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. September 25, 2017

Owner Operated Companies

Alphabet Inc. – Google said it would pay $1.1 billion for the division at Taiwan's HTC Corporation that develops the U.S. firm's Pixel smartphones - its second major foray into phone hardware after an earlier try. While Google is not acquiring any manufacturing assets, the transaction underscores a ramping up of its ambitions for Android smartphones at a time when consumer and media attention is largely focused on rival Apple Inc. The move is part of a broader and still nascent push into hardware that saw Google hire Rick Osterloh, a former Motorola executive, to run its hardware division last year. It also comes ahead of new product launches on Oct. 4 that are expected to include two Pixel phones and a Chromebook. Pixel smartphones, only launched a year ago, have less than 1% market share globally with an estimated 2.8 million shipments, according to research firm IDC. Google will be aiming not to repeat mistakes made when it purchased Motorola Mobility for $12.5 billion in 2012. It sold it off to China's Lenovo Group Ltd. for less than $3 billion two years later after Motorola failed to produce appealing products that could compete with iPhones. This time around, however, the deal price tag is much smaller and the lack of manufacturing facilities also minimizes risk.

Carnival Corporation – Fincantieri, leader in cruise ship design and construction, and Carnival Corporation & plc, the world's largest cruise company, announced the signing of a memorandum of agreement (MoA) for the construction of one next-generation cruise ship for the iconic luxury brand Cunard. The ship will be built at the Monfalcone yard and join the Cunard's fleet in 2022. The 113,000 ton ship will carry 3,000 guests and be the 249th to fly the Cunard flag, the first since 2010 when Fincantieri delivered the "Queen Elizabeth", three years after the "Queen Victoria" was built in 2007. Marking the first time since 1998 that the luxury cruise brand will have four ships in simultaneous service. Fincantieri has built 78 cruise ships since 1990 (55 from 2002), 63 of which for Carnival's different brands, while other 33, including agreements, are currently being designed or built in the Group's yards, 9 of which for the shipowners of Carnival.

Walgreens Boots Alliance, Inc. – U.S. antitrust regulators have allowed a slimmed-down deal for drugstore chain Walgreens to buy about 42% of Rite Aid Corporation's stores for $4.38 billion, Walgreens said on Tuesday. Walgreens will acquire 1,932 Rite Aid stores, 254 fewer than it announced in July, in areas where competition between the two chains is not significant. The deal, which widens Walgreens' footprint in the U.S., began as an offer made in October 2015 to buy all of Rite Aid's 4,600 stores. But Walgreens failed to win approval for that $9.4 billion deal and restructured it. Walgreens operates stores under its own name as well as Boots stores in Britain and Duane Reade stores in the U.S. Under the deal, Rite Aid has the option of joining Walgreens' group purchasing agreement to negotiate discounts on generic drug prices. Walgreens said it will also buy Rite Aid's three distribution centers in Connecticut, Pennsylvania and South Carolina.

Energy Sector

U.S. land rig count decreased by 2 rigs to 913 rigs week/week, which is the second consecutive week of declines and has now declined in 5 of the last 7 weeks. The rig count was driven by declines in Horizontal Oil (-6) and Vertical Oil (-1), offset by gains in Directional Oil (+2), Horizontal Gas (+1), Vertical Gas (+1), and Directional Gas (+1). Total horizontal land rig count is down 42% since the peak in November 2014. The Permian currently makes up 53% of all oil rigs.

U.S. horizontal oil land rigs decreased by 6 rigs week/week to 636, marking 7 consecutive weeks of declines, with declines in Eagle Ford (-4), DJ-Niobrara (-2), Williston (-2), "Other" (-2), and Granite Wash (-1), partially offset by gains in Permian (+5), with Woodford and Mississippian remaining flat week/week.

Canadian rig count increased by 6 rigs week/week, and is up 59% from the level this time last year.

U.S. Gulf of Mexico offshore rig count increased by 2 rigs to 19 rigs week/week and is down 65% since June 2014.

Financial Sector

BNP Paribas S.A. is understood to be among financial companies exploring a fund-management tie-up with Axa SA European asset-management unit, as the French insurer seeks potential partners for the business. France's largest bank has studied the feasibility of combining BNP's money-management unit with Axa Investment Managers. Axa is reviewing its unit and has reached out to competitors, including Natixis SA, Bloomberg reported last week.

The Royal Bank of Scotland Group PLC (RBS) - "Agreeing the agreement ..." European Commission has announced formal approval of the Alternative Remedies Package in relation to RBS's remaining State Aid commitments, in particular relating to the Williams & Glyn business (previously agreed in principle on 26 July 2017). Costs and commitments in line with previous expectations. Conclusion: One more step completed on the road to redemption in our view. Management have highlighted four hurdles prior to paying a dividend, of which this is the first - (i) Resolve Williams & Glyn; (ii) Settle U.S.

Department of Justice action; (iii) Pass the stress test; and (iv) Return to bottom line profitability. We believe RBS has (a) a market leading restructuring program (c15% of costs); (b) US litigation is largely provided and (c) cash generation is set to exceed 100p a share by 2020. (Source: Reuters)

Activist Influenced Companies

Brookfield Business Partners L.P. has agreed to issue 6.67 million limited partnership units, on a bought deal basis, to a syndicate of underwriters at a price of $30 per unit, for gross proceeds of approximately $200 million. In addition, Brookfield Asset Management Inc. will concurrent with the offering, purchase, directly or indirectly, 6,945,000 redeemable exchangeable units (REUs) of Brookfield Business Partners' holding limited partnership at the offering price, for a total amount of approximately $200 million. Brookfield Business Partners will also, concurrent with the offering, issue 6.67 million units at the offering price by way of private placement to OMERS for gross proceeds of approximately $200 million. The aggregate gross proceeds of the offering and the concurrent private placements will be approximately $600 million. Brookfield Business Partners intends to use the net proceeds from the offering, together with the proceeds of the concurrent private placements, for general corporate purposes, including the financing of previously announced transactions and future growth opportunities.

Dividend Payers

ABB Ltd. today announced the acquisition of GE Industrial Solutions, GE's global electrification solutions business. GE Industrial Solutions is headquartered in Atlanta, Georgia and has some 13,500 employees spread throughout the globe. In 2016, GE Industrial Solutions had revenues of approximately $2.7 billion, with an operational EBITDA margin of approximately 8% and the operational EBITA margin was 6%, both adjusted to ABB financial definition. GE Industrial Solutions provides electrical solutions in order to control electricity from the grid to its point of use. This marks the second deal announced this year post B&R Automation GmbH acquisition (~€2 billion) and should strengthen ABB group's no. 2 position in electrification, particularly in the North American market where the company had several gaps in its low voltage portfolio. Whereas the business was clearly non-core to GE, it is very core to ABB in our view, which aims to strengthen its low voltage business. The purchase price of $2.6 billion represents 0.96x historic sales, 12x EBITDA and 16x EBITA (based on ABB definitions of earnings) and includes a long-term deal to use the GE brand. Cost synergies are estimated by management at $200 million by year 5 and integration costs will be around $400 million. The deal will negatively impact the Electrification Product margin and the division is only expected to return to its target range of 15-19% in 2020. ABB and GE will establish a long-term, strategic supply relationship for ABB products. The deal, which is expected to close in first half 2018 will be EPS accretive on an operational basis in year one, according to the company.

Aryzta AG's 2017 results - underlying EBITA of €277 million represents a 12% miss on consensus forecasts (€316 million) and a 43% decline year/year. Group margins have fallen 520bps to 7.3% and the company has announced €860 million of goodwill and other impairments. For 2018 management expect EBITDA to be broadly flat year/year, which implies ~€420 million, 5% below current Bloomberg consensus. Aryzta closed the year with a Net Debt (ex hybrids) / EBITDA multiple of 4.15x, which looks like a breach compared to the 4.0x covenant. However, the group has since refinanced €1.8 billion of debt into a new five year term facility with a raised Net Debt/ EBITDA covenant ceiling of 4.75x (reverts to 4.0x after the July 2018 test). The new interest cover covenant is 3.0x, which compares to 4.6x actual interest cover in 2017. Management have re-committed to generating €1 billion of free cash flow over the next four years and as part of that have announced some cash conservation measures. Those include moving to a scrip dividend (€0.30 per share dividend proposed) and plans to defer dividend payments (quasi interest) on the hybrid debt. Management have reiterated their intention to sell their 49% stake in the business but no new developments. The business itself continues to perform well, generating €173 million of EBITA in the period. The contract renewal issues in Switzerland and foreign exchange movements of Sterling are also likely to be helpful. Overall management's current expectation is that 2018 EBITDA will be broadly similar to last year, which would imply a 5% downgrade to current Bloomberg estimates.

Johnson Matthey PLC during its investor conference last week highlighted its ability to grow earnings ahead of market – despite the changing nature of the Global Automotive industry. It is estimated Johnson Matthey remains at a ~23% Enterprise Value/EBITDA discount to key peer Umicore N.V. Management demonstrated outperformance in Catalysis markets – in spite of Euro diesel market share loss. Importantly, increasing regulatory standards supports mid single digit top line growth over the coming decade. This, in conjunction with market share growth which more than offsets the impact from European diesel share reduction. The highlight of the conference was the launch of eLNO – Johnson Matthey's significant entry into battery cathode materials. We acknowledge the earnings opportunity is still 4-5 years away. However, launching a viable cathode materials technology (potentially more cost efficient than a Lithium Nickel Manganese Battery (NMC) with positive early feedback from customers) should improve investor sentiment towards Johnson Matthey as we believe most analysts would have previously placed zero value for this business in their valuations.

Northland Power Inc. announced that the final turbine for the Nordsee One offshore wind project was successfully installed on Sept. 22. The 332 MW offshore wind farm is anticipated to begin full commercial operations by the end of 2017. The installation process began in March, 2017. First power was achieved on March 31, 2017 and the project is earning pre-completion revenues. Commissioning of the turbines is nearly complete and remaining construction activities will be finished in the coming months. Once operational, Nordsee One is expected to produce an annual output of more than 1,300 gigawatt-hours of electrical energy, enough to meet the needs of approximately 400,000 German households. The project is owned by Northland (85%) and Innogy SE (15%). Nordsee One is the second project in Northland's offshore wind portfolio. Gemini, the company's first offshore wind project, began commercial operation in April 2017; with a 600 MW capacity, it is one of the largest in the world in size as well as production. In September, 2017, the company acquired a third offshore wind project, Deutsche Bucht, a 252 MW project also located in the North Sea, approximately 77 km from Nordsee One.

Economic Conditions

Canada – Retail sales in Canada shot up 0.4% in July, ahead of expectations for a 0.1% improvement and June's 0.1% advance, driven, however, by a pick-up in the retail price levels and still robust auto sales. Excluding sales of vehicles, the core retail reading was only up 0.2% in the month, short of the expectations. Food, drugs and clothing sales have led the growth, with the remainder of the retail categories, notably furniture and electronics subtracting from growth. Core consumer prices inflation moved to 1.4% year/year in August, from July's 1.2% figure, yet one tenth short of the expected 1.5% rate.

Canada - Manufacturing sales volumes fell by a larger 1.4% month/month in July, the second consecutive monthly decline, confirming that the industrial sector began the third quarter on a soft footing. That said, much of the weakness in July relates to longer-than-normal seasonal shutdowns in the auto industry. Auto production would normally have rebounded in August, but the disruption to U.S. industrial production caused by the recent Hurricanes probably had a knock-on negative impact on activity in Canada too.

New Rules to Dampen Home Sales in Canada, Mortgage Lenders Warn - The Globe & Mail reported last week that Canada's mortgage lenders say tougher borrowing rules proposed by Canada's banking regulator could reduce the volume of home sales in Canada by 10% to 15% annually as buyers find it harder to qualify for loans. Mortgage Professionals Canada – an industry association representing lenders, mortgage brokers and mortgage insurers – said the economic impact of proposed stress-testing rule changes could result in 50,000 to 75,000 fewer home sales a year in Canada when combined with other mortgage-rule changes announced last year and a recent increase in interest rates. Association president Paul Taylor said the impact of the change could cascade further as other buyers will still make purchases, but will qualify for smaller mortgages and buy less-expensive homes. 'Essentially, everybody is going to step down a rung or two, which means there will be real pressure on all home prices to also fall by a rung or two,' Mr. Taylor said in an interview. The mortgage association is the latest group to air concerns about a proposal from the Office of the Superintendent of Financial Institutions (OSFI) to require home buyers who do not need mortgage insurance – those with down payments of more than 20% of the purchase price – to prove they could still afford their mortgages if interest rates were two percentage points higher than they negotiated. OSFI published the proposed changes in July with a request for public comment, saying it was aiming at implementing the changes in the fall if the plan proceeds. The Canadian Home Builders' Association has also voiced concerns about the proposed change, saying Canada could see 20,000 to 30,000 fewer new housing starts annually when combining the proposal with other recent policy changes.

U.S. – Housing starts in the U.S. advanced to 1.18 million units annualized in August, broadly in line with the consensus expectations, from July's 1.155 million reading. Building permits, meanwhile, were also higher for the same month, at 1.3 million units annualized from 1.23 million in the prior month. Sales of existing homes, however, dropped by 1.7% in August, short of the expectations for a 0.3% advance, with much of the negative surprise being driven by the impact of hurricane Harvey.

German Elections – Angela Merkel's election win marred by rise of far right AFD (hard-right), weakening the CDU [Christian democrat] / SPD [Socialist] ruling party's alliance (CDU-CSU at 32.9% vs. ~38% polling support; SPD at 20.8% vs. ~22% polling support). Support from the FDP [pro-business] likely first step. Traditional parties eroded, and Socialist vote captured by other parties. AFD is now #3 in Germany and #2 in East Germany (21.5%). CDU-CSU (32.9% vs previously 41.5%), SPD (20.8%/25.7%), AFD (13.1%/4.7%), FDP (10.5%/4.8%), Greens (8.9%/8.4%), Left (8.9%/8.6%). SPD no longer part of a "grand coalition". Alternative coalition: CDU-CSU/FDP/Greens (32.9%+10.5%+8.9%), negotiations will be difficult in our view. FDP likely to field a candidate for Minister of Finance, less favorable to transfers from Germany to Europe. Angela Merkel will have to take into account concerns regarding migration and increased anti-Europe/anti-Euro feelings. The 'European project' and Macron's plans for more Europe will be seen to have been set back and AFDs rise will remind investors of Italian elections (though not yet on radar in our view given May 2018) and 5 Star's popularity and amidst unrest in Spain's Catalonia.

France - Impact of German elections: With Merkel weakened and the German political landscape more fragmented, France will possibly play a more powerful political role in the German/French tandem. However, the election results can be seen as a setback for Macron's plan for more Europe. Economic reform in France will become more critical as financial transfers to Europe from Germany will be less likely or with more stringent conditions. A likely outcome is that Germany may insist on a German Head of ECB when the mandate comes for renewal.

September 25, 2017

Financial Conditions

U.S. Federal Reserve's decision last week to keep interest rates unchanged at 1.0-1.25%, as well as its long-anticipated move to formally announce the start of the balance sheet normalization process next month, came as little surprise. The bigger news was that, despite the weakness of core inflation in recent months, a clear majority of Federal Reserve officials continues to project one more 25bp rate hike by year-end. Accordingly, we expect the Fed to raise rates again in December. The rate of monthly reinvestment of matured Treasuries and prepaid Mortgage Backed Securities (MBS) will be reduced by $6 billion and $4 billion, respectively. Then every three months, these amounts will be raised by $6 billion and $4 billion, respectively, until they reach $30 billion and $20 billion by October 2018. They will stay at these levels until the balance sheet has been right-sized, which is estimated will be by the end of 2021 (at $2.9 trillion of the current $4.5 trillion balance sheet). Afterwards, net purchases of Treasuries will resume to allow for normal balance sheet growth and to replace the MBS that will continue to not be reinvested.

Standard & Poor's has lowered China's sovereign credit rating to A+ from AA-, while changing its outlook to stable from negative. The action brings all the three major credit-rating firms in line in terms of their views of the creditworthiness of the world's second-largest economy. Fitch Ratings lowered China's rating in 2013, and Moody's Investors Service did so in May. The downgrade of China's rating, the first such move by S&P since 1999, reflects its assessment that "a prolonged period of strong credit growth has increased China's economic and financial risks".

U.K. - Moody's downgraded UK rating by 2 notches to AA2 over Brexit uncertainty (matching Fitch & S&P). The outlook is now stable from negative. Separately, Brexit talks begin again today with the Brexit bill fresh in the mind post Prime Minister May's Florence speech last week. Arguably Germany's results could toughen the EU stance over Brexit.

The U.S. 2 year/10 year treasury spread is now .80% 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 3.83 (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 10.97 (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

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

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.

Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'ROE' return on equity, 'ROTE' return on common equity.

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