News Highlights

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. April 30, 2018

Owner Operated Companies

Alphabet Inc. reported worldwide sales of $31.1 billion, above the average analysts' estimate of $30.3 billion, according to Thomson Reuters. Strong growth in ad sales on Google search and YouTube were not enough to offset a surge in costs at parent Alphabet that shrank the first-quarter operating margin. Alphabet got a boost from how it values investments in Uber Technologies Inc. and other start-ups. That accounting change and a one-time benefit cut its effective tax rate nearly in half. Alphabet's operating margin of 22%, down from 27% a year ago, missed expectations because of the growth in expenses. Alphabet is investing to keep pace with Amazon.com, Inc. and having to share more of its revenue with phone and browser makers. Longer-term capital expenditures nearly tripled to $7.3 billion in the first quarter from $2.5 billion a year ago. Alphabet's quarterly profit of $9.4 billion, or $13.33 per share, exceeded estimates of $6.56 billion, or $9.28 per share, according to Thomson Reuters. About $2.4 billion in earnings were attributable to a new accounting method for unrealized gains in Alphabet's investments in startups such as Uber and Airbnb Inc. Alphabet now records estimates of the current value of its startup investments rather than waiting to report income once it has opportunity to sell those shares. Excluding the investment-related gains and other items, adjusted earnings were $9.93 per share. Continuing cost increases came from acquiring streaming rights for YouTube's new TV service and marketing new products. Revenue from Google's non-advertising units was $4.4 billion in the first quarter. Alphabet is paring back on "other bets," a set of ancillary projects in areas such as medical technology and drones. Operating loss from "other bets" fell to $571 million, from $703 million a year ago. Investors are counting on one other bet, the Waymo self-driving vehicles effort, to generate noteworthy revenue this year as it begins offering ride-hailing services. Google revealed smart thermostat maker Nest generated about $726 million in revenue in 2017, above some analysts' estimates.

Fortive Corporation reported net earnings of $261.2 million for the first quarter ended March 30, 2018. For the same period, adjusted net earnings were $277.5 million. Diluted net EPS for the first quarter ended March 30, 2018 were $0.74. For the same period, adjusted diluted net EPS were $0.78. For the first quarter of 2018, revenues increased 13.4% year/year to $1.7 billion, with core revenue growth of 2.6%. James A. Lico, President and Chief Executive Officer, stated, "We are very excited with our start to 2018. The strength of our portfolio and focused execution by our teams using the Fortive Business System drove double digit growth in both earnings and revenue as well as strong gross margin and core operating margin expansion driven by favorable price and productivity in the quarter." For the second quarter of 2018, Fortive anticipates adjusted diluted net EPS to be in the range of $0.86 to $0.90. For the full year 2018, Fortive expects adjusted diluted net EPS to be in the range of $3.40 to $3.50. Mr. Lico added, "As evidenced by our recent announcement to combine four of our Automation & Specialty businesses with Altra Industrial Motion Corp. as well as the success of our acquisitions, we are committed to creating sustainable long-term value for both our customers and shareholders."

Energy Sector

Crescent Point Energy Corp. – Leading independent proxy advisory firm Glass, Lewis & Co. has recommended that shareholders vote for all of Crescent Point's director nominees using only the company's white proxy prior to the its annual general meeting (AGM) on May 4, 2018. In reaching its recommendation, Glass Lewis stated the following: "The company's current directors appear to us to have made concerted efforts in recent periods to actively engage with its shareholders and address various relevant issues facing the company, well before the dissident launched this seemingly rushed activist campaign. We believe that the dissident's plan is decidedly vague and bereft of any meaningful substance. We believe that the dissident has presented shareholders with a slate of nominees and a plan for the company that, taken together, strains credibility."

Financial Sector

Barclays PLC - Edward Bramson's activist investment fund has increased its interest in Barclays ahead of a meeting with the British bank's chief executive that was due to be arranged after its quarterly results last Thursday. Sherborne, Mr Bramson's Guernsey-based investment vehicle, raised its holding from 5.16% of its voting rights to 5.41%, according to a filing by Barclays. The move comes only days before Barclays' annual meeting on May 1. Sherborne has also increased the proportion of its interest that it holds directly rather than via financial instruments. Its directly held stake has risen from 1.94% to 4.95%, with the rest held via two types of derivatives known as contracts for difference and total return swaps. (Source: Financial Times)

Deutsche Bank AG (not held in Portland funds) is expected to cut around 1,000 jobs or 10% of its workforce in the U.S., as the German lender scales back its global investment banking ambitions. The bank has already axed 400 U.S.-based employees this week - of which around three quarters worked in its trading business and the rest in corporate finance. Last Thursday, the bank announced that it would make "significant" cuts at its investment bank, scaling back its corporate finance operations in the U.S. and Asia, U.S. government bond trading and equities. (Source: Reuters)

Fifth Third Bancorp reported Q1 2018 EPS of $0.97. The company puts its 'adjusted' EPS at $0.57 excluding one-off gains while its core earnings appears closer to $0.53 still beating consensus of $0.48. Relative to its guidance, Net Interest Income and Net Interest Margins were above expectations, while expenses were slightly better. Its loan loss provision was $58 million ($0.07) less than net charge-offs despite its Non-Performing Assets increasing (though criticized assets improved). Operating revenues increased 5% year/year and rose 1% linked quarter. Tangible book value slipped 0.3% to $18.05 (trading at 1.8x). It posted an adjusted ROTE of 13.4%. Its CET 1 ratio was 10.82%, up from 10.61% last quarter. After share buybacks its average diluted shares declined by 1.8% in Q1 2018. The bank's management also anticipate a total payout over 100% of projected earnings, with increased dividends and repurchases, over the next year or so.

Nordea Bank AB – As expected it was a tough Q1; Nordea reports Q1 2018 results that are weaker than earlier expected despite the headline which is 6% ahead of market expectations. Core revenue line items of Net Interest Income was 2% lower than consensus & fees 7% lower. On the positive, costs are 1% better, loan losses 51% better and the group reports a CET 1 ratio of 19.8% (20 basis points (bps) better on lower Risk Weighted Assets). Nordea's CEO again quoted not to be happy with the quarterly development and effectively writes off 2018 revenue guidance.

Royal Bank of Canada (RBC) is raising the posted rates on some of its fixed-rate mortgages, becoming the second big bank last week to make adjustments following sharp increases in government bond yields. RBC confirmed on Friday that it is raising rates on its one-to-four year mortgages by 15 bps. It is also raising rates on its five-to-10-year mortgages by 20 bps. Based on the bank's current posted fixed five-year mortgage rate of 5.14%, the new rate will rise to 5.34% – although home buyers can generally negotiate with lenders to get rates considerably lower than their posted rates. RBC joins **The Toronto-Dominion Bank (TD)**, which announced earlier this week that it will raise its posted rate for five-year fixed mortgages by 45 bps, taking the rate to 5.59%. TD raised rates on other mortgages too. Late Friday afternoon, **National Bank of Canada** also said that it is raising its fixed rate mortgages, by 15 to 30 bps. The rate on its five-year mortgage, for example, will rise 20 bps, to 5.34%.

Activist Influenced Companies

Pershing Square Holdings, Ltd. (PSH) announced a tender offer to purchase up to an aggregate amount of $300 million of PSH's public shares. The purchase will be funded from the company's existing cash resources and will be made under the tender offer authority granted by shareholders at the company's annual general meeting held on April 24, 2018. As was announced following the withdrawal in February 2018 of the proposed tender offer for up to $300 million in value of public shares by PSCM Acquisition Company LLC, an entity controlled by Bill Ackman, CEO of Pershing Square Capital Management (PSCM), and other affiliates of PSCM, Mr. Ackman and his affiliates may, subject to applicable laws and restrictions, choose to purchase, directly or indirectly, public shares, including through open market purchases. While Mr. Ackman and his affiliates will not acquire any public shares during the tender offer, they may do so after the tender offer has completed.

Dividend Payers

AT&T Inc. – reported net income attributable to the company of $4.76 billion, or 75 cents per share, for its first quarter, up from $3.47 billion, or 56 cents per share, a year earlier. That was somewhat lower than expected, as the No. 2 U.S. wireless carrier lost subscribers from its pay TV business. AT&T is fighting the U.S Department of Justice in court to complete its $85.4 billion takeover of Time Warner, Inc. which it has called necessary for it to compete for advertising dollars and in an industry increasingly dependent on content. On an adjusted basis, the company earned 85 cents per share in the first quarter, missing analyst estimates of 87 cents per share, according to Thomson Reuters. Total operating revenue fell 3.4% to $38.04 billion. The company attributed the revenue decline to a new accounting standard and held its full-year profit forecast steady. Excluding the accounting changes, revenue would have been $38.9 billion. Analysts expected revenue of $39.31 billion, according to Thomson Reuters. The company, which owns satellite television service DirecTV, lost 187,000 traditional U.S. video customers, fewer than the 257,000 customers analysts had expected them to lose, according to research firm FactSet Research Systems Inc. As more viewers seek to cut pay-TV packages, AT&T added 312,000 customers to its DirecTV Now streaming service. The Time Warner deal, which would give AT&T access to content like HBO's "Game of Thrones" and Warner Bros. entertainment Inc.'s "Justice League," reflects AT&T's effort to compete for advertising dollars against Alphabet's Google and Facebook.

Barrick Gold Corporation - During Q1 2018, Barrick produced 1.05Moz of Gold and 85Mlb of Copper and generated adjusted net earnings of $170 million or 15 cents, broadly in line with consensus of 14 cents. Barrick noted that Q2 production should be similar to Q1 due to the continued ramp up at Porgera and scheduled maintenance downtime at Pueblo Viejo and Barrick Nevada, but has maintained its overall 2018 guidance of 4.5 to 5 million ounces. Barrick ended Q1 with $2.4 billion in cash and intends to use ~$1.4 billion of it to repay debt over the next nine months, reducing total debt to ~$5 billion by the end of 2018. With minimal debt maturities over the next five years the company is now done with asset sales to fund debt repayment. Funds from future divestitures will be reinvested in the business or distributed to shareholders.

Novartis AG announced the launch of FocalView app, a smart phone tool that allows patients to participate in ophthalmology clinical studies from home by using the patients self-recorded measurements. This app promises to reach out to patients who are less mobile, hence, not easily finding their way to clinical trial sites while still eager to participate in clinical studies. We consider this app as great tool to facilitate the collection of patient data in a much more peripheral setting, i.e. closer to the patients actual daily life, critically important when it comes to collection of patient-reported outcome data. Overall, we expect more of such IT types of news to be announced going forward, as Novartis will have to prove how its CEO's eagerness to pervade the company with IT initiatives will succeed and finally extract more value from the firm as such internally and, externally, in the market, clinics and at the research front.

Walmart Stores, Inc. - On Saturday (April 28) Sky News reported that J Sainsbury PLC and ASDA Stores Ltd. (owned by Wal-Mart) were in mfrest erger discussions. Subsequently, Sainsbury confirmed that it is 'advanced talks with Wal-Mart' regarding ASDA. A much fuller statement has been issued this morning. The key aspects of the planned transaction are as follows: Sainsbury will issue shares to Wal-Mart (so Wal-Mart will own 42% of the combined business, but not more than 29.9% of the voting rights) and will pay £2.97 billion in cash to acquire ASDA – however it will acquire it debt-free and pension-deficit free (these would amount to something similar to £2.975 billion). Wal-Mart will be a long-term shareholder and partner. Upon completion, two of Wal-Mart's representatives will join the Board of the combined entity. It will be a dual-banner business. The merger is expected to generate at least £500 million of net synergies, more gross. The difference is basically price investment - the two banners expect to lower prices by ~10% on many products - the amount invested will differ depending on amount of enforced store divestments (no view given). The realization of the synergies will require one-off operating costs of around £150 million. It's also expected that incremental capex of ~£600 million will be incurred, primarily related to IT system migration and property opportunities for Argos within ASDA stores. Around £230 million of the estimated net EBITDA synergies are expected to be realized in the first full financial year after completion. The two companies emphasize that this has been in gestation for a long time and they have done a lot of work on store overlaps. They expect the merger will be double-digit EPS accretive and low double digit Return On Invested Capital within two full years post completion. According to Kantar Worldpanel market share data, Sainsbury had 16.0% share of the U.K. food retail market over the last 52 weeks, compared with 15.4% for ASDA – a combined market share of 31.4%. For reference, Tesco had 27.9% share and Morrison had 10.5% share over the same period. The hard discounters Aldi and Lidl Stiftung & Co. KG had 12.1% share combined (7.0% for Aldi and 5.1%) for Lidl. ASDA has been fully-owned by Wal-Mart since 1999. Its sales growth has been weak in recent years and it has lost a significant amount of market share, but there has been greater stability over recent quarters.

WPP PLC - Q1 organic growth was -0.1% vs. company-compiled consensus of -0.9%. This represents a small acceleration compared to the -1.3% delivered in Q4. Mergers and Acquisition contributed 1.1% to net sales growth in Q1 and foreign exchange represented a 6.1% drag. Overall, revenues decreased 5.1% to £2,948 million, 0.3% above company compiled consensus. By geography, North America's organic net sales decline improved to -2.4% in Q1 from -3.4% in Q4 slightly below expectations. Organic growth in the U.K. decelerated to 1.6% from 9.1% in Q4. Organic in Western Continental Europe improved to -0.2% in Q1 from -0.8% in Q4. Finally, net sales in the Rest Of the World increased 2.3% on organic basis, above the 3.1% decline posted in Q4. Management outlook is staying at flat for 2018 and calling for a "slightly stronger second half". The joint COO statement and the new lower gearing target of 1.50-1.75x (down from 1.50-2.00x) hints at some disposals. Also, press articles over the week-end mention an approach for Kantar by CVC Capital Partners valuing Kantar at £4.3 billion or 12.3 x 2017 actual earnings while WPP currently trades on about 9.3x.

Economic Conditions

U.S. existing home sales rose 1.1% in March to 5.60 million units, just modestly beating expectations and the highest since November. This is the second pickup in a row, which followed two consecutive declines, with more sales in both single-family homes (+0.6%) and condos (+5.2%). And, more owners listed their dwellings for the third month in a row, which is helping boost inventories and providing more choice to those hunting for a new home. But supplies are still tight and inventories are still 7.2% below year-ago levels. And the months' supply is at a very tight 3.6.

U.S. economy expanded at a 2.3% pace in the first quarter of 2018, slowing down from the 2.9% rate in Q4 of 2017, though ahead of the expectations calling for a 2.0% improvement. Most economic sectors, including consumer, business investment, government and net exports contributed to growth, with the only detractor being residential investment (construction) during the quarter.

U.S. personal consumption was up 0.4% in March, ahead of February's flat reading, supported by a 0.3% improvement in personal income, though the latter fell short of the expectations for a 0.4% advance. Part of the same report, the change in personal consumption expenditures (PCE) price index, the U.S. Fed's favourite price gage, clocked in at 1.9%, in line with the expectations, but three tenths larger than February's reading, providing scope for the Fed's steady program of rate increases.

Canada - Bloomberg reported last week that new mortgage rules are pushing more home buyers to alternative lenders like Firm Capital Corporation. "We think there will be some opportunities because the credit unions will pick up the vast majority of the bank rejects. It goes down the food chain." said Eli Dadouch, 52, founder and chief executive officer of Toronto-based Firm Capital. "We'll get their business." Alternative lenders are playing a growing role in Canada's real estate market as the industry searches for new sources of financing, risk-averse banks become more picky, and investors look for yield. The march to the private market has been driven in part by a desire to reduce taxpayer exposure to housing, which has until recently, been on steroids. Federal and provincial governments have gradually been tightening the screws, reducing amortizations, instituting foreign-buyer taxes and making it tougher to get a mortgage. The moves have begun to bite. About 49% of all outstanding mortgages were uninsured at the end of last year, up from 36% five years ago. And the housing market in Toronto, Canada's biggest city, has abruptly slowed, with average prices plunging 14% in March from a year earlier, the biggest drop since 1991. That doesn't seem to worry Dadouch, who thinks any slump is temporary in Toronto due to the simple fact that more people want to own a home than there is land or homes available. He met Firm Capital's Chief Financial Officer, Jonathan Mair, buying distressed debt from him in the early 1990s, when interest rates reached double-digits and several trust companies collapsed in the recession. Even at that time, portfolios of residential mortgages sold to investors at only a slight discount to face value, Dadouch said. "I think single-family always does really well in this country," he said. Single-family mortgage lending currently makes up about 15%of the company's business. The company has about CAD $1.3 billion ($1 billion) in mortgage assets, including CAD $562 million in its publicly traded mortgage investment corporation at Dec 31.

Italy - Bloomberg reported this morning that 5 Star's Di Maio has indicated that no government is possible with the Democrats (PD). Also reports that Mr. Berlusconi sees chances that Italy will head back to polls soon are far from negligible. Also Boomberg reports that Sunday's election in Friuli-Venezia-Giulia are expected to show an easy win for the centre-right candidate and a particularly strong showing for the far-right League.

Financial Conditions

The European Central Bank (ECB) left rates and policy unchanged at the April 26th meeting, as expected. The press release itself was identical to the one in March. On the rate front, they'll remain at their levels "for an extended period of time, and well past the horizon of the net asset purchases". And those levels are: Refi rate 0.00%; Marginal lending facility 0.25% and Deposit facility -0.40%. The net asset purchases of €30 billion per month are still running "until the end of September 2018, or beyond, if necessary". President Draghi reiterated the need for an "ample degree of monetary accommodation" to ensure inflation (which is still subdued but expected to rise gradually) gets to target over the medium term. And that more reforms are needed, and fiscal buffers must be rebuilt, especially for those countries with high debt. He acknowledged the recent moderation in the economy but that it may reflect a pull back from the last year's high pace of growth, as well as some temporary factors (weather, strikes, Easter's timing, etc.). But broadly speaking, the Euro Area economy is still expected to remain solid and broad based, supported by the ECB's policies.

The U.S. 2 year/10 year treasury spread is now .47% and the U.K.'s 2 year/10 year treasury spread is .65% - 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 4.58% (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 15.52 (compares to a post-recession low of 9.52 achieved in early November) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

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- Portland Focused Plus Fund
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- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen LP
- Portland Private Growth Fund
- Portland Private Income Fund
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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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