plc, Credit Suisse Group AG, Deutsche Bank AG, Royal Bank of Canada and Royal Bank of Scotland Group Plc are also among the defendants sued in Manhattan. (Source: Bloomberg).

Activist Influenced Companies

Zoetis Inc. announced the launch of the first prescription medicine for treating anxiety over loud noises - a widespread problem linked to property destruction, terrified dogs running away and even life-threatening injuries to some. Veterinary medicine maker Zoetis of Florham Park, New Jersey, says recently approved Sileo (SILL'-lee-oh) will be available through U.S. veterinarians within a week. It gives dog owners an alternative to human anti-anxiety pills, tranquilizers that sedate dogs for many hours and generally unsuccessful behavioral treatments. Owners of a third of the 70 million dogs in the U.S. report problems with fear of loud noises. Dogs are sometimes so frightened they jump through windows or run into traffic, getting hit by cars.

Canadian Dividend Payers

Brookfield Infrastructure Partners LP – Australian ports and railway company Asciano Ltd. said its AUD$9.1 billion (US$6.65 billion) sale to an international consortium will be pushed back by regulatory delays due to a federal election. Asciano said it had agreed to a request from Australia's Foreign Investment Review Board to delay the approvals process as the watchdog will cease operations ahead of the July 2 vote. Approvals were now expected on July 22 rather than May 26 as previously scheduled, the company said in a statement. Asciano shareholders were set to vote on the proposal on June 1 but this could also be deferred. Asciano in March agreed to be bought by a host of global investors including Canada's Brookfield Asset Management Inc. and China Investment Corporation.

Global Dividend Payers

Barry Callebaut AG announced today the successful placement of €450 million 8-year 2.375% Senior Fixed Rate Notes at an issue price of 99.104, yielding 2.5%. The company stated offering of the Notes created sizeable demand and was significantly oversubscribed, allowing the Company to price at a historically low coupon and substantially improve the Company's financial flexibility as well as its liquidity profile.

Diageo plc announced that consumer industry veteran Javier Ferrán will be its next chairman. Mr. Ferrán started his working life with Lloyds Bank plc but went on to work at Martini & Rossi which was bought by Bacardi in 1993. He became President of Bacardi Europe in 1994 and was appointed CEO of Bacardi in June 2003; easily the most significant transaction during his tenure was the purchase of Grey Goose vodka for a reputed $2 billion. Since September 2005, he has been a Partner at the consumer specialist Private Equity firm Lion Capital. It is not clear which transactions he has been involved in and whether his role was primarily operational or financial but over this period the firm has been invested in a very diverse set of consumer businesses including: Weetabix, Jimmy Choo, Orangina Schweppes and Russian Alcohol Group (Russia's largest vodka producer, exited in Dec 2009). In our view, Mr. Ferrán is at least a very safe pair of hands, and possibly more. He undoubtedly has deep experience in the consumer goods industry in general and spirits in particular, notably as CEO of Bacardi and non-Exec at Grants, with some additional exposure to beer in Africa from SAB. His role at Lion Capital will have given him detailed experience of business improvement programmes and M&A. And he has a very broad background as a non-Exec. However, it remains to be seen if he will be the forceful catalyst for continued transformation at Diageo which many investors have been hoping for.

Dufry AG, the market leader in the global travel industry has advised of extensions of its concessions in Brazil's airports (Sao Paulo till 2032 and Rio de Janeiro till 2021/23) with expansion of retail space - Brazil is now just 6% of group revenues. Sao Paulo extended till 2032 with 2,300 sq. metre new space: Sao Paulo is Dufry's most important airport in Latin America (3% of group revenues) and had 39 million passengers (25mn domestic). The contract is now extended from 2024 to 2032 and retail space is increased by 2,300 sq metres (before total of 7,000 sq metres). The addition is in the duty-paid segment, which will have 3,500 sq metres at the end of 2016. Rio de Janeiro is the no. 2 airport in Brazil (17mn passengers, 13millin domestic). The contract was renewed in 2014 till 2020 and is now extended till 2021 for duty-paid and 2023 for duty-free. The retail space will be increased by 7,000 square metres reaching 12,800 square metres with 11,000 square metres in duty-free and 1,800 square metres in duty-paid. With the change in government the long waited decision on the duty free allowance (from US$500 to US$1,200 per person) could become reality perhaps later this year. The early renewal and the expansion of Sao Paulo and Rio de Janeiro are a positive move despite Brazil (approximately 6% of group revenues) still feeling a decline in revenues due to weak foreign exchange. We expect a positive momentum in organic growth as Brazil and Russia will become less negative and a change in the duty-free allowance in Brazil would increase the attractiveness of the airports and improve the current low margin.

Novartis AG - The independent data monitoring committee recommends stopping the trial early on MONALEESA-2 / LEE011 as it met the primary endpoint, significantly extending progression-free survival (PFS) compared to letrozole alone, at the pre-planned interim analysis. Still, the MONALEESA-2 trial will continue to assess overall survival data. It is a Pivotal phase III trial of MONALEESA-2 / LEE011, a cyclin dependent kinase inhibitor in combination with letrozole, compared to letrozole alone in the first-line treatment of postmenopausal with hormone receptor positive, advanced breast cancer. That LEE011 works is clearly good news - detailed data will be presented later in the year at a medical conference. With the proposed stopping at the interim results, the drug could reach the market about six months earlier than anticipated.

Economic Conditions

U.S. industrial production jumped 0.7% in April, the most in 18 months and more than doubling expectations, which makes up for the downward revision to March (from -0.9% instead of -0.6%). February's 0.6% decline was revised down to -0.2. The gains in April were, however, mostly due to the utilities sector, where stronger demand fired up a 5.8% surge. Mining was down for the count (8 months in a row), but manufacturing completely reversed March's decline with a 0.3% gain. The latter is what one should focus on, given that it accounts for over 80% of overall production.

U.S. consumer prices matched consensus expectations in April, with the headline rising 0.4% (largest in about three years), or 1.1% above a year ago (3-month high). Much of that was energy-related, as energy prices rose 3.4% in the month (gasoline was up 8.1%), while food grew 0.2% (almost reversing the prior month's decline). Excluding food & energy, prices were more tame, rising 0.2% in the month, or 2.1% above a year earlier. Higher costs for energy-related areas (transportation, airlines), as well as health care (medical, drugs) were offset by clothing (a product of past USD-strength), as well as lower prices for not only used cars (a trend) but surprisingly new cars as well.

U.S. existing home sales rose for the second month in a row, up a better-than-expected 1.7% in April to 5.45 million units annualized. That's the highest since January and, aside from a few other months that they were modestly higher, one can say it is close to the highest in over nine years. Also for the second consecutive month, more contracts closed for both **single family** homes (which make up the lion's share of sales) and for **condos**. Prices continue to edge higher: **median prices** grew 6.3% year-over-year, which is in line with the average over the past couple of years. Perhaps this enticed more **first-timers** to get a foothold in the door: their share of home sales picked up to 32% in April. Although that is an improvement from the 30% share in the prior two months, during normal times, first timers account for 40%-to-45% so we still have a way to go. The **number of homes that became available for sale** perked up (to 2.14 million) sharply, which lifted the **months' supply** to 4.7….that's above the prior month's 4.0 reading but still indicating tight inventory.

Canada – Canadian retail sales retreated 1.0% in March, which fell short of the expectations for a 0.6% pull-back and more than offset February's 0.6% advance. Sales of vehicles were down 2.9% in the month, contributing to the overall decline. The core retail sales, which strip off the sales of autos, were down by 0.3%, marginally better than the expected 0.4% retrenchment. The consumer price index (CPI) advanced at a 1.7% year-on-year pace in April in Canada, an acceleration from March's 1.3% rate, pushed higher by a jump in gasoline prices during the month. The core inflation reading (which excludes the effects of eight most volatile price series, including food and energy) was 2.2%, ahead of the expected 2.0% and March's 2.1% rate.

Japan avoided a technical recession with the GDP rising by an annualized 1.7% in the first quarter, beating estimates of a 0.3% rise, helped by a small increase in consumer spending.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .93% and the UK's 2 year/10 year treasury spread is .99% - 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 3.58% (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 4.7 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 15.45 (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
- Portland Global Aristocrats Plus Fund

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