News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. June 30, 2017

Owner Operated Companies

Alphabet Inc. (GOOGL) – Not surprisingly, the largest EU regulatory fine has seen a lot of press. At its face value, a $2.7 billion cash fine is an impact of just over 40 basis points (bps) relative to GOOGL's market capitalization. The initial market reaction, which put GOOGL about 2.5% lower, while outsized relative to the fine's impact, was relatively muted, compared to the tech selloff from a couple of weeks ago, triggered by valuation concerns. That said, the market pull-back prices-in the fine's impact and allows for contingencies (more than 5x the size of the fine). The announced fine is in relation to GOOGL's use of its search engine in relation to its own and competitor price comparison applications. The probe was launched more than 7 years ago and GOOGL has the option of appealing (which has announced it would), essentially on the basis of its rights to monetize a service which is otherwise free of charge to its users. The fine may be overturned or significantly altered/diminished as a result of the appeal process. Other probes open with the EU include GOOGL's use of its Android platform, its advertising practices as well as the use of its maps and local searches, with some in earlier stages. Of interest, Margret Vestager, the EU Commissioner on Competition until 2019, has made a name for herself as a fierce fighter for increased competition in many sectors within EU's boundaries. While well within the scope of her job, we believe it is not lost on many that the target of her anti-trust rulings have overwhelmingly been U.S. companies. Some of the targeted companies in the past include Apple, Microsoft and Intel. It is possible that the US administration pushes back and the issues are approached in the broader context of re-negotiated "fair trade" agreements. We believe such regulatory challenges are the cost of doing business and are unavoidable in a fast changing industry where a limited number of players achieve market dominance. We believe GOOGL, as well as other Silicon Valley companies in the regulator's cross-hairs, has the wherewithal to negotiate an industry structure that is efficient, profitable and satisfies antitrust concerns.

Walgreens Boots Alliance, Inc. - In a surprise move yesterday, Walgreens terminated its Rite Aid Corporation merger agreement and instead will buy only half of Rite Aid, providing it the opportunity to expand its footprint by about 2,000+ stores, buy back shares, and perhaps satisfy regulators – this unexpected twist should provide Walgreens the added scale it sought and sizable synergies (about $400 million) within 3-4 years, and it looks structured to address the competitive concerns raised around the prior deal by the regulator in our view. The smaller deal sees Walgreens announce a $5 billion share repurchase program - all said, this does look like a better deal in our view. Walgreen is focused on Long-Term value-creation, particularly with respect to changing the game for its U.S. operations and building a broad global healthcare enterprise.

Walgreens reported better-than-expected profit and sales for the third quarter, helped by a rise in prescription volumes in its U.S. pharmacy business. The company also authorized a $5 billion buyback program and raised the lower end of its full-year profit forecast by 8 cents per share to a range of $4.98 to $5.08. Analysts on average were expecting full-year profit of $4.96 per share, according to Thomson Reuters.

Energy Sector

Nothing new to report.

Financial Sector

U.S. Banks – all 34 banks tested, passed the Comprehensive Capital Analysis & Review (CCAR) capital adequacy tests. The results show an expectation of **returning over $130 billion of capital back to shareholders over the next 4 quarters** in the form of dividend and share repurchases, up over 35% from the prior 4 quarters, suggesting attractive all-in yields for instance: **Bank of America Corporation expects:** $0.12 dividend and $12.9 billion gross buyback ; **Citigroup Inc.**: $0.32 dividend and $15.6 billion gross buyback, suggests an all-in yield of about 10.8%; **Citizens Financial Group Inc.** - $0.80 dividend (42% up) and $850 million buyback; and **JPMorgan Chase & Co.**: $0.56 dividend and $19.4 billion gross buyback, suggests an all-in yield of about 8.5%. **Fifth Third Bancorp**: $0.16 dividend now, $0.18 for Q2 2018; $1.16 billion buyback; **Morgan Stanley** - buyback of $5 billion and a quarterly dividend of $0.25; **State Street Corporation**: $0.38 dividend and $1.4 billion buy back; and **Wells Fargo & Company**: $0.39 dividend and $11.5 billion buyback.

Berkshire Hathaway Inc. / Bank of America's 2017/18 capital plan includes an increase in the common dividend to $0.48/share annually (from $0.30/share currently). Warren Buffett stated in his 2016 annual shareholder letter that if Bank of America's annual dividend were to rise above $0.44 before 2021, **Berkshire Hathaway** would anticipate making a cashless exchange of its Bank of America preferred shares into common shares. Berkshire invested $5 billion in Bank of America preferred shares in 2011. The preferred shares have a 6% coupon plus 700 million of attached warrants of Bank of America common stock which expire in 2021 and are exercisable for an additional $5 billion ($7.14/share). The primary value in this investment is in the warrants. Berkshire's unrealized investment gains on the Bank of America warrants are currently $12 billion and are included in Berkshire's book value. This morning Berkshire

Hathaway issued a press release confirming that when Bank of America increases its quarterly dividend to $0.12 (which we expect in late July) it will exercise its warrants to acquire 700 million shares of Bank of America common stock at the exercise price of $7.142857 per common share ($17.0 billion value). Pursuant to the terms of the warrants, Berkshire Hathaway expects to use its $5 billion of Bank of America 6% Preferred Stock that it currently owns as the consideration to acquire the shares. This would make Berkshire Bank of America's largest shareholder (about 7%). It is already the largest shareholder in Wells Fargo and Todd Combs, who is an investment officer at Berkshire is on JP Morgan's board of directors. In April, Berkshire announced plans to sell Wells Fargo shares to keep its ownership below 10%.

Activist Influenced Companies

Nothing new to report.

Dividend Payers

Bunzl PLC - Revenue in the first half was up 19% year/year, made up of 3-4% organic, 4% from acquisitions and a 12% impact from currency. It implies trading in the second quarter is better than the first (where the group posted organic growth of 2% in Q1 (from 1.5% in Q4)), as the previously announced contract wins in the U.S. and U.K. ramp up. **In North America**, work relating to the grocery contract has phased in more quickly than expected, with the region running at 6%. **The U.K.** was flat in the half, with the work relating to Compass expected to phase in more gradually. **Rest of World** – Australia and Brazil are now doing slightly better following difficult trading conditions last year.

Nestlé SA announced the outcome of a strategic review with the aim of getting the right balance between Earnings Per Share growth, shareholder returns, external growth and access to financial markets. The announcement is unlikely to be a reaction to recent news related to Third Point LLC, but much more the outcome of a thorough strategic review triggered by CEO Mark Schneider. Capital spending with priority on Coffee, Pet Care, Infant Nutrition and Water as well as on high-growth regions. Acquisitions in Consumer Healthcare are also targeted; sizeable ones are not ruled out. Further margin improvement on the agenda (efficiency programs), but without jeopardizing long-term performance. Nestlé will launch a CHF 20 billion buyback on July 4, 2017 to be completed by end of June 2020. The program will be backloaded in 2019/20. Expected net debt to Earnings Before Interest Tax Depreciation and Amortisation of 1.5x by 2020.

Pattern Energy Group Inc. (PEGI) – Pattern Energy Group, Riverstone Holdings, and PSP Investments have announced a series of initiatives to increase Pattern's long-term growth and enhance its access to capital. The arrangements expand Pattern Development's renewable project pipeline to 10GW total capacity, including an additional 275MW of owned capacity to the identified right of first offer (ROFO) list. There is U.S. $724 million in new long-term funding commitments for investment vehicle Pattern Development 2.0, primarily from major institutional investors through a Riverstone managed investment entity as well as a U.S. $60 million initial investment by Pattern Energy, for a roughly 20% interest in Pattern Development 2.0. PSP Investments will acquire 8.7 million shares (9.9%) of Pattern Energy stock from Pattern Development 1.0 and co-invest U.S. $500 million in projects acquired by Pattern Energy under the company's ROFO with Pattern Development, including investments in the Meikle, Mont Sainte-Marguerite and Panhandle 2 projects. Pattern Energy acquired a 51% interest in the 179MW Meikle project for U.S. $65 million and a 51% interest in the 143MW Mont Sainte-Marguerite project for US $40 million, and sold 49% of Class B interest in its 182MW Panhandle 2 project to PSP Investments. The initial investment by Pattern Energy in Pattern Development 2.0, Meikle and Mont Sainte-Marguerite, net of the Panhandle 2 proceeds, will require U.S. $106 million from Pattern Energy, which will be funded from available liquidity, with no capital raise required.

Economic Conditions

Canada – Canadian economy expanded at a 0.2% pace in April, in line with the expectations and building on March's 0.5% advance. The advance was driven by the retail and transportation sectors, but also by the mining sector, partly offset by a pullback in manufacturing.

U.S. housing prices, as measured by the CaseShiller price index for 20 U.S. metropolitan areas, continued to appreciate in April, though, at a 5.7% year on year rate of change, slightly short of the expectations for a 5.9% pace and March's 5.9% rate. US pending home sales retreated by 0.8% in May, in contrast to expectations for a 0.8% rebound from April's 1.7% pull-back.

U.S. consumer sentiment improved in June, on the basis of the measurement provided by the Conference Board, with the consumer confidence index up to a 118.9 index points level. In contrast, the University of Michigan's measurement of the consumer sentiment worsened in the month, from 97.1 points to 95.1 points, tough at a slower pace relative to the expectations. The "current conditions" component of the University of Michigan's composite index actually improved in May, to 112.5 index points from 111.7 index points, more than offset by the "expectations" component.

U.S. Personal spending rose 0.1% in both nominal and real terms in May, with the latter slowing from 0.2% and 0.6% in the previous two months. This keeps consumer spending on track for a 2.8% annualized gain in Q2, supporting estimations for 2.7% GDP growth in the quarter. Worker compensation also cooled to a 0.1% pace after jumping in April, though personal income was juiced by an outsized dividend payout (even before the Fed's latest positive stress test results). The saving rate jumped to 5.5%, providing some cushion for a rainy day. Cheaper gas reduced PCE prices, lowering the yearly inflation rate to 1.4% from 1.7%. Core prices rose a mild 0.1%, trimming the yearly rate to 1.4%, down from a recent cycle-high of 1.8% earlier this year. While lower cell phone charges and physician fees are weighing temporarily, there's little upward pressure on inflation from still-contained wage costs. In fact, the three-month advance in core prices (0.3% annualized) is the slowest since the recession. That's good for purchasing power in our view.

Financial Conditions

The Bank of England plans to increase capital requirements for U.K. lenders by £11.4 billion ($14.5 billion) to tackle risks posed by the recent rapid growth in consumer credit and prepare for the uncertain outcome of Brexit talks. The Bank of England set the countercyclical capital buffer at 0.5% of risk-weighted assets for U.K. loans effective in June 2018, and if nothing material changes the central bank plans to increase the level again to 1% in November. Additionally, next month regulators will publish new guidelines for consumer lending to ensure risks are priced and managed appropriately. "We want to move the levels of capital back up to the level they should be - any time you move into more benign credit conditions there have been fewer defaults," which can lead to complacency, Governor Mark Carney said on Tuesday.

The U.S. 2 year/10 year treasury spread is now .92% and the U.K.'s 2 year/10 year treasury spread is .90% - 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 costs of capital.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.88% (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 4.2 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 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 10.81 (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 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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