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. May 1, 2017

Owner Operated Companies

Alphabet Inc. - Google parent Alphabet Inc. posted a surge in profit and revenue as its core advertising business continued to grow and problems such as an advertiser boycott of YouTube had little impact. Alphabet's profit beat Wall Street estimates and rose 29% to $5.43 billion. Like its arch-rival Facebook Inc., Google has aggressively shifted the focus of its business to mobile advertising. Google is expected to command a 61.6% share of the search ad market worldwide in 2017, up from 60.6% in 2016, according to research firm eMarketer. Google's revenue rose 22.2% to $24.75 billion from $20.26 billion in the quarter ended March 31. Google's non-advertising revenue, which consists mainly of the cloud computing business, the Pixel smartphones and the Play store, also grew dramatically in the quarter, jumping 49.4% to $3.10 billion.

Fortive Corporation announced results for the first quarter 2017, which included adjusted net earnings of $209.4 million. Diluted net earnings per share were $0.60. For the first quarter of 2017, revenues increased 4.1% year/year to $1.5 billion, with core revenue growth of 4.9%. James A. Lico, President and Chief Executive Officer, stated, "We had a strong start to 2017 by delivering double-digit earnings growth above the high end of our guidance and mid-single digit revenue growth amidst stabilized markets." Fortive expects 2017 adjusted diluted net earnings per share to be in the range of $2.68 to $2.78. Fortive is a diversified industrial growth company comprised of Professional Instrumentation and Industrial Technologies businesses that are recognized leaders in attractive markets. With 2016 revenues of $6.2 billion, Fortive's well-known brands hold leading positions in field instrumentation, transportation, sensing, product realization, automation and specialty, and franchise distribution. With a culture rooted in continuous improvement, the core of the company's operating model is the Fortive Business System.

LVMH Moet Hennessy Louis Vuitton SE announced it is acquiring Christian Dior Brand from the Arnault family for €6.5 billion, equivalent to 15.6x EBITDA (earnings before interest tax depreciation and amortization) in 12 months to March 2017. LVMH has a strong balance sheet in our opinion and can easily pay this with debt – the transactions leads to about 1.1x Net Debt/EBITDA proforma after the deal. Christian Dior (CDI) made around €415 million EBITDA in the year to end March 2017 with €150 million of depreciation leading to approxe €265 million EBIT. Assuming a circa 2% interest rate on the transaction the deal is circa €135 million accretive, equivalent to 2% enhancing for LVMH. This acquisition reunites the CDI brand with the very profitable perfume operation. At the same time the Arnault family is relinquishing its stake in Hermes to increase its stake in LVMH from 36% to 46%.

Energy Sector

U.S. land rig count increased by 15 rigs to 849 rigs (7th consecutive double digit gain). The rig count was driven by gains in Horizontal Oil (+10), Directional Oil (+5), Vertical Gas (+2), Horizontal Gas (+1), and Directional Gas (+1), partially offset by Vertical Oil (-4). Total horizontal land rig count is down 47% since the peak in November 2014. The Permian currently makes up 50% of all oil rigs.

U.S. horizontal oil land rigs increased by 10 rigs to 591 as gains in Eagle Ford (+5, now up 11 rigs in 3 weeks, which is largest 3 week gain since Dec 2012), Woodford (+3), Permian (+2), and "Other" (+1), were slightly offset by declines in Mississippian (-1).

Canadian rig count decreased by 14 rigs, but is up 136% from the level this time last year.

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

Crescent Point Energy Corp. reported a surprise quarterly profit as higher realized prices for oil offset a marginal fall in production. The company said total average production fell to 173,329 barrels of oil equivalent per day (boe/d) in the first quarter, from 178,241 boe/d a year earlier. The company's operating expenses rose 16.5% to C$11.89 per boe, while its transportation costs per boe dropped by about 4.5% to C$2.12. Crescent Point's average crude oil selling price was C$51.70 boe, compared with C$31.29 a year ago. The company reported a net profit of C$119.4 million, or C$0.22 per share, compared with a loss of C$87.5 million, or C$0.17 per share, a year earlier. Funds flow, a measure of the company's ability to fund new drilling, rose to C$427.1 million from C$378 million.

Veresen Inc., a holding of Portland Advantage Plus – Everest and McKinley Funds, became the subject of a friendly takeover offer from Pembina Pipeline Corp (PPL), which valued the company at $9.7 billion, including debt. The offer, structured as either cash or PPL shares, constituted a 22% premium to Veresen's stock last closing price before the announcement. The combined company will have a strong position in the Western Canadian Sedimentary Basin, home to the world's third largest crude reserves. After the deal with Veresen, Pembina will own about 5.8 billion cubic feet per day of gas processing infrastructure across Western Canada by 2018. The combined company will have about 3 million barrels of oil equivalent per day of pipeline capacity. Our funds started building their position in Veresen at the beginning of August 2016 and we are pleased that the offer price represents a significant premium to our acquisition cost, materially contributing to the funds' performance. In addition, Veresen has been a major contributor of dividend income for the two funds.

Financial Sector

Barclays PLC reported Profit Before Tax is +15% ahead of consensus. However, the beat is primarily in non-core and includes £300 million of one offs in core. £192 million one gain on asset sale in consumer cards and payments and another £98 million gain on Visa Europe. So stripping those out then group numbers are in line and core Profit Before Tax misses consensus by 12-15%. Impairments lower than expected which is encouraging. Core Equity Tier 1 of 12.5% is in line with consensus but with Risk Weighted Assets down -2% this is disappointing.

Fifth Third Bancorp reported Q1 2017 earnings per share (EPS) of $0.38. Consensus was $0.38. Operating revenues increased 1% and slipped 0.2% from Q4 2016. Tangible book increased 1.7% to $16.89. It posted a 7.8% Return On Equity (ROE) and 9.3% Return On Tangible Common Equity (ROTE). Its Core Equity Tier 1 ratio was 10.66%, up 37 basis points. Its average diluted share count increased 0.4%. Its reported net interest margin increased 16 basis points to 3.02%. Reported net interest income rose 3.3%.

Nordea reported a relatively straight-forward set of Q1 2017 results last week. Revenues were 1% ahead of consensus driven by Net Interest Income (+1%), Fees (+4%). Costs were marginally weaker and Loan Loss Costs better. Core Equity Tier 1 ratio is up 40 basis points Quarter on Quarter at 18.8% and 10 basis points better than expectations. Management are looking at Denmark or Finland as potential locations for the group HQ.

Royal Bank of Scotland Group PLC (RBS) - operating profit £1371 million versus consensus £942 million with beat across all lines. Income £3.2 billion ahead of consensus at £3 billion. Costs better at £1.8 billion versus £1.9 billion consensus. 14.1% Core Equity Tier 1 40bps versus 13.7% consensus. Tangible Net Asset Value 297p +1p versus consensus. Beat driven by Corporate Investment Bank. Separately, RBS has reached an out-of-court settlement with another batch of shareholders who alleged they were misled during a £12 billion cash call in 2008.

Standard Chartered PLC reported a statutory pre-tax profit of $990 million, compared with a profit of $500 million in the same period last year, excluding its private equity arm, which is being wound down. The bank's revenues were up 8% at $3.6 billion, but this was largely due to a big gain from trading in its own debt and the exclusion of losses from its private equity arm.

State Street Corporation reported Q1 2017 operating EPS of $1.21. Core was closer to $1.17. Consensus was $1.11. Higher than expected fee income (asset management and processing) combined with decent cost controls drove the beat and overshadowed weaker than anticipated net interest income. Its Return On Equity (operating) was 10.4%. Its Core Equity Tier 1 ratio is 10.9%. It repurchased $523 million of common stock in Q1 2017. Average diluted shares declined by 0.7%.

Activist Influenced Companies

Restaurant Brands International Inc. reported a drop in quarterly comparable-store sales at both coffee and doughnut chain Tim Hortons and fast-food chain Burger King. Comparable sales for restaurants open for at least 13 months slipped 0.1% at both Tim Hortons and Burger King. The fall at Burger King was primarily due to a 2.2% drop in U.S. comparable sales, while Tim Hortons' was impacted by a decline in Canada comparable sales. The drop in sales was offset by net restaurant growth of 5.1% at Burger King and 4.6% at Tim Hortons. Net profit attributable to shareholders was $50.2 million in the first quarter, largely unchanged from $50 million a year earlier. EPS was unchanged at 21 cents. Excluding items, the company earned 36 cents per share, beating analysts' average estimate of 35 cents, according to Thomson Reuters. Oakville, Ontario-based Restaurant Brands' total revenue rose 8.9% to $1 billion, beating analysts' average estimate of $990.3 million.

Canadian Dividend Payers

Barrick Gold Corporation reported Q1 2017 adjusted EPS of $0.14 versus consensus of $0.20. The key difference from reported EPS of $0.58 is the removal of $0.45/share in gains resulting from an impairment reversal at Cerro Casale due from Barrick's recent partnership agreement with Goldcorp. The operating EPS miss was primarily driven by substantially lower gold and copper volumes and higher cash costs compared to forecasts, slightly offset by lower exploration and evaluation expenses.

Northland Power Inc. confirmed that the 600 MW Gemini offshore wind farm achieved full completion on April 28, 2017, ahead of schedule and under budget of €2.8 billion.

Global Dividend Payers

Novartis AG reported solid headline Q1 2017 results with Group sales and Core Earnings before interest and taxation (EBIT) broadly in line with consensus. Pharma sales were in line and EBIT beat by 1%. Alcon was broadly as expected on sales and EBIT, offsetting weaker Sandoz performance on lower expected volume growth. Overall Core EPS at $1.13 was 2% above consensus, on higher income from Associates and lower financial charges.

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Pattern Energy Group Inc. announced it has acquired interests in the two wind projects that comprise the 324 MW Broadview Wind power facilities and associated independent 35-mile 345 kV Western Interconnect transmission line from Pattern Energy Group LP for $269 million, consisting of cash consideration of $215 million and an assumed project loan of $54 million. Broadview, which is located 30 miles north of Clovis, New Mexico, commenced commercial operations in late March.

Economic Conditions

U.S. Real GDP growth was reduced to 0.7% (annualized) in Q1 from 2.1% in Q4, modestly less than the consensus call (1.0%) recognising the "residual seasonality" issue, which has sliced an average of 1.1% from Q1 growth since 2003, and likely carved a similar amount this time. Conversely, **Nonresidential fixed investment** surged 9.4%, led by a 22% jump in structures and a 9% leap in capital expenditure. From a year ago, **real GDP growth** has slowed to 1.9%, suggesting that surpassing the moderate post-recession norm of 2.1% will be tough.

U.S. new home sales jumped 5.8% to 621,000 annualized in March, more than expected, to the second highest level in nearly a decade from a downwardly-revised tally in February. This extends the upward trend in place since 2011.

U.S./Canada - President Trump says he will be slapping tariffs of up to 24% on imported softwood lumber.

U.S. durable goods orders rose 0.7% in March, a bit weaker than expected on the headline, with a jump in transportation orders partly offset by weakness in computer products and autos. After some upward revisions, core capital goods orders have now posted gains in each of the past six months—that points to firming business investment through 2017.

Financial Conditions

The European Central Bank left rates unchanged last week.

The U.S. 2 year/10 year treasury spread is now 1.02% and the U.K.'s 2 year/10 year treasury spread is 1.01% - 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 4.03% (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 3.6 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 10.88 (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.

And Finally ......

Canadian Housing/Ontario mortgage market/Home Capital Group ....and Portland Private Income Fund: Recently there have been three noteworthy events:

(i) On April 20, 2017, the Ontario provincial government announced the Ontario Fair Housing Plan aimed at cooling the surging Toronto housing market, including a 15% non-resident speculation tax.

(ii) Ontario has moved to tighten oversight of syndicated mortgage investments: The Ontario government announced in its budget last Thursday that it will transfer responsibility for the syndicated mortgage sector away from the Financial Services Commission of Ontario (FSCO) and to the Ontario Securities Commission (OSC). The shift was recommended last year recognizing the significant increase in the syndicated mortgage sector over recent years and OSC's experience of policing securities products. Syndicated mortgages are mortgage investment products marketed by companies that finance real estate development using money provided by a pool of investors. Several mortgage firms have faced lawsuits in recent years from investors upset that development projects have not proceeded after companies faced financial difficulties. The shift of oversight to the OSC is consistent with the way syndicated mortgage products are regulated in other provinces. The shift follows recent publicity of some failing syndicated mortgage investments. CNBC News last week reported that 120 Chinese investors in Greater Toronto lost nearly $ 9 million, that Tier 1 Mortgage Corporation was issued a cease and desist compliance order by FSCO in October 2016 and that since then a trustee has been appointed to protect the interests of syndicated mortgage investors in sixteen Tier 1 real estate development projects. The Financial Post also mentions that First Commonwealth Mortgage Corp., also had its license suspended by FSCO last October and that Grant Thornton was appointed by the courts to administer eleven corporations involving Tier 1 real estate projects. A few weeks earlier a Globe & Mail article focused on Mortgage Investment Entities (MIE's) and the premise that more money than ever is chasing mortgage deals which, in turn, has caused interest rate compression for MIEs. As a consequence, MIE's have been faced with the decision to either let the yield fall or take on extra risk to keep yields up.

(iii) Challenges faced by Home Capital Group (HCG) (misconduct allegations by the OSC and funding issues) are intensifying market concerns related to Canada's housing market. The market's reaction clearly suggests that HCG's issues could spread across the sector.

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The disclosure from HCG that the embattled alternative lender had (1) experienced a 30% decline in its high-interest savings account balances over the past month; and (2) agreed to a $2 billion credit facility with a usurious 22.5% implied interest rate as a replacement; understandably spooked the market regarding the funding profile of the company, and resulted in considerable pressure on share prices across the independent mortgage spectrum. For perspective, As of February HCG had ~$16 billion in residential mortgage loans outstanding; by comparison the six big banks plus Canadian Western and Laurentian ended Q1 2017 with total domestic residential real estate exposure of $1,175 billion. In other words, HCG has a ~1% market share and there is no indication, in our view, of credit deterioration in the mortgage portfolio of HCG (delinquency rate is < 0.21%). And since the market is more focused on the funding of these loans rather than on their credit quality, it is important to differentiate the diversified funding structures of Big-6 banks relative to HCG's (and others) that rely in large part on a single source: broker deposits. The hefty cost associated with the $2 billion financing once again underscores that a stable funding profile is the lifeblood of the banking system, and a disruption in this regard will destabilize a lender even when capital and credit quality are not an issue. HCG revealed last Thursday that it has hired RBC Capital Markets and BMO Capital Markets to advise on "strategic options" for the troubled lender, which was understood to mean the company's board is at least considering a potential sale.

Taking each issue in turn and its impact on Portland Private Income Fund (PPI). We wrote in PPI's 2016 Annual Report that since mid 2015 we have been gradually reassessing the attractiveness of the housing market compared to commercial opportunities and in particular the heightened evidence of overvaluation in Toronto spreading to more adjacent cities, causing the moderation of the fund's exposure to mortgages. Earlier we shunned exposure to mortgages in the condo market in downtown Vancouver or Toronto and so now welcome the macro prudential efforts underway to engineer a cool down in prices. We do source commercial mortgages from MarshallZehr Group Inc. (MZ), a licensed mortgage broker which we have worked alongside for several years; we both welcome the tightening oversight of the syndicated mortgage market and expect the differences between how MZ and other well practised firms operate, will shine through compared to those brokers now losing their licenses and present attractive opportunities. MIE's are not a homogeneous group and should be viewed as a "sector" only in the broadest of terms. PPI lends short term to developers and not long term to individuals labelled by FICO as rating below scores of 660 and by banks as sub-prime. Portland lends to developers known to MZ based on an understood exit, typically take-out financing as the development progresses or verified presales. In a capital structure equity holds the greater risk and is the cushion against which debt can be repaid. As of March 31, 2017, the weighted average loan-to-value of the mortgage portion of the Fund's portfolio was 73% and its securities consisted primarily of first mortgages. In our view it would take a decline in value in the order of greater than 25% to put the fund's portfolio of mortgages at risk from a tangible collateral perspective and typically all the mortgages to developers are also secured by corporate or personal guarantees. Banking requires confidence, requires liquidity. Without confidence, there is no liquidity. Without liquidity, a financial company will struggle to survive – as being evidenced by the gyrations of HCG. Funding HCG's long term liabilities with short term broker deposits required constant confidence; recent quarterly reports and seeming lack of transparency undermined confidence. The requirement to shore up liquidity with a 'bazooka' –type credit facility on very expensive terms has undermined the equity value of HCG but likely not impinged the credit worthiness of HCG's debt as the mortgage assets now securing that commercial line are likely more than adequate. Of course, given the large banks are now embarking on introducing mortgage-backed securities to the Canadian market, those banks have an interest in maintaining orderly markets but this credit line to HCG is opportunistic and attractive and is likely the kind of commercial loan that Crown Capital Inc., a specialty investment manager of PPI, would entertain.

Christopher Wain-Lowe

Mutual Funds

Portland Investment Counsel Inc. currently offers 8 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
- Portland 15 of 15 Fund

Private/Alternative Products

Portland also currently manages the following 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

Individual Discretionary Managed Account Models - SMA

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