News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. February 21, 2017

Energy Sector

U.S. land rig count increased by 13 rigs week/week to 730 rigs, up 96 rigs in the last five weeks and is up 95% off the May 2016 trough. The rig count is up on average 28% Quarter to Date quarter/quarter. Gains in Horizontal Oil (+5), Directional Oil (+7), Horizontal Gas (+2), Vertical Gas (+1) and Directional Gas (+1) were slightly offset by declines in Vertical Oil (-3). Total horizontal land rig count is down 55% since the peak in November 2014. The Permian currently makes up 52% of all oil rigs.

U.S. horizontal oil land rigs increased by 5 rigs week/week to 493, up 65 rigs in the last five weeks and is up 100% off the May 2016 trough, as gains in the Permian (+4) and Granite Wash (+4) were partially offset by declines in Eagle Ford (-1), Woodford (-1) and "Other" (-1) as Mississippian, Williston and DJ-Niobrara remained flat week/week.

Canadian rig count decreased by 20 rigs week/week and is up 63% from the level this time last year.

U.S. Gulf of Mexico offshore rig count decreased by 3 rigs week/week to 17 and is down 69% since June 2014.

Crescent Point Energy Corp. – Whilst still at the rumor level, markets seem to give some credence to a U.S. activism interest in Crescent Point. Activism in Canada hasn't historically been very successful (CP Rail being the notable exception) and difficulty would be compounded in Crescent Point's case by the relatively lower institutional following. As pointed out recently in Portland's Product seminars, there is, we believe, quite a gap in the valuation of the company, currently at about 6.0x EV/DACF (enterprise value to debt adjusted cash flow) relative to a roughly 8.5x EV/DACF valuation for the company's peers or the company's longer term average of 9.5x EV/DACF. The gap could be explained by the markets being less than enthusiastic with the company's recent equity deals and, quite likely, a lack of meaningful transactions during this period of duress for many in the industry. While Crescent Point's assets continue to be top quality, with still some of the best economics across the continent, and perhaps because of that, well deliverability improvements seem to have fallen short of the improvements in other oil plays, most notably the Permian (Texas) and Montney (in Canada), which seem to currently attract most of the investor interest. To this last point there isn't much an activist could do to improve as Crescent Point arguably has one of the best technical teams and has been at the tipping point of the technical innovation and also the most active Canadian driller throughout the downturn. What might be pursued is pushing the company into a merger and acquisition deal with the purpose of acquiring interest in the above-mentioned oil plays or, conversely a break-up of the company, both of which come with their own perils. We're following developments around this news story with interest, though until further details we have limited expectations from this rumored activist action.

Veresen Inc. said it would sell its power generation business, its largest division, for $1.18 billion in three separate deals. The Calgary-based company, which owns energy infrastructure assets in Canada and the U.S, said it would sell the division and use the proceeds to fund growth projects. The sale, which is expected to close in the second quarter of 2017, will also allow Veresen to strengthen its balance sheet, as well as focus on its pipeline and midstream businesses. The company owns 50% of a joint venture with New York-based private equity firm KKR & Co. LP called Veresen Midstream, a natural gas midstream business focused on the Montney region, which straddles the Alberta-British Columbia border. TD Securities Inc. is the company's sole financial adviser on this divestiture. The company didn't name the buyers, though in a separate announcement, Capital Power Corporation revealed it acquired two gas-fired facilities and two waste heat assets from Veresen.

Financial Sector

Berkshire Hathaway Inc. – An investor consortium headed by American giant Berkshire Hathaway is understood to have turned to Goldman Sachs for advice on its bid for New South Wales (NSW) electricity networks company Endeavour Energy. Endeavour is the Australian state's third-largest electricity distribution network, providing electricity to close to 1 million customers and a regulated asset base worth about $6 billion. Warren Buffett's Berkshire was an aggressive buyer of stocks in last year's fourth quarter, nearly quadrupling its stake in Apple Inc. and increasing its stake sevenfold in the four biggest U.S. airlines. In a regulatory filing, Berkshire reported owning 57.4 million shares of Apple as of Dec. 31, which would now be worth $7.74 billion, up from just from 15.2 million shares three months earlier. It also disclosed new stakes in satellite radio company Sirius XM Holdings Inc. and seed company Monsanto Company, which is being bought by Germany's Bayer AG. Less popularized, but consequential for one of our key holdings, Berkshire now holds more than 5% of Liberty Global PLC LiLAC's voting shares, effectively the third largest investor in the company's A shares.

HSBC Holdings PLC said last week that it had appointed Ian Stuart as the chief executive officer of its ring-fenced U.K. retail business. Stuart, who is currently head of commercial banking for U.K. and Europe, will step down from that role to lead the bank's British retail banking and wealth management, commercial banking and global private banking operations. Britain's ring-fencing rules aim to avoid a repeat of the 2008 financial crisis, when banks' bad bets in wholesale financial markets put ordinary depositors' cash at risk, and led to big taxpayer-funded bailouts. The rules apply to all banks in Britain that have both retail and commercial or investment banking activities. HSBC's ring-fenced bank will be headquartered in Birmingham from 2018, a year before the separation of the business has to take place. (Source: Irish Times)

Royal Bank of Scotland Group PLC (RBS) - The U.K. Treasury could be forced to impose tougher terms on Royal Bank of Scotland to free the bank from selling Williams & Glyn (W&G) following an investigation by Brussels. The Treasury announced late on Friday that it had proposed to the European Commission a plan that involved RBS supporting small British businesses rather than selling W&G as a separate bank — the original condition of receiving its £45 billion bailout during the financial crisis. The alternative plan comprises measures to boost competition in banking for U.K. small businesses, with an expected cost to RBS of at least £750 million. It includes a fund for so-called challenger banks to expand their business banking operations, funding for fintech, access to RBS's branch network and "dowries" to tempt business customers to move to a rival bank. Prima facie, although not yet finalized, against the £1.8 billion of restructuring costs and loss on disposal for W&G in estimates this represents a good outcome provided the scheme cost doesn't rise and incremental reintegration costs for W&G remain controlled. That said it remains a very high level proposal at the moment and, as with all State Aid agreements, in our opinion the devil is likely to be in the detail which will be agreed over the coming months. The chief executive of RBS has signaled a return to profit in 2018, finally drawing an end to a decade of losses that have exceeded £50 billion since the financial crisis. The lender, which is 72% backed by the government, is braced to report its ninth consecutive net annual loss at the end of this week, which analysts estimate could reach £6 billion. The painful loss will come after a $3.8billion provision to cover a looming fine from U.S. authorities for mis-selling mortgage securities, and more hefty restructuring expenses. (Source: Financial Times).

Activist Influenced Companies

Liberty Global PLC LiLAC advanced some 20% since the release of its fourth quarter and full year results, which exceeded the previously lowered expectations and saw improvements at Cable & Wireless Communications PLC (CWC) and robust delivery in its Chile operations. Highlights include an operating cash flow (OCF) for the quarter which, at $377 million, handily beating expectations, though much of the beat was based on a legal win in Puerto Rico. Of the Q4 OCF, Chile delivered a 10% growth, whilst CWC delivered $226 million of reported OCF. The other key driver of the outperformance, we believe, is the guided $1.5 billion of OCF for 2017, which also exceeded expectations. Revenue in the quarter was $923 million, driven by Chile, up 6.2%, whilst CWC grew 0.5%, relative to Q3's 3.6% contraction. Management also flagged large project wins in Panama and wholesale business growth. The first LiLAC only conference call provided insight in the transformation of the three component businesses, including the legacy businesses of Liberty Global in Latin America (Chile and Puerto Rico), the legacy businesses of CWC (mostly fixed line telephony and broadband services in the Caribbean) and Columbus International (including broadband, TV and data wholesale services). Of note, management repeatedly emphasized the need for industry consolidation, an area in which the Liberty team has unique capabilities.

Restaurant Brands International Inc., owner of the Burger King and Tim Hortons fast-food chains, said it would acquire Popeyes Louisiana Kitchen for $1.8 billion in cash. The deal is a bet by Oakville, Ontario-based Restaurant Brands that it can use its international reach to introduce Popeyes' Louisiana-style fried chicken and buttermilk biscuits to more diners globally. Popeyes shareholders will get $79.00 for each share they hold, a 19.5% premium to the stock's Friday close. Popeyes, whose fans include pop singer Beyoncé, began 45 years ago as a Southern-fried "Chicken on the Run" restaurant in a New Orleans suburb. It has since expanded to more than 2,000 restaurants, of which 1,600 are in the United States. Restaurant Brands was formed in 2014, when 3G Capital-backed Burger King acquired Canadian coffee and doughnut chain Tim Hortons Inc for $11 billion. Restaurant Brands said it would finance the deal with cash on hand and a financing commitment from J.P. Morgan Chase & Co. and Wells Fargo & Company. Not surprisingly, markets reacted positively to news of the acquisition, a testimony of the investors' faith in the 3G Group's (the controlling group of Restaurant Brands International and operator of the business) ability to streamline operations and extract value through unrelenting focus on cost cuts.

Canadian Dividend Payers

Barrick Gold Corporation reported Q4 2016 adjusted Earnings Per Share of $0.22 versus consensus of $0.20. While gold and copper production had been previously released, the main variance to estimates was 12% better-than-expected copper sales and a higher realized copper price ($2.62/lb vs. $2.39/lb market price). Gold production in 2017 is now estimated to be 5.6-5.9 Million ounces (Moz) (vs 5.0-5.5Moz previously) and 4.8-5.3Moz in 2018 (vs. 4.6-5.1Moz previously). Production in 2019 is guided to 4.6-5.1Moz gold. Capital spending is forecast to decline versus previous guidance with a 14% reduction in 2017 (to the mid-point) to $1.3-$1.5 billion, and a 13% decline in 2018 to $1.35-$1.65 billion. We believe Barrick posted a strong finish to 2016 with an earnings beat despite having pre-released operating results. Financial prudence and a focus on free cash flow has shored up the balance sheet sufficiently for the company to increase the quarterly dividend by 50% to $0.03/share. Management continues to focus on debt reduction, with an additional $2.9 billion in reductions planned in 2017/2018 (evenly split between the two years), resulting in an expected debt balance of $5 billion by year end 2018 (Net debt to Earnings Before Interest Tax Depreciation and Amortisation) EBITDA of a respectable 1.03x.

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Global Dividend Payers

ABB Ltd. - In a continuing effort to grow the gap to the competition in Robotics, ABB has set up a new global application centre for 3D metrology and announced last week the acquisition of Spanish start-up company NUB3D for an undisclosed amount. This company expands the offer of 'ABB Ability' cloud-based solutions and connected devices. In principle this sounds like a good deal from a strategic point of view, hopefully transacted at a fair price. With the appointment of the Chief Digital Officer Guido Jouret last year as well as a new CFO Timo Ihamuotila joining in April, we expect ABB to step up bolt-on acquisitions to boost its digital offer over the coming quarters.

Aryzta AG - Overdue in our view but Owen Killian, CEO; Patrick McEniff, CFO/COO; and John Yamin, CEO Americas, all members of Aryzta Executive Management, have finally tendered their resignations and intend to step down from their respective roles at the end of the current financial year. Aryzta's Board will engage a leading international recruitment firm to identify the highest calibre candidates for these important roles. Meantime, three new members have been appointed in the Executive Management with immediate effect: COO Europe, COO Americas, COO APMEA (Asia Pacific/ Middle East/Africa) (all in their late 40's). Aryzta has commenced a process with Lion Capital to evaluate investment alternatives for the Picard business. Aryzta's interest in Picard is a 49% equity stake, together with a call option on the remaining 51% stake. Net proceeds of any transaction which may monetize Aryzta's interest in Picard would be used to strengthen the Aryzta Group's balance sheet. Aryzta has increased the covenant headroom on its debt facilities from 3.5x to 4x Net Debt to EBITDA. No incremental financing costs associated with the amendment, while Aryzta remains at its existing covenant of 3.5x. In the event of Aryzta moving into the range of 3.5 to 4x, financing costs would increase by 40–50bps. The covenant amendment applies to the three tests at 31/7/2017, 31/1/2018 and 31/7/2018. Management is not willing to share the current rates, but stated that financing costs would inflate by €5-7 million. Management is guiding for 3.3x-3.4x at the end of 2017.

BHP Billiton PLC has reported a strong set of 1st Half 2017 results, in our opinion. EBITDA beat consensus by 3%, while underlying earnings were +6% versus consensus. Cost-cutting performance was strong at $1.2 billion, representing 13% of Cost Of Goods Sold and leaving the $1.8 billion full year 2017 target well within reach. The proposed dividend of $0.40/share was +18% ahead of consensus, driven by a payout ratio of 66% versus the 50% expected, reflecting difference between net income ($3.2 billion) versus free cash flow ($5.8 billion) resulting from the currently low capital expenditure/ Depreciation & Amortisation ratio of 0.7x. Capital expenditure and exploration guidance for full year 2017-18 was nudged up by $0.3 billion over the 2 years, reflecting higher exploration spend particularly in oil. Operating expenses forecasts for key divisions were essentially unchanged on a constant foreign exchange basis. Net debt was much better than expectations benefiting from a $2 billion gain on fair value re-measurements.

Dufry AG through a joint venture with Bright Power Co. Ltd. (operates bookstores throughout China), Dufry has opened 8 Hudson stores in China at Chengdu Shuangliu International Airport, which is the 4th most important Chinese airport (44 million passengers). The Asian region makes for Dufry just 10% of group sales and had 130 shops at the end of 2015. In Mainland China, the duty free business is not open to international players and therefore Dufry is present in China in duty paid, having shops at the airport of Beijing, Shanghai and Chengdu. The tender for the Hong Kong airport duty free (liquor & tobacco: 3,400m2; beauty & accessories: 3,300m2) was closed at the beginning of February and it is expected the winner will be announced in Q2 2017. Dufry will be interested in the beauty & accessories tender as Nuance was the concessionaire 4 years ago, and Duty Free Store is the current owner but making huge losses and therefore it is expected that concession fee will be considerably lower. The start of the Hudson concept in China is an important step for the development of this successful retail concept - it is already in 14 countries (US, Canada, Mexico, Dom. Rep., Brazil, Morocco, Spain, Italy, Switzerland, Russia, UAE) and therefore it is also the first move into the Asian market, where Dufry is still underrepresented. The financial impact is minor with the HK tender being more of an issue, but the internationalisation of the Hudson brand is part of Dufry's growth story.

The Procter & Gamble Company (P&G), maker of Tide detergent and Gillette razors, will face ever greater pressure to slice costs and slow-growing divisions now that activist investor Trian Partners is a major shareholder. Trian reportedly holds more than $3 billion of P&G's stock. Trian has a track record of pressuring large consumer companies to break up. But Trian has yet to publish a white paper, and the firm's exact plan remains to be seen. P&G has been selling off unprofitable brands, including 41 beauty brands to Coty Inc., and focusing on core brands such as Tide, Pampers and Gillette to revive sluggish sales. Trian pressured PepsiCo Inc. to spin off its beverage business from its snacks division. In 2012, under pressure from Trian, Kraft spun off its North American grocery business and its global snack division to become Mondelez International Inc., the maker of Oreos, Cadbury chocolate and Wheat Thins.

South32 Limited reported a solid set of 1st Half 2017 results in our view with reported underlying EBITDA of US $1,064 million coming in +3% ahead of our estimates and underlying Earnings Per Share of US $0.09/share very much in line. South32's maiden interim dividend of US$0.36 /share is in line with our expectations and the company's guided 40% payout policy. With 1st Half 2017 Free Cash Flow annualizing at approx. South African Rand 1 billion and reported net cash of US $859 million at the end of December, the 1st Half 2017 result reaffirms South32's cashflow and balance sheet credentials in our view.

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Economic Conditions

U.S. retail sales rose for the 5th consecutive month, with the January 0.4% lifting sales up 5.6% above year-ago levels, the most since March 2012. Revisions can go both ways but this time, they were upward. December's 0.6% gain was revised to +1.0%, which could push Q4 GDP up over 2% (currently estimated at +1.9%). By sector, the gains were broad-based (a couple of flat readings). Only the auto sector saw a pullback, which is in line with what we've seen for unit sales. Excluding autos, sales were up +0.85%, the most since April. Core sales (which subtract autos and gas and building materials) were up 0.4% again, or 4% above a year earlier. This is one of three months for the quarter but we are off to a good start, and supports forecasts of ~3% annualized growth in real consumer spending for Q1.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 1.24% and the U.K.'s 2 year/10 year treasury spread is 1.14% - 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 4.15% (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 11.89 (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.