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 3, 2018

Owner Operated Companies

Nothing significant to report.

Energy Sector

The Organization of Petroleum Exporting Countries (OPEC), together with Russia, came to a decision on June 22nd. In the face of significant continued strong crude demand growth around 1.5 million barrels of oil per day (bopd) per year, and concern over a range of OPEC countries' ability to maintain delivery - Iran, Venezuela, Libya, Nigeria - for a variety of reasons, OPEC decided to....comply with its own quotas. This seems to have been designed to increase production by about 1 million bopd, but the more widespread expectation is that actual new barrels will be rather less, perhaps 0.5-0.8 million bopd and that would be driven by the OPEC Gulf states and Russia, with the rest of OPEC distinctly second tier.

We believe there are two particular uncertainties that will likely shape the oil market over the coming months and years. The first is Venezuela which has gone from bad to worse over the last couple of months. The country's production of crude oil fell to 1.36 million barrels in May which is 600,000 barrels per day down from its level a year ago. The second issue is the production of so-called 'tight oil' from shale rocks in the U.S. Tight oil production is now running at more than 5 million barrels a day and this year lift total U.S. oil output to over 11 million barrels per day – the highest figure for almost 50 years. The growth in shale production over the past 10 years has been profoundly disruptive, first for the gas market and then for oil. But that it seems is just the start. According to an authoritative study from IHS Markit – a leading industry consultancy with access to detailed data sources – the Permian Basin in Texas and New Mexico which is the core of the U.S. shale business is about to deliver more. By 2023, the Permian is likely to be producing an additional 3 million barrels per day along with an extra 15 billion cubic feet of gas. The Markit study suggests the volumes involved will further reduce the cost of unit of production to below $25 a barrel. For the global oil market the effect will be dramatic. The U.S. will become a significant exporter...expected by Markit to be exporting around 4 million barrels a day by 2023....which would absorb much of the expected growth in demand. The full increase in supply from Permian will not come immediately. The expansion of production from the basin has already pushed local pipeline capacity to its limit in our view. Four new pipelines to take oil out of the Permian are under construction and will not be operational until 2019...that is when we expect the next surge in output will begin to reach the market.

Until recently it was expected that U.S. shale would fill any supply shortfall and so provide some balance to crude price rises. But there are now clear questions over short term increased production, at least for the next year or so, as infrastructure limitations bite and amid increasing evidence that 'sweet spots' are less productive than anticipated. It will probably take a few months to see which way the oil price wind is blowing, and so for now the bulls appear to be winning. Crude prices, at least for Brent, look unlikely to dive below the $70/barrel mark for a sustained period anytime soon.... but uncertainties and instabilities only fuels speculation and volatility. (Source: Financial Times and Canaccord)

Financial Sector

Asset Management: Bloomberg highlighted The Vanguard Group's launch of four low fee mutual funds in Canada. Vanguard, known for its bargain-basement fees on exchange traded funds, is launching its first suite of mutual funds with a maximum management fee of 0.5%. That compares with a median expense ratio of 2.23% for Canadian equity funds in 2017, the highest of 25 countries, according to a Morningstar study. "We've brought the cost down for Canadian ETFs and our competitors have brought their costs down to compete," Atul Tiwari, managing director and head of Vanguard Canada, said in a phone interview. "We want to bring that same competition to the mutual-fund space." The foray in Canada is part of a global push by the company that's emphasizing actively managed funds over index trackers. That strategy bucks the trend of mutual-fund providers moving into ETFs. Firms including AGF Management Limited, Mackenzie Investments and Manulife Financial Corporation have all recently entered the ETF space in Canada. In our view Vanguard (a private company) has the organizational and financial heft to compete in the Canadian marketplace but adoption of traditional mutual fund substitutes has not been as successful as in other geographies, which we attribute largely to the way that advice is offered in Canada. While we do expect Vanguard to be a very credible competitor for firms such as AGF and Manulife, it may not be the same disruptor as it is in other regions.

The Federal Reserve released its annual examination of the capital planning practices of the nation's 35 largest banks, the Comprehensive Capital Analysis and Review (or CCAR). The largest and most complex banks are subject to both quantitative and qualitative assessments, while other firms are subject only to the qualitative assessment. The Board objected to the capital plan of Deutsche Bank USA Corporation due to 'qualitative' concerns, and issued a conditional non-objection to capital plans of The Goldman

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Sachs Group Inc., Morgan Stanley, and State Street Corporation. The Fed did not object the capital plans of the remaining 32 banks.

Barclays PLC - Barclays' investment bank is exploring ways to re-enter the South African and South Korean markets, in a break from the transatlantic retrenchment embarked on a few years ago. South Africa and South Korea had been identified as two of the markets that the investment bank would like to rebuild operations. Barclays International, which includes Barclays' investment bank, private bank and cards business, has already reopened an office for its investment bankers in Australia, reversing a retreat made two years ago.

BNP Paribas S.A - To focus on Southeast Asia for Wealth expansion. Also decided to sell part of its private banking portfolio in Spain. 1,300 customers representing 550 million of assets under management would be concerned.

HSBC Holdings PLC - Announces that Iain Mackay will retire from HSBC, to be succeeded as Executive Director and Group Finance Director by Ewen Stevenson. In May, media reports suggested former CFO of The Royal Bank of Scotland (RBS), Ewen Stevenson interviewed for role at HSBC. HSBC - Has agreed to pay Ewen Stevenson up to £10.6 million to buy out the unvested bonuses of RBS' finance director.

Activist Influenced Companies

GEA Group AG - Elliott Advisors who now owns >5% in GEA has come out with its first major public announcement since taking a stake in Oct 2017. Pointing to GEA' s Total Share Return of -28% versus SXNP (Europe 600 Industrial Services & Goods Index) +29% during the tenure of the current Chairman Helmut Perlet, Elliott demands 3 steps of immediate action: 1) Acceleration of the CEO succession timeline after a formal selection process was launched in March 2018, noting that it's disappointing it is not already been completed; 2) Steps to strengthen the composition of the Supervisory Board, including replacement of the current Chairman Helmut Perlet; and 3) Initiation of a substantial share buyback program and a commitment to refrain from material Mergers and Acquisitions in 2018. (Source: Reuters)

Nestle SA - If we assume Third Point Management, which disclosed its $3.5 billion investment in June last year, accumulated its shares in the preceding 2 months, then we estimate its average purchase price was $85 per share. With the share price currently $78 - whilst the S&P is up 13% over the same period – it would suggest Third Point is running out of patience. A year ago Third Point welcomed the 'wise' appointment of Schneider and recognized that "change at a company like Nestle can be complex". Now it argues "the pace and magnitude of change seem insufficient and reflect Nestlé's staid, sometimes sclerotic, culture and tendency toward incremental improvements" and highlight the most notable executive change under Schneider has been an internal appointment (Head of U.S.).Third Point is now asking for more disposals (approximately 15% of group sales, including U.S. ice cream, frozen food, peanut milk and Nestle Skin Health) and the separation of the group into three distinct divisions; Beverages (coffee and bottled water), Nutrition (pet food, infant formula, milk products and Nestle Health) and Grocery. Third Point re-iterates its view that Nestle should monetize its L'Oréal S.A. shareholding via an exchange offer for Nestlé shares. Although given the L'Oréal share price has outperformed Nestlé's by 20% year-to-date Nestlé shareholders may be thankful Schneider has so far spurned Third Point's advice. Of course, CEO Schneider's mantra that change will only be announced when it is a 'done deal' means some of Third Points 'suggestions' could conceivably be announced in the coming months in our view.

Dividend Payers

Aryzta - Post the company's latest profit warning (May 24th), we expect the challenges Aryzta faces will continue into next year. Despite management's announcement of an approximate €90 million cost savings plan by year three, we do not expect an imminent profit recovery. Lidl's return to insourcing only began in the third quarter and U.S. distribution and labor cost inflation will only fully anniversary in the second half of next year. Whilst we expect the group will pass its covenant test in July (courtesy of two Picard dividends), the reduced equity value of Picard means even its disposal may not be sufficient and management may be need to dispose other parts of the portfolio that offer the most margin upside. The company will release fiscal year 2018 results on Oct 1st – we expect management to provide a cautious profit outlook for fiscal year 2019 citing insourcing in Europe and a challenging pricing environment in North America.

Bunzl PLC - Revenue in the first half was up 11% year/year in constant currency terms, made up of 5% organic, 6% from acquisitions and a 6% drag from currency. Q2 implied organic growth of 4% slowed from 6% in Q1, as expected, as the large contract win with Wal-Mart Stores, Inc. in the USA last year annualizes. Walmart contributed for one month of the quarter and excluding that, organic growth is running at 2-3%. No new acquisitions announced. The group is however disposing of their marketing services business in the U.K. which has £46 million of revenue, a business considered to be non-core, with limited opportunities to expand overseas in the short to medium term. Analysts' are forecasting organic growth of 2.7% for the full year; this implies second half organic growth of 1.1%, with the comparisons becoming tougher through the rest of the year. Acquisitions: The spend so far this year is low in a historic context. Management says the pipeline for acquisitions is said to remain active. We don't see any change to the acquisition situation and it is only a matter of timing. The shares are approximately trading on 17x 2019 estimated PE and 14x EV/EBITA, with a 2.2% dividend yield and a 6% FCF yield.

Novartis AG has announced its intention to spin out 100% of Alcon Surgical and Consumer. The move requires shareholder approval at the Annual General Meeting in February 2019, and final Board approval. It is expected to complete in first half 2019 if approved. The new company will be incorporated in Switzerland and listed on the Swiss and New York stock exchanges. As expected, the Ophthalmology Pharma business will remain with Novartis. Current Alcon CEO, Mike Ball moves to Chairman-designate of Alcon. David Endicott, current COO Alcon, is promoted to Alcon CEO. A $24.2 billion valuation for Alcon is estimated. Transaction expected to be tax neutral for Novartis. Novartis has also announced the intention to buyback $5 billion of shares by the end of 2019. This is in line with the company's previously-stated capital priorities and represents the balance of the proceeds from the GSK Consumer transaction net of the acquisition price for AveXis, Inc. It is estimated that each incremental $1 billion share buyback is approximately 1% EPS accretive to Novartis Group. Novartis stated it "intends to continue paying a strong and growing dividend … building on the CHF2.80 per share paid in March 2018". This move does reinforce that 2019 will be a critical transition year for Novartis in our view with the Alcon spinout coinciding with generic entry for Gilenya and Afinitor and major pipeline catalysts with BAF312 in multiple sclerosis and AVXS-101 in spinal muscular atrophy. Novartis is to retain ophthalmology pharma portfolio. Long-term strategy is to focus company/capital as medicines company Investing in organic business, growing dividend, bolt-ons, buybacks.

Tesco PLC and Carrefour S.A. have both announced the formation of a "long-term strategic alliance". Essentially this is a buying alliance, one of a number that have been announced recently in the sector (though U.K. food retailers have tended to get involved in these arrangements less often than the continental European grocers). The first priority seems to be the relationship with global suppliers – for which, we would read combining volumes to improve buying terms with multinational suppliers. It also talks of buying private label together and also goods not for resale – though we would expect opportunities to be more complicated here. Heads of terms have been signed already and it is expected to be formally agreed within two months. It will then be governed by a three-year operational framework. Poland – the only country where the two companies actually overlap – is not included in the agreement.

Economic Conditions

The U.S. manufacturing ISM unexpectedly rose in June, up 1.5 pts from May to a 4-month high of 60.2, the 2nd increase in a row. But some of the details indicate that there was a bit more to the headline strength. First of all, we note that all of the components remain elevated, or well above the expansionary 50 mark. But in June, new orders slipped 0.2 pts, employment fell 0.3 pts, and while production grew 0.8 pts, supplier delivery delays surged 6.2 pts, the biggest monthly jump since November 2010. Interestingly, prices paid slipped, but every single commodity was reported to be 'up in price' (none were down). Aluminum was the most oft-cited commodity that saw higher prices, and it was also found to be in short supply. The increase in the ISM manufacturing index in June is a clear sign that, for now at least, the strength of the domestic economy is more than offsetting any increased uncertainty on trade policy. However, with the dollar appreciating by 6% since April, global growth slowing and retaliatory tariffs just beginning to bite, the sector looks unlikely to fare so well for long in our view.

U.S. Personal Income & Spending in May was unchanged but big gains in previous months mean that consumption growth is still on track to rebound in the second quarter overall, to around 3% annualized, from 0.9% in the first quarter. Together with a big contribution from investment and net trade, that would leave overall GDP growth on track to rise by 3.5% - 4.0% annualized.

The U.K.'s economic growth has been revised up for the first quarter of the year after construction data was found to be stronger than earlier estimates. Growth for the three months to March was 0.2%, the Office for National Statistics said, a surprise upgrade from the earlier estimate of 0.1%. (Source: BBC)

S&P Global Ratings raised long-term debt rating on Greece as it sees reduction in debt risks due to creation of cash buffers and extension of maturity on its debts. The rating agency raised its long-term foreign and local currency sovereign credit ratings on Greece to 'B+' from 'B'. Euro zone finance ministers on Friday extended maturities and deferred interest of a major part of their loans to Greece along with a big cash injection ahead of its exit from its bailout in August. "We believe this significantly reduces sovereign debt servicing risks over the next two years," S&P said. Moody's, which rates Greece at 'B3+', said on Monday the debt relief package offered by Greece's creditors is credit positive for the over-borrowed country. The banking sector is making progress on reducing high levels of non-performing loans that will help boost growth, S&P said. (Source: Reuters)

Financial Conditions

The Reserve Bank of Australia (RBA) has maintained its official cash rate (OCR) at the emergency low of 1.5% for a record 21st meeting. The concluding paragraph of the accompanying statement was exactly the same as the one in June, with the central bank saying that: "The low level of interest rates is continuing to support the Australian economy. Further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual. Taking account of the available information, the Board judged that holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time."

The U.S. 2 year/10 year treasury spread is now .32% and the U.K.'s 2 year/10 year treasury spread is .56% - 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 4.55% (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 4.0 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 15.05 (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.

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:

- Bay & Scollard Development Trust
- Portland Advantage Plus - Everest and McKinley Funds
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- 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
- Portland Special Opportunities Fund
- Portland Value 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.

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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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