News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. October 17, 2016

Energy Sector

U.S. land rig count increased by 13 rigs week/week to 513 and up 21% compared to the first 2 weeks of last quarter (3Q 2016). The rig count increase was driven by gains in Horizontal Oil (+10), Horizontal Gas (+8) and Vertical Gas (+1), offset by declines in Vertical Oil (-6) while Directional Oil and Direction Gas remained flat. Total horizontal land rig count is 69% down since the peak in November 2014. The Permian currently makes up approx. 49% of all oil rigs.

U.S. horizontal oil land rigs increased by 10 rigs week/week to 349, driven by gains in the Permian (+4), DJ-Niobrara (+2), Woodford (+4) and "Other" (+4), partially offset by declines in Eagle Ford (-3) and Mississippian (-1) while Granite Wash, Utica and Williston remained flat week/week.

U.S. Gulf of Mexico offshore rig count held flat week/week at 22 and is down 59% since June 2014.

Canadian rig count increased by 1 rig week/week and is 9% off the level this time last year.

International rig count averaged 934 in September, with land rigs up 4 and offshore rigs down 7 month/month, led by gains in the Middle East (+7) and Latin America (+2, third consecutive month of gains, with offshore rigs up 1 month/month and up 8 since May), offset by declines in Europe (-4), Africa (-4) and Asia Pacific (-4).

Veresen Inc. – Alliance Pipeline today announced the successful and safe completion of two days of natural gas flaring activities west of Regina. Alliance shut down its pipeline system October 12 and undertook the flaring so it could replace two sections of pipe where the Regina Bypass ring road will cross its pipeline. The company expects to have the pipeline re-started October 19. Alliance's construction work at the Regina Bypass locations will continue into November. The Alliance Pipeline system consists of an approximately 3,848-kilometer (2,391-mile) integrated Canadian and U.S. natural gas transmission pipeline system, delivering rich natural gas from the Western Canadian Sedimentary Basin and the Williston Basin to the Chicago market hub. The Alliance system delivers, on average, about 45.3 million standard cubic metres (or 1.6 billion standard cubic feet) of natural gas per day. Alliance Pipeline is owned 50% each by affiliates of Enbridge Income Fund Holdings Inc. and Veresen Inc.

Financial Sector

Barclays PLC signed an agreement to sell its U.K. Trust business to Zedra. Terms of sale are not disclosed. Sale is expected to have a minimal impact on Barclays' reported financials. (Source: Reuters)

Barclays has also announced the disposal of a portfolio of non-core Italian loans. The portfolio consists of approx. £260 million of salary secured loans with an anticipated Risk Weighted Average reduction of approx. £170 million. It is expected to complete in Q1 2017 and will be broadly Core Equity Tier 1 ratio neutral.

Bank of America Corporation reported earnings per share of $0.44, well above consensus. Investment Banking/trading results stood out in our view. Core trading (ex. Debt Value Add /Counterparty Value Add) increased 18% Year-on-Year, with Fixed income, currency and commodities up 39% and equities down 17%. Investment-banking fees were $1.5 billion in Q3, up 3% Quarter-on-Quarter (Q-Q). Investment and brokerage fees declined 1% Q-Q. Mortgage banking fees were elevated from a Mortgage service revenue hedge gain of $363 million, partially offset by a reps/warranties provision of $102 million (nets to +$0.01). Excluding these items, mortgage banking was up 5% Q-Q. Card fees were light but service charges looked good in our view, while other income was elevated again (+$200mm). **Net Interest Income up 1% Q-Q** on a bigger balance sheet (+1% Q-Q). Avg. core loans grew 1% Q-Q and avg. total loans were flat (modest consumer growth and flat wholesale). Energy loans were down another $1.5 billion. **Net Interest Margin flat at 2.23%.** Core expenses (ex. retirement eligible costs) were $13.5 billion, flat vs. Q2. Litigation expense was $20 million lower Q-Q at $250 million. Non-Conforming Obligations were down 10% Q-Q to $888 million. Non-Performing Assets were flat Q-Q. Non-Performing Loans (NPL) increased $340 million (+20% Q-Q) to $2.0 billion, offset by $355 million lower consumer NPLs (down 5% Q-Q to $6.4 billion). Provision of $850 million was down 13% Q-Q and reserve release was $38 million. The wholesale NPL increase looks to be mostly from non-U.S. commercial and within metals/mining/energy. **Core Equity Tier 1 ratio up 40bp to 11.8% (standardized), advanced to 10.9% after revisions.** Tangible book value was up 3% Q-Q to $17.14 with help on denominator (Risk Weighted Assets down <1% Q-Q).

Citigroup Inc. agreed to sell its consumer business in Argentina to Banco Santander Rio for an undisclosed amount, a day after it sold some of its Brazilian retail banking assets to Itaú Unibanco Holding SA. The bank had said earlier in the year that it plans to exit retail banking and credit card operations in Brazil, Argentina and Colombia to cut costs and boost profitability. Citi said that the sale would include about $1.4 billion of its assets, including credit card, personal loans and retail brokerage business in Argentina. Citi also agreed to sell its Brazilian assets to Itaú Unibanco Holding SA for 710 million reais ($220.43 million), four days after it had announced that it will invest another $1 billion in its Citibanamex. (Source: Reuters)

JPMorgan Chase& Co. reported Q3 2016 Earnings Per Share of $1.58 - clearly well above consensus ($1.39) and its 13% Return On

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Tangible Common Equity ought to prove well above the peer group average. Stronger than anticipated trading, Fixed Income in particular (strength fairly broad based by product) and higher than forecast Investment Banking fees; 15% year/year core loan growth; solid core deposit growth; efficiency gains (good expense control and another firm-wide legal expense benefit); far better than forecast commercial credit trends/low loss rates/no evidence of broader contagion - aggregate credit costs below forecast even with consumer portfolio net reserve build; solid net positive inflows in asset management. It wasn't all good as there is a narrowing of revenue margins/profitability in the credit card business and mix-driven pressure on fee margins in asset management businesses but the group's business lines all performed - which doesn't very often happen and so should not be extrapolated as such in our view.

NN Group NV hosted a sell-side briefing to repeat its message that it had made "several serious attempts" over a "prolonged period of time" to initiate discussion with Delta Lloyd NV but decided to go public last week with a bid because there had been no response. The group (of course) believes that its €5.30 per share cash offer is "full" but it also confirmed that it wanted to start with a simple and clear figure as a basis of discussion. It is not opposed to structuring the transaction differently, including introducing a share element, for example. It has not decided whether the debt-financing element will be senior or subordinated and said it would back-solve for this once it knew final terms. NN Group intends to maintain the €0.5-1.5 billion holding company cash capital buffer and said that it would not end up at the low end of this range. To date, it has generally raised debt in the centre rather than at the subsidiary level. NN Group is focusing on the dividend per share accretion of this transaction.

Royal Bank of Scotland Group PLC denied deliberately forcing the collapse of small-business customers in the wake of the financial crisis after two news organizations published leaked internal documents. The majority taxpayer-owned lender sought to make more money from small-and medium-sized enterprises that ran into trouble during the financial crisis as part of a project code-named "Dash for Cash," according to documents published Monday by the BBC and Buzzfeed News. While Edinburgh-based RBS said in a statement it failed to meet its own standards and let some customers down, it denied deliberately bringing them to ruin. (Source: Bloomberg)

Wells Fargo & Company said Chairman & CEO John Stumpf has informed the Board he is retiring effective immediately. President & COO Tim Sloan was named CEO and board member and Lead Director Stephen Sanger was named Chairman. Stumpf believes new leadership at this time is appropriate to guide Wells Fargo through its current challenges. Stumpf, a 34-year veteran of Wells Fargo, joined the bank in 1982, became CEO in June 2007 and its chairman in Jan 2010. Sloan joined Wells Fargo 29 years ago, and had numerous leadership roles across the bank's wholesale and commercial banking operations, as well as CAO, CFO and COO functions. Sanger has been a member of Wells' Board since 2003, serving as its Lead Director since 2012. He is the former CEO of General Mills.

Wells Fargo reported Q3 2016 earnings per share of $1.03-better than Consensus ($1.01). Upside was a function of better than forecast fee revenues and lower than forecast credit costs; efficiency deteriorated - this is not at all surprising. Wells Fargo put up a 12% Return on Equity and a 14% Return on Tangible Equity, on 10.7% Core Equity Tier 1. Revenues up 2% year over year (up 1% quarter/quarter) on better fee income comparisons driven by trading ($0.03/share better) and trust ($0.02/share better); mortgage banking strength was clear, with a very strong unclosed pipeline to support Q4 2016; deposit growth remained strong at 2% qtr/qtr. In terms of credit the update was overall better (Non Performing Assets -8%, Non Conforming Obligations -13% qtr/qtr, reserves flat); lower losses related to oil and gas exposures. Net capital return of $3.2 billion or 61% to shareholders. Guidance and financial targets: management reaffirmed the financial targets laid out at the company's May 2016 Investor Day (1.1-1.4% Return On Assets; 11-14% Return On Equity) albeit with efficiency ratios at the high end of the guidance range inclusive of higher legal and compliance costs.

Activist Influenced Companies

Brookfield Business Partners L.P. – Brookfield Asset Management Inc., Canada's largest alternative-asset manager, is considering a bid for troubled hockey gear-maker Performance Sports Group Ltd., as reported by Bloomberg. Performance Sports Group said, as previously announced, it had formed a special committee with the assistance of its financial adviser Centerview Partners LLC, and is continuing to review and evaluate strategic alternatives. The company said it had discussions with certain interested parties and stakeholders, but no agreement has been reached with a third party. Brookfield raised its stake to 13.2% in Performance Sports in September after having said it would push for a restructuring and a possible sale. The asset manager is Performance Sports' second largest shareholder after Sagard Capital Partners Management Corp., according to Thomson Reuters data.

Canadian Dividend Payers

Brookfield Infrastructure Partners L.P. – Brookfield Asset Management Inc. has acquired India operator Reliance Communications Ltd.'s tower assets and other infrastructure for about $1.65 billion. Reliance said it will have a 49% economic upside from the towers in the future, and that both expect the gains from the towers to only rise from her with developments in data consumption and 4G technology.

Global Dividend Payers

Aryzta AG, a producer and retailer of specialty bakery products, organised last week its first Investor Day since 2010 which Chris Wain-Lowe attended. The event took place in Brantford at Maidstone Bakeries (who supplies Tim Horton's, among others). There was a factory visit as well, which was really impressive in our view, with state-of-the-art facility and a high level of automation. For 2017, management of Aryzta has set up some key priorities. In North America, Aryzta has to restore growth after two large contract renewals, and in particular push two of the brands through Business to Consumer (B2C) channels. In Europe, Aryzta will have to fully optimize the new German factory capacity. In Switzerland, the company will have to find a new key customer in order to absorb the lost volume from Co-op. With the call of all outstanding private placements in September, Aryzta will be required to replace the €1.0 billion bridge loan through senior bonds (and other capital instruments) by February 2018. Exercising the call option for Lion Capital's 51% stake in Picard Group in 2018/2019 is likely to result in further refinancing needs of more than €1.8 billion in order to simplify Picard's group structure and gain full access to Picard's cash flows. Thanks to the announcement of two new board members, a new financing being negotiated as well as a decent free cash flow generated in 2016, Aryzta's share price has partially recovered. However, 2017 will be another transition year. Aryzta is facing a conundrum: how to get back growth in order to get some operating leverage, condition sine qua non to generate some free cash flow. The decision to introduce the branded products (La Brea Bakery and Otis Spunkmeyer) into B2C is arguably risky in our view, depending on how its Business to Business (B2B) clients view such competition (i.e, McDonald's is largest client with about 9% of Aryzta's revenue, Restaurant Brands International Inc. (RBI) (RBI aka Tim Hortons and Burger King), Starbucks, Applebees, Wendy's, Subway and Taco Bell). And it will be difficult to fill in the lost revenues from three key contracts in the mid-term, especially in Switzerland. In our view, management made a huge error in delivering (i.e. building) best execution completely in accord with latest FSMA regulations (Food Service Manufacturing Act) before agreeing its contract renewals with 3 of its larger clients (includes RBI) ...and paid the price with all three contracts being renewed at prices linked directly to return on invested capital and significantly lower than the previous contract. However, telegraphing the mistake was our entry point into a company which has an A list of clients and facilities which few can match and indeed as FSMA regulations tighten should now place the company in a strategic advantage over smaller competitors unable to meet FSMA standards. Management struck a contrite pose throughout the presentations but with bakeries that are understood to be at about 2/3rds capacity and retail products that are differentiated – in particular La Brea which has grown into the largest bakery in U.S. of artisan breads and is taking an industry leading position on non-genetically modified breads – there appears plenty of scope and determination to deliver on their growth targets of 5% by 2020.

AT&T Inc. – International Business Machines Corporation (IBM) and AT&T have announced a partnership to reportedly offer advanced cloud networking for businesses. In a world in which hybrid cloud and IT-as-a-service deployments have quickly become a business imperative, existing networks do not offer the agility and support needed to respond to the demands of today's ever-changing business climate. AT&T and IBM are working together to help businesses meet these needs. Through the expansion of their strategic relationship, IBM will take advantage of AT&T's new offering AT&T FlexWare, a transformative solution announced this summer that makes it easy to set up and manage virtual network functions (VNFs) on a single device. AT&T FlexWare, formerly called AT&T Network Functions on Demand, is available globally through the AT&T Network on Demand platform. The solution features both software-defined networking and network function virtualization technologies. By taking advantage of IBM's sales and marketing teams, the two companies are extending their global reach to bring new capabilities and additional cost savings to companies. AT&T will also be able to run applications on IBM's cloud, cognitive, analytics and security infrastructure. In addition to making this available to clients, IBM has begun to roll out AT&T FlexWare in many of its own sites.

LVMH Moet Hennessy Louis Vuitton SE reported Q3 revenue of €9.14 billion, beating Bloomberg consensus of €8.92 billion by 2.5%. Q3 organic sales increased 6%, ahead of Bloomberg consensus estimates of 4% growth. This represents an acceleration compared to 1st Half organic growth of c4% and implies nine-month revenue grew 5% at organic growth rate. LVMH commented in the press release that Q3 recorded an acceleration in Asia except Japan, while U.S. and Europe ex France performed in line with the previous quarter.

- **Wines & Spirits: +4% versus consensus' 4% estimate.** Champagne volume grew 3% in nine months, this implies the category experienced a strong volume acceleration in Q3 to c9% from -1% in 1H 2016. Cognac showed solid volume growth as well despite a very tough comparison base from last year (+24%) and its estimated volume increased c5% in Q3 to match the 9% volume growth reported in the nine-month period. The U.S. continued its strong growth while China normalizes after the destocking-restocking cycle.
- **Fashion & Leather: +5% growth beats consensus (2%).** Assuming DKNY (sold) negative effect this quarter was consistent with the previous quarter, underlying organic growth for the division should have been stronger at about +6%. We believe Louis Vuitton benefited from the price increase of c7% in the U.K. in August (post Brexit decision), a sign of solid price leadership by the brand, driving higher organic growth in what we believe is the strongest European market at the moment. The launch of first LV fragrance in the quarter and a new line of luggage had a positive halo effect (advertising and innovation) on the brand, in our view. Fendi recorded another quarter of strong growth, firmly heading to break the €1 billion revenue level by year end. Marc Jacobs remains a drag as the brand suffers during the repositioning phase while Loro Piana, Céline, Loewe and Kenzo recorded good growth.
- **Perfumes & Cosmetics: +10% beats consensus (6%).** We believe the business is enjoying strong growth driven by solid demand in make-up, a category that we estimate will account for almost 45% of division sales by year end. Parfums Christian Dior continued

its strong performance, gaining market share in all countries, with momentum in fragrance and makeup. Also Givenchy and Le Petite Robe Noire recorded solid growth in makeup products.

- **Watches & Jewelry: +2% misses consensus (4%).** Although outperforming the hard luxury market, we believe LVMH is not immune to soft trends in jewellery and watches, as shown by Richemont and Swatch recent profit warnings. Bvlgari gained market share thanks to the innovation originated from the launch of the Serpenti Seduttori new line, but we believe recorded a slowdown versus previous quarter.
- **Selective Retailing: +8% beat consensus (5%).** Sephora continues its strong development with double-digit growth rate in what we believe is a mix of organic growth and new space openings. DFS business remains challenged by the weak trends in Macau and Hong Kong over the quarter. In September the brand opened the T Galleria in Venice, we believe this is a positive development for the brand that captures tourists in iconic European destinations such as Venice.

Nestlé SA Skin Health - Management change at top level: CEO of Nestlé Skin Health (NSH) Humberto Antunes is leaving the company at the end of the month - quite an abrupt move. Humberto joined Galderma in 1997 and has been CEO since 2004. Under his tenure, the company had a spectacular performance until 2010-11. Since then, Galderma reported sales growth below 10%, and profitability dropped from peak margin of 19.8% in 2010 to an estimated 10% last year. NSH has sales of CHF 2.3 billion. Last year, the division was hit by close to CHF 100 million in pricing/rebates issues. Paul Navarre will take over as new CEO as of November 1st. He spent 15 years with Procter & Gamble Company and then joined Allergan in 2007, where he was most recently President of Allergan International (USD $1.9 billion sales, operating in more than 100 countries). Active in medical devices (breast and facial aesthetics), skin care and eye care, Allergan offers Over-the-Counter as well as prescription products. In our view this is a surprising management change at NSH, which hints at an underperforming business. The appointment of Paul Navarre is the right move, in our view, and should give the division new impetus. The new CEO's long experience with P&G (consumer solutions) and Allergan, which covers all NSH's business segments, will be more than useful. Following an external new CFO last year and external new CEO this year, it is the third external appointment in key positions at Nestlé.

Economic Conditions

U.S. retail sales improved by 0.6% in September, in line with the consensus expectations, driven by sales of vehicles and parts, but also improvement in gasoline, sporting goods and building and gardening categories. The core retail sales, which excludes the autos, were also up by 0.5%, one notch above the expectations. The US consumer sentiment, as measured by the University of Michigan, dropped two index points, to 87.9 in October from 89.9 in September, falling significantly short of the expectations, which were calling for an improvement, to a 91.9 index points level. The culprit was the 'expectations' component of the composite index, which dropped to 76.6 from 81.1, as its 'current conditions' counterpart actually improved in the month, by a couple of index points.

U.S. Industrial production rose 0.1% increase which was in line with the consensus call. However, the prior two months were each revised down by a tenth, to -0.5% in August and +0.5% in July. Volatile utilities production was again a factor (-1.0%), but mining output was up 0.4% thanks to renewed oil drilling. The remaining sluggish 0.2% gain in factory output once again felt the sting of tentative capex (e.g., business equipment production was down for second consecutive month at -0.2%). To make matters worse, the NY Fed's Empire State factory index decreased again in October (when a small increase was expected), heralding another potentially sluggish month for America's manufactures.

British house prices rose at their slowest pace in more than three years in the three months to September, figures from mortgage lender Halifax showed, adding to signs of a slowdown in the housing market after Britain's Brexit vote in June. The increase in prices slowed to 5.8% from 6.9% in the three months to August, Halifax, part of Lloyds Banking Group, reported. In monthly terms, prices rose by 0.1% from August, the first increase since June. "The reduction in annual house price growth from a peak of 10.0% in March to 5.8% six months later remains in line with our forecast at the end of 2015," Halifax stated (Source: Reuters)

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .96% and the U.K.'s 2 year/10 year treasury spread is .94% - 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 3.47% (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 4.3 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 16.59 (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

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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