News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. July 27, 2017

Owner Operated Companies

Alphabet Inc. reported a 21% jump in quarterly revenue, maintaining a growth rate that is rarely seen among companies its size. Alphabet, the owner of Google and YouTube, said it made $3.5 billion in net income on sales of $26 billion. The profit would have been much larger but for a record $2.7 billion European Union antitrust fine. The company noted that costs were rising faster than sales and warned that expenses would remain high as more searches shift to mobile devices. With its latest profits, Alphabet reported $15.7 billion in cash and cash equivalents, and another $79 billion in marketable securities. This year, Google is expected to have $73.75 billion in net digital ad revenue worldwide while Facebook is expected to take in $36.29 billion, according to research firm eMarketer. Together they will have about 49% of the market, eMarketer said. Adjusted for the European Union antitrust fine, Alphabet said that earnings per share (EPS) would have been $8.90 in the second quarter, compared with $7 a year earlier. With the fine, Alphabet reported earnings per share of $5.01, beating an average estimate of $4.49. Google's ad revenue rose 18.4% to $22.67 billion. Revenue from other Google products, a category that includes the Pixel smartphone, the Play Store and Google's cloud business, rose 42.3% to $3.09 billion. Losses from other Alphabet units - that includes the Waymo self-driving car company, thermostat-maker Nest and the life sciences firm Verily narrowed to $772 million from $855 million a year earlier.

Energy Sector

Crescent Point Energy Corp. (CPG) posted a quarterly profit, compared with a year-earlier loss, helped by higher realized oil prices and an increase in production. The company's net income was C$83.6 million, or 15 cents per share, in the second quarter ended June 30, compared with a loss of C$226.1 million, or 45 Canadian cents per share, a year earlier. The company's production, operating cash flow and adjusted earnings were ahead of the consensus expectations. The production beat was driven, presumably, by strong drilling results at the company's Uinta (Utah) field, where extended reach horizontal wells have delivered impressive initial production rates. CPG increased its average production guidance for 2017 by 5%. Standing out from the announcement is a series of non-core asset sales, to amount to roughly C$350 million for the second half of 2017 (of which about half is nearly finalized) in addition to an already closed disposition of the company's Manitoba assets for about C$93. CPG spent around C$100 million for land around its existing Uinta position. Despite disposals, CPG expects to exit '17 at the same level, guided before (i.e. 183,000 barrels of oil equivalent per day (boed)), but with about $340 million extra on hand.

Royal Dutch Shell PLC - Adjusted earnings of $3,604 million were 14% ahead of consensus, adjusted earnings before interest and tax (EBIT) of $4,037 million was 12% ahead of consensus, driven mainly by a stronger than expected downstream result in particular Oil Products. Upstream production of 3,495 kboed (thousands of barrels of oil equivalent per day) was 3% below forecast but flat year/year. It's estimated the upstream net income per barrel of $4.7/boe, up $6.1/boe year/year which compares to the $4/barrel increase in the Brent oil price. On a divisional basis, upstream net income of $339 million was $101 million above consensus. Reported cashflow from operations of $11.3 billion was close to 5x the level a year ago with a release of working capital of $2.3 billion. Excluding working capital movements, it is estimated the underlying cash flow of $9 billion was up 89% year/year. With cash capital expenditure of $5.8 billion and dividends payments of $3.1 billion, there was a positive free cash flow post capex and dividends of $0.1 billion. Net debt of $66.4 billion was down 8% quarter/quarter. Hence, gearing (net debt to capital) of 25.3% was down 2% quarter/quarter.

Total SA - Adjusted net income of $2.5 billion was 8% ahead of the company compiled consensus. Net operating profit of $2.8 billion was in-line with estimates, driven mainly by a stronger than expected Upstream results, partly offset by a weaker than expected Refining & Chemicals contribution. Upstream production of 2,500kboed was in-line with forecast, up 3% year/year. It is estimated the upstream net income per barrel of $6/boe, up $1.3/boe year/year and compares to the $4/barrel increase in Brent oil price. On a divisional basis, upstream net operating profit of $1.4 billion was $159 million above consensus. Reported cashflow from operations of $4.6 billion was up 61% year/year with an implied build of working capital of $0.7 billion. Excluding working capital move, reported underlying cash flow of $5.3 billion was up 33% year/year. With organic capex of $3.9 billion and dividends payments of $1.5 billion, there was a negative free cash flow post capex and dividends of $0.1 billion. Net debt of $22 billion was 7% lower quarter/quarter. Hence, gearing (net debt to equity) of 20.3% was down 2% quarter/quarter.

Financial Sector

Citigroup, Inc. has signalled it will hand over at least $60 billion to shareholders over the next three years as the U.S. bank tries to move on from a protracted period of post-crisis restructuring. Speaking at Citi's first investor day since 2008, chief executive Michael Corbat recognised that returns had disappointed shareholders but insisted the bank had "crossed an inflection point". "Our restructuring is over," he said. Citi said it would generate a return on tangible common equity of about 11% in 2020, up from 7.8% in the past 12 months. Capital distribution would boost shareholder returns, Mr. Corbat said. Share buybacks would help EPS grow in the "high teens" by 2020. The bank said, however, that the cumulative $60 billion return figure was not a formal target but a way of reaching the return goal. (Source: Financial Times)

Royal Bank of Scotland Group PLC (RBS) - The UK government moved closer to selling some of its 71% stake in Royal Bank of Scotland after agreeing a deal with Brussels over the bank's £45.5 billion bailout during the financial crisis. RBS said on Wednesday that the European Commission had "agreed in principle" to its revised £835 million plan to boost competition in the UK's small business banking market, as a condition of having received state aid. The plan involves providing funding to RBS's rivals, and a scheme to incentivise some RBS business customers to move their accounts and loans. It will also include money to cover the cost of customers switching banks. The deal nearly draws to a close a seven-year state aid process for RBS, which has been subject to numerous delays. The state aid obligation has served as a major obstacle to the government's plans to sell down its stake in the bank. (Source: Financial Times)

State Street Corporation reported second quarter EPS of $1.53, inclusive of higher than forecast restructuring charges ($0.11 per share); consensus was at $1.57. Factoring out those higher charges, results were better than forecast. Upside was revenue driven. Net interest income was driven by 10 basis points of Net interest margin expansion (higher short term interest rates and liability mix improvement); higher than forecast investment management fees (market value appreciation and foreign exchange impact driving that momentum with continued realization of savings related to State Street Beacon project. Asset servicing grew 4% to a record $31.0 trillion, amid strength in equity markets and new business. New asset servicing mandates during Q2 2017 totaled $135 billion (up from $110 billion in Q1 2017). Servicing assets remaining to be installed in future periods were $370 billion ($375 billion in Q1 2017). Assets Under Management rose 2% to $2.6 trillion, also an all-time high. Still, net institutional flows were -$28 million with outflows in long-term institutional (-$22 million), ETFs (-$4 million) and cash funds (-$2 million). Still, market appreciation (+$56 billion) and the FX impact (+$17 billion) aided results. Management now expects fee revenue growth in the 6-7% range (vs. prior guidance at the middle to upper end of a 4-6% range); Net interest income outlook increased to $2.43-$2.45 billion (vs. prior guidance at the upper end of $2.27-$2.3 billion range).

Activist Influenced Companies

Brookfield Business Partners L.P. said it would buy 60% of Teekay Offshore Partners, a subsidiary of marine transportation provider Teekay Corporation, for about $750 million. Brookfield said it would invest $610 million to buy the stake in Teekay Offshore and will also acquire a $200 million loan given by Teekay Corp. to Teekay Offshore. Teekay Corp. in a separate statement said, following the transaction, it would own 14% percent of Teekay Offshore. Teekay Offshore provides a wide range of marine services including transportation, oil production, storage, towing and offshore installation and maintenance and safety services to the oil industry, primarily focusing on the offshore oil regions of the North Sea, Brazil and the east coast of Canada. Teekay Offshore has consolidated assets of $5.6 billion and its fleet of 62 offshore vessels provides critical services to its customers.

Dividend Payers

AT&T, Inc. reported second quarter profit, which exceeded the street's estimates as the No. 2 U.S. wireless carrier introduced new promotions bundling video with phone service that helped to attract customers. Net income attributable to AT&T rose to $3.9 billion, or 63 cents per share, in the second quarter ended June 30, from $3.4 billion, or 55 cents per share, a year earlier. Excluding some items, EPS were 79 cents, ahead of analysts' average estimate of 73 cents per share, according to Thomson Reuters I/B/E/S. Revenue declined to $39.8 billion from $40.5 billion in the year-ago period, in-line with the expectations. Churn, or customer defections among phone subscribers who pay a monthly bill, was 0.79%, the lowest in the company's history, AT&T said.

Barrick Gold Corporation announced second quarter net adjusted earnings of $0.22 which came in above the consensus estimate of $0.17. The strong financial result was largely fueled by a massive 509 Koz (thousands of ounces) of performance from Cortez accounting for more than a third of the company's Q2 gold production of 1.43 Moz (millions of ounces). Barrick generated only $43 million in free cash flow (FCF) in the quarter due to higher capital costs associated with the Veladero leach pad works, waste stripping in Nevada and due to the Tanzania concentrate export ban (Acacia) and higher cash taxes. Despite the near term restriction in FCF, Barrick still managed to improve its debt position by $309 million from the previously announced asset sales (Cerro Casale, 50% of Veladero). The goal remains to have less than $5 billion in debt at the end of 2018 with only $200 million currently due before 2020. The improved balance sheet is integral to Barrick's ability to fund its new wave of capital intensive development projects in our view (e.g., Goldrush, Alturas, Cortez UG, Lagunas Norte).

Bunzl PLC has announced three acquisitions with annual revenues of £134 million and a purchase cost of £240 million. Collectively the deals would add nearly 2% to group revenue next year and more to earnings before interest tax and amortization (EBITA) as their margins are above the group average. If approved, it takes spending this year to £530 million, a record level for the group, surpassing the previous high - £324 million in 2015 - by more than 60%. The group has paid a higher multiple than we would typically see for the largest deal of the three – a French cleaning & hygiene business, Heidis, but we view that as justified by the strategic importance of the asset and significant potential synergies. Hedis is a family-owned national player with sales of €131 million in 2016 and margins above Bunzl's Continental Europe average of 9.4%. It's estimated Bunzl has agreed to pay in the region of €210 million (£186m) for Hedis, which would imply an Enterprise Value/EBITA multiple of 12x. This is above the typical 8x Bunzl multiple due in large part to the larger size of the business and management expects synergies over the next three years to reduce the multiple to 8-9x. Also a business called Comptoir de Bretagne and Générale Collectivités were acquired. This represents Bunzl's first entry into catering equipment in France. It has similar operations in the UK (a business called Lockhart) and in Australia. The business has sales of €24 million (£21 million). A business called Pixel Inspiration has also been bought. It provides digital signage to companies, including the hardware, installation and consultancy services.

Compass Group PLC's has reported performance since March 31, 2017. Organic revenue growth in the third quarter was 3.9% (up 5.0% excluding the impact of Easter). Growth accelerated in the quarter with strong net new business in North America, good progress in Europe, and a challenging - but improving - environment in Rest of World. For the nine months to June 30, 2017 organic revenue growth was 3.7%. The group's ongoing commitment to generating efficiencies in the business continues to be supported by its management and performance (MAP) programme. The end of the restructuring programme in its Offshore & Remote business also contributed to the improvement in the operating margin in the quarter. Overall, the operating margin for the nine months to June 30, 2017 increased by 20 basis points. In the nine months to June 30, 2017 Compass bought back £19 million in shares and on July 17th paid a £1 billion special dividend in line with its policy of returning surplus cash to shareholders. The group issued a £300 million sterling bond and a €750 million euro bond with a blended rate of 0.93% to fund the special dividend. As a result, at the end of our fiscal year net debt to earnings before interest tax depreciation and amortisation (EBITDA) is expected to be around 1.7x. Going forward, management will continue to maintain a strong investment grade rating by targeting net debt to EBITDA of around 1.5x.

Diageo PLC - The 2017 Revenue growth of 4.3% compares to consensus +4.2%. Earnings before interest and tax (EBIT) growth of 5.6% compares to consensus +5.1%. On an absolute basis underlying EBIT was in line at £3.6 billion but EPS came in 3% ahead at 108.5p. North America (49% of EBIT): profit growth actually fell short of expectations (+4% vs. consensus +5.9%) but the underlying momentum looks good, in our view. Diageo report that they have taken market share in every category apart from the (admittedly important) vodka. Flat Smirnoff volume depletions (sales still down on inventory reduction) and outperformance of Captain Morgan in the rum category suggest the core is slowly being fixed. Europe, Russia & Turkey (25% of EBIT): 8% organic EBIT growth was better than expected (+6.5%). Asia Pacific (13% EBIT): along with Africa, this division provided one of the bigger surprises of the results. 4% organic growth (consensus -1%) was achieved despite the current headwinds in India. 25% sales growth in China is notable, driven by Chinese White Spirits (+69%) and 5% growth of Scotch. Scotch in particular has been a headwind in China, so the return to growth is significant. Africa (7% of EBIT): grew 10% consensus (6%) where Diageo's push towards mainstream spirits and affordable beer seems to be working (divisional sales +5%) in an unhelpful macro environment. Zero based budgeting and cost savings are behind the profit performance. Management have declared a new share buyback programme which aims to return £1.5 billion of cash to shareholders in 2018. The weighting of the actual buyback is likely to be second half weighted, so the full benefit from an EPS perspective is unlikely to fully evident until 2019.

LVMH Moet Hennessy Louis Vuitton SE reported solid 1st half 2017 results. Sales growth was better than expected and profit from recurring operations came in in line with forecasts, despite a number of temporary and/or one-off effects. The group's two key value drivers, LV and Hennessy are in particularly rude health, and FCF generation hit a new record. Wines & Spirits: Cognac posted a solid Q2 2017 and H1 2017, with volumes up 16% over the period. The Cognac & Spirits activities as a whole posted a sharp (250bp) improvement in operating margins to 34.8%. Champagne volumes increased 8%, and margins here also improved (by 160bp). The division's growth is set to slow in H2 2017, also as a result of capacity constraints (accentuated by the impact of adverse weather on harvests). Fashion & Leather Goods: Sequential sales growth slowed from 15% in Q1 2017 to 13%, in line with expectations. However, operating margins improved more significantly that forecast (+410bp). LV was clearly a key drive in this respect. However, we believe that dilution from the other brands has also declined. Fendi's performance continues to improve, and Céline, Kenzo, Berluti and Loewe all reported solid growth. Losses from Marc Jacobs also declined as some initial signs of improvement are emerging. The net impact from M&A activity (the sale of Donna Karan, and acquisition of Rimowa) has also been positive with respect to profitability. Watches & Jewellery: Growth was stronger than expected in Q2 2017. Bulgari again performed particularly well, with the watch activities also having returned to growth. Hublot and TAG Heuer also generated solid growth, outperforming the industry. Free cash flow generation was excellent in our opinion, and hit a new record for an 1st half. Improved profitability was compounded by good net working capital control, and a moderate increase in capex. Net debt thus came in at a better than expected €3,957 million.

Nestlé SA - 1st half organic sales grew by 2.3% (consensus 2.7%), of which 0.9% was price. The deconsolidation of European ice cream sales and a small foreign exchange headwind meant reported sales fell by 0.3% to Swiss Francs (CHF) 43.0 billion. Organic sales grew by 0.8% in developed markets, with growth in Nespresso and c3% growth in Water (helped by weather in Europe), offset by softness in infant nutrition, skin health and confectionery. Organic sales grew by 4.4% in Emerging Markets driven by pricing (2.5%) and decent volume growth in Asia/Africa (ambient culinary). Trading operating margin decreased by 30 basis points to 15.0% (consensus 15.2%), reflecting a 10 basis point increase in the 'clean' margin offset by higher restructuring. Underlying EPS increased by 2% (constant currency 3%) to CHF1.68 (consensus CHF1.68). CEO Schneider has narrowed full year organic sales growth guidance to "the lower half" of the previous 2-4% range, but maintained guidance for a "stable" trading operating margin and constant currency growth in underlying EPS.

The Procter & Gamble Company (P&G) reported another quarter of market-beating quarterly profit, helped by cost-cutting, and forecast a full-year profit that topped estimates. P&G's report comes amid rising pressure from investors, including activist Nelson Peltz, to prop up its stock price and sales, which have lagged those of peers such as Unilever Plc. Peltz, who owns a $3.3 billion stake in the company through his Trian Fund Management LP, is seeking a board seat. While P&G's organic sales rose 2% in the latest quarter, Unilever's increased 3% in the same period. P&G's net sales were flat at $16.08 billion in the quarter. Growth in organic sales, which excludes acquisitions and foreign exchange rates, were boosted by a 5% rise in sales in its beauty segment, which sells brands such as SK-II and Olay, and fabric & home care segment, which sells brands such as Febreze. Selling, general and administrative expenses fell 7% in the quarter. Net income attributable to the company rose to $2.22 billion, or 82 cents per share, in the three months ended June 30, from $1.95 billion, or 69 cents per share, a year earlier. Excluding items, the company earned 85 cents per share.

Roche Holding AG reported stronger than expected 1st half results: core operating profit CHF10,135 million coming in ahead of consensus driven by strong Q2 sales from the pharma division which delivered sales of CHF10,344 million, up 7%, well ahead of the 3% posted in Q1 and beating consensus forecasts (CHF10,064 million) by 2.7%. The beat came out of strong sales development in the U.S. which rose 10% on the back of an extremely strong launch of Ocrevus (multiple sclerosis), which reported sales of CHF192 million in the quarter (CHF191 million in U.S.) after launch in April. Tamiflu sales in the quarter CHF94 million were also strong (CHF37 million). First half sales rose 5% in constant currencies to CHF26,344 million, ahead of consensus forecasts for CHF 26,124m on the strength of the Q2 sales performance. Core EPS increased by 6% to CHF 8.23, well ahead of expectations for CHF8.0 (Bloomberg consensus). Roche lifted full year guidance to mid-single digit sales growth.

Economic Conditions

U.S. existing home sales took a bigger-than-expected 1.8% drop in June to 5.52 million units annualized, the lowest level since February. All of the weakness was in single-family homes (-2.0%). But as the number of homes available for sale were down 0.5% in June and are 7.1% below year-ago levels, options are limited, and prices are rising (@ record high in June). Months' supply of 4.3 is pretty low. Not a good combination for the homebuyers out there (but great for homeowners).

U.S. – The U.S. durable goods jumped 6.5% in June, ahead of the expectations for a 3.0% improvement, driven by a leap in the usually lumpy aircraft orders, up 131% in the month. Excluding transportation orders, durable goods orders were up only 0.2% in the month, compared to 0.6% in May and just short of the expectations for a 0.4% advance.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .95% and the U.K.'s 2 year/10 year treasury spread is .95% - 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 3.92 (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 4.4 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 9.26 (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

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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