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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. August 7, 2018

Owner Operated Companies

Alphabet Inc. reported that expenses from its Google search business grew more slowly in the second quarter while revenue rose more steeply than expected. The company has grown quarterly revenue at least 20% year/year for two straight years. The quarterly growth rate of what the company pays ad partners, called traffic acquisition costs, fell for the first time in three years. Google Chief Executive Sundar Pichai told analysts that investments in artificial intelligence software meant to better predict where to place ads are making its services more attractive to advertisers. The company is selling more ads as its YouTube video service and Google search grow globally. Operating margin rose to 24% from 22% last quarter, excluding the $5 billion antitrust fine issued last week by the European Commission over Google's anticompetitive licensing of Android software. The margin was down from 26% a year ago. Net profit dropped to $3.2 billion from $3.5 billion, due to the fine. Adjusted earnings per share were $10.58, excluding the fine and the effects of other investments, ahead of the expectations for $9.52 of earnings per share. Alphabet's $32.66 billion in second-quarter revenue, 86% of which came from Google's advertising business, beat an average estimate of $32.17 billion.

Brookfield Asset Management Inc. announced it would buy Forest City Realty Trust, Inc. in a deal valued at $11.4 billion, including debt, months after Forest City ceded board control to activist shareholders. Forest City had been looking to sell itself and had reached out to more than 50 potential buyers, but failed to strike a deal. Brookfield said it would pay $25.35 in cash for each Forest City share. Forest City's portfolio includes office space, life science assets, retail space and multifamily units, as well as large-scale projects in New York, San Francisco and Washington, D.C.

Facebook, Inc.'s shares rose on optimism that the company is forging deeper relationships with banks to offer customer-service products via its Messenger chat application, a business that could boost engagement as growth slows on its main social network. Facebook has, for years, worked to make Messenger a natural place for consumers to communicate with businesses, aiming to replace email. Customers who opt in can already receive some airline boarding passes and receipts from PayPal transactions on Messenger. To do the same with major banks, Facebook has been trying to convince them that the conversations will be secure and customers' personal data won't be used in advertising. "Account linking enables people to receive real-time updates in Facebook Messenger where people can keep track of their transaction data like account balances, receipts, and shipping updates," Facebook said in a statement. "We're not using this information beyond enabling these types of experiences - not for advertising or anything else." (Source: Australian Finance Review).

Fortive Corporation – Industrial products maker Fortive announced it would buy software maker Accruent, LLC from private equity firm Genstar Capital, LLC for about $2 billion in cash. Accruent's software is used by more than 10,000 customers to manage real estate, facilities and assets and the company is expected to generate revenue of about $270 million in 2018. The Accruent deal will help complement strengths in its Fluke Digital Systems unit and its recent acquisition of construction software company Gordian, Inc. to create a technology portfolio consisting of connected devices, software enabled workflow and data analytics, Fortive said. Everett, Washington-based Fortive, the industrial technology spun off from Danaher Corporation, will fund the deal with available cash and proceeds from borrowings. The deal is expected to close in the third quarter and would add to Fortive's free cash flow and earnings next year.

The Kraft Heinz Company – topped quarterly profit and revenue estimates as the company raised prices of its products and posted higher-than-expected sales in the United States. Sales in the United States fell 1.9% to $4.51 billion in the second quarter, but topped the average analyst estimate of $4.43 billion. This is the company's first better-than-expected U.S. sales performance in at least five quarters. Kraft Heinz raised prices of its packaged foods and condiments as rising input expenses, including higher transport and commodity costs, weighed on the company's margins. "While cost inflation on many fronts has been holding back our bottom line, we expect our profitability to improve by year-end, with further momentum into 2019," Chief Executive Officer Bernardo Hees said in a statement. Net income attributable to the company's shareholders fell to $756 million, or $0.62 per share, in the three months ended June 30, from $1.16 billion, or $0.94 per share, a year earlier. Excluding items, the company earned $1 per share, beating analysts' estimate of $0.92, according to Thomson Reuters. The company said net sales rose 0.7% to $6.69 billion, topping average estimate of $6.59 billion.

Energy Sector

Baytex Energy Corp. reported second quarter results, which included production of 70,664 boed (79% oil and NGL), exploration and development capital expenditures of $79 million, and adjusted funds flow of $107 million ($0.45 per basic share) or $136 million excluding realized financial derivatives gains and losses. "We continued to deliver on our operational and financial targets in the second quarter, which included strong drilling results in Canada and the Eagle Ford. In addition, we are excited to be moving forward with the proposed merger with Raging River [Exploration Inc.] as we unite two strong oil companies with exceptional people and assets. We believe the combined company will deliver a powerful combination of per share production growth and strong free cash flow. We will be well-positioned to optimize our capital investment across our high rate of return asset base," commented Ed LaFehr, President and Chief Executive Officer. Operating netback was $35.42/boe in the Eagle Ford, the strongest since Q3 2014. The company's first two northern Seal wells at Peace River generated 30-day initial production rates of 918 boed and 660 boed, respectively. Baytex expanded its crude by rail volumes to 8,300 barrels per day (33% of its heavy oil production) in Q2 2018 and secured additional rail capacity, which will see its crude oil volumes delivered to market by rail increase to approximately 9,500 barrels per day in Q3 2018 and 10,500 barrels per day in Q4 2018.

Crescent Point Energy Corp. reported a broadly in line set of results for its second quarter. It reduced net debt in the quarter by over $390 million, driven by funds flow from operations in excess of capital expenditures and proceeds from recently announced dispositions of approximately $280 million. Funds flow from operations totalled $500.3 million, or $0.91 per share diluted, based on an operating netback of $40.74 per boe. Total capital expenditures during second quarter was $313.6 million. Second quarter production averaged 181,818 boed, comprised of approximately 90% oil and liquids. Crescent Point's U.S. operations continued to advance during second quarter. This included horizontal development in the Uinta Basin and North Dakota across multiple zones. In the East Shale Duvernay, the Company completed its first half 2018 drilling program with encouraging initial well results.

Whitecap Resources, Inc. reported second quarter results with record average production of 75,813 boed which was approximately 2,300 boed above its earlier forecast of 73,000 - 74,000 boed on development capital spending of $66.3 million. Outperformance in the quarter was driven by strong results in southwest Saskatchewan and the Deep Basin Cardium program and the company's ability to reduce the impact of down-time due to scheduled turnarounds. Funds flow netback (prior to hedges) increased 37% to $34.46/boe compared to $25.19/boe in Q2 2017 and increased 25% from $27.64/boe in Q1 2018. Whitecap generated record funds flow of $196.5 million ($0.47/share), invested $66.3 million to grow production per share by 4% compared to Q1 2018 and returned $32.7 million in dividends to shareholders which resulted in $97.5 million of free funds flow that was applied towards debt repayment in the quarter. Net debt to funds flow for Q2 was 1.7 times, a 19% decrease compared to 2.1 times in Q1 2018.

Financial Sector

Berkshire Hathaway Inc.'s Q2 2018 operating EPS of $4,190 per A Share ($2.79 per B share, up 67% year/year) was above consensus ($3,387 per A share) including stronger-than-expected results across all the major operating segments. Foreign Exchange gains likely boosted Q2 2018 operating EPS by around 10%. Q2 earnings were especially above analyst expectations in Insurance, BNSF Railroad, Finance and Financial Products, and the Manufacturing, Service, and Retail segment. Insurance results in Q2 included solid underwriting results in our view, especially at GEICO Corporation. Net Q2 EPS was $4.87 per B share including net unrealized investment gains from equity investments. Book value per share increased 3.1% quarter/quarter to $217,677 per A share ($145.12 per B share). This increase includes a $5.6 billion Q2 pre-tax non-cash mark-to-market net unrealized equity investment gain. In Q2, pre-tax Insurance earnings doubled year/year to $2.6 billion including improved underwriting and investment results. BNSF railroad Q2 earnings increased 8% year/year. The Manufacturing, Service and Retail segment's earnings increased 13% year/year. Berkshire Hathaway Energy segment earnings decreased 10% year/year including weaker year/year results at most business segments. The Finance & Financial Products segment earnings increased 15% year/year. It is estimated Berkshire now has approximately $88 billion of immediately deployable cash available for accretive acquisitions to supplement its organic growth as well as for investments and share buybacks. Berkshire also generates substantial annual free cash flow (estimated approximately$22 billion normalized). Warren Buffett (age 87) intends to remain at the helm for the foreseeable future, and his succession plan is in place. We would expect Berkshire to buy back shares under its recently updated share repurchase methodology if the company is unable to deploy a growing pile of excess cash in large acquisitions. We view a shareholder dividend as unlikely for now.

Barclays PLC has hit back against activist investor Edward Bramson with a strong quarterly performance in its investment bank, which helped the U.K. group to report an almost tripling of pre-tax profits in the period. The investment banking unit's solid performance, which mirrors strong trading results from U.S. rivals, contributed to an overall 10% rise in revenues at Barclays. Revenues also inched up at Barclays' U.K. unit, which made a healthy pre-tax profit compared with a loss last year. Barclays reported a £1.9 billion pre-tax profit for the quarter, up from £659 million a year ago. Operating costs across the group were down 2.6%, while sharply lower bad loan impairments particularly International consumer, litigation and conduct charges helped the bank to make a net profit of £1.2 billion — more than a third above consensus analysts' expectations and compared with a loss of £1.4 billion in the same period last year. Tangible Net Asset Value per share of 259 pence was slightly ahead of Q1 2018 251 pence. Published CET 1 of 13.0% looks marginally ahead of consensus of 12.9%, although includes +0.1% from Africa. Risk Weighted Assets of £319 billion were in line.

HSBC Holdings PLC posted a small increase in first-half pretax profit, as rising expenses from investments in a new growth strategy and a $765 million settlement for alleged mis-selling of U.S. mortgage securities ate into higher revenues. HSBC reported on Monday, a pretax profit of $10.7 billion in the six months through June, up 4.6% from the year-ago period. As the bank spent on hiring more frontline staff and expanding digital capabilities, its costs climbed 6% to $17.5 billion. Underlying Profit Before Tax of $6,106 million was 1% better with impairment offsetting weaker revenues. Pre-provision was 6% worse with Income of $13.7 billion missing by 2% whilst costs were 1% better at $8.1 billion. Balance sheet trends were impacted by foreign exchange with loans of $973 billion 2% light vs consensus. Looking on a constant currency basis, excluding volatile balances the trend was better with 1st half growth annualizing at approximately 9%. Tangible Net Asset Value of $7.00 was -$0.32 with a FX impact of -$0.29, whilst CET 1 ratio was -0.2% light at 14.2% with foreign exchange again likely to account for much of the miss.

Royal Bank of Scotland Group PLC produced a good set of Q2 2018 numbers. Profit Before Tax Q2 2018 was £613 million vs consensus' loss estimate of -£339 million. However, these results included material retail mortgage-backed securities' settlement and a £115 million fair value gain in revenue. Underlying Profit Before Tax Q2 2018 was £1.3 billion or +78% ahead of £720 million consensus. Though the beat was driven by lower restructuring and core litigation costs as well as lower impairments. The all-important pre-provision profit ex. litigation and restructuring was £1,466 million, +2% ahead.

Activist Influenced Companies

Brookfield Business Partners L.P. reported earnings attributable to unitholders of USD $119 million on revenue of USD $8.77 billion in fiscal Q2 2018. The company reported funds from operations (FFO) of USD $177 million in the quarter. "We reported strong company FFO growth as we benefited from the larger scale of our operations," said Cyrus Madon, Chief Executive Officer of Brookfield Business Partners. "In addition, we closed our acquisitions of Westinghouse Electric Company [LLC] and Schoeller Allibert [Holding B.V.], which meaningfully diversify our operations and are expected to contribute positively to our results over the long term." Company FFO in the quarter benefited from significantly improved results in the industrials segment and a gain, net of taxes, of $46 million realized in the business services segment. Net income attributable to unitholders for the quarter was $119 million compared with a net loss of $6 million in 2017. Net income per unit was $0.60.

Dividend Payers

Ares Capital Corporation reported core earnings of $0.39/share that was in-line with consensus. Ares also increased its quarterly dividend by $0.01/share to $0.39/share. This was another strong quarter for Ares, in our view, as the portfolio yield continues to benefit from increasing LIBOR as well as portfolio rotation of legacy assets. In addition, management noted the board approved a reduction in the company's asset coverage ratio that would allow Ares to increase its target leverage range to 0.9x-1.25x Debt /Equity over a 12-36 month period beginning next June.

Brookfield Property Partners L.P. (BPY) posted solid results with healthy operating performance from all its key segments. For Q2 2018, BPY reported FFO per diluted unit of USD $0.35, up 13% from USD $0.31 in the year-ago quarter (excluding a USD $40 million legal settlement in Q2 2017) and slightly below consensus of USD $0.37. The solid performance was entirely from strong same-property growth in the office portfolio as well as completed development projects. FFO from BPY's office platform was USD $149 million in Q2 2018, up 22% from Q2 2017 after excluding non-recurring items. The strong increase was driven by impressive 6.6% same-property Net Operating Income growth (4.7% on a constant currency basis), as well as contributions from recently completed developments. Management stated that developments completed in the last twelve months have been a key driver of FFO growth, contributing USD $11 million in FFO or 40% of the incremental increase during the quarter. BPY sold partial interests in all of its core Manhattan office and multi-family properties as part of a Brookfield Asset Management sponsored New York focused real estate venture. It has initially sold 28% of its ownership in this portfolio, and intends to sell an additional 7% interest (bringing the total to 35%) through the remainder of the year. Management indicated that the sale was in line with the properties IFRS value, implying a cap rate of 4.9%, and that BPY expects to generate total proceeds of USD $1.8 billion upon completion. Year-to-date, BPY has generated USD $2.2 billion from its capital recycling initiatives. Looking forward, BPY expects to generate an additional USD $1.7 billion of proceeds from asset sales which will fund both development and acquisitions, the Forest City acquisition in particular.

Dufry AG: Organic growth +5.5% in 1st half with +3.9% in Q2 – slow-down in Latin America: After organic growth of +7.2% in Q1, Q2 showed the expected slowdown (high comparisons Q2 2017 +8.7%) and with +5.5% in 1st half 2018 it was almost in line with expectation (6%). Southern Europe (1st Half +0.5%, Q1 -1.4%) had a slight improvement, U.K./Central Europe just slightly changed (1st half 2018 +3.3%, Q1 +3.9%), Asia continued with high growth (1st half 2018 +22%, Q1 +21%), also North America (1st half 2018 +7.7%, Q1 +8.4%), but Latin America had a slowdown (1st half 2018 +4.2%, Q1 +9.0%) due to a decline in Brazil/Argentina (currency devaluation). Gross profit margin with 59.8% and EBITDA margin with 11.3% at new record level: Gross profit margin was +30 bps to 59.8% and continued the trend seen in Q1 whereas EBITDA margin was at 11.3% (+50 bps) with less of an improvement in Q2 as concession fees were +40 bps in the 1st half of 2018 (Q1 -20 bps). FCF more than doubled: FCF was at CHF 330 million compared to CHF 128 million in the 1st half of 2017 with capital expenditures at CHF 127 million (First half 2017 CHF 152 million). Net debt/EBITDA is now at 2.95x (year-end 3.6x).

TransAlta Renewables Inc. reported Q2 2018 EBITDA (comparable) of $98.0 million, essentially in line with consensus of $98.8

million ($95.3 million - $102.0 million) reflecting a 118.0% payout ratio. TransAlta Renewables maintained its outlook for 2018, with comparable EBITDA ($400 - $420 million). On June 22, 2018, TransAlta Renewables issued 11.86 million Common Shares at a price of $12.65 per share for gross proceeds of approximately $150 million. The net proceeds were used to partially repay drawn amounts under its credit facility, which were drawn to fund recent acquisitions.

Economic Conditions

U.S. Nonfarm payrolls rose 157,000 in July, falling short of expectations (190,000) but the prior two months were bumped up by 59,000 to well above 200,000 each. The three-month average (224,000) is still above any similar period last year. Factory jobs are accelerating, and there were broad gains in other sectors. The biggest increase in temporary help jobs in nearly two years bodes well for the coming months. Household survey jobs spiked 389,000 and the employment rate hit a new cycle-high of 60.5%. This, alongside a steadier participation rate, shaved the jobless rate to 3.9%. The more comprehensive U6-rate (which includes the unemployed, underemployed and discouraged workers) fell to a new cycle low of 7.5%, indicating a very tight labour market in our view. Accordingly, wages are slowly edging higher, up 0.3% in the month. While the yearly rate held at 2.7%, this is near the top of the cycle range.

U.S. non-manufacturing ISM fell for the first time in three months, down 3.4% in July to 55.7%, the lowest since August 2017. That, in itself, suggests some downside risk for Q3 growth in our view. The breakdown of the components was very similar to the manufacturing ISM. The headline was dragged down by a 6.2% drop in new orders (a signal for future activity), the largest monthly setback in two years, to a 7-month low of 57.0%, and a 7.4% dive in business activity (aka production), the largest monthly drop in nearly a decade (or since November 2008) to a 12-month low of 56.5%.

U.K. Consumer spending grew +5.0% year/year in July 2018, according to the latest Barclaycard data. This is the third consecutive month with spending growth over +5.0%, which is the strongest consistent growth in our data history. U.K. domestic sectors have held up YTD and resilient spending should continue to support their near-term performance. The strength came from in store this month, where spending grew +2.9%, which is the strongest growth since April 2014. Online spending grew +10.4%, which, while still buoyant, is weaker compared to its history.

Financial Conditions

The Bank of England (BoE) Monetary Policy Committee (MPC), as widely expected, voted unanimously to increase the cost of borrowing from 0.5% to 0.75% at its August meeting. The latest move brings the policy rate to its highest level since March 2009. For the first time, the BoE also gave a hint of where borrowing costs may end up once they are back to "normality". It provided an estimate of the "trend real interest rate", what it calls R*. Whilst this used to be around 5% before the crisis, the BoE said it was currently about half that, at 2-3%, once inflation is included. In its follow-up Quarterly Inflation Report (QIR), the BoE also raised its inflation forecasts marginally, lifting its 1-year inflation forecast to 2.15%, from 2.13%, 2 year inflation forecast to 2.09%, from 2.03% and 3 year inflation forecast to 2.13%, from 2.00%. The BoE also raised its GDP growth forecast for this year slightly, from 1.4% to 1.5%, and lifted next year's GDP forecast from 1.7% to 1.8%. The BoE cut its unemployment forecast in the coming years, predicting for the first time that the jobless rate would drop beneath 4%, to 3.9%.

The Reserve Bank of Australia (RBA), as expected, held its official cash rate (OCR) at 1.5% for a record 222nd meeting. The concluding paragraph of today's accompanying statement was exactly the same as the one in July, 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 0.30% and the U.K.'s 2 year/10 year treasury spread is 0.58% - 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. Also, the narrowing gap between yields on the two-year and 10-year Treasuries is of concern given its historical track record that when shorter term rates exceed longer dated ones, such inversion is usually an early warning of an economic slowdown.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.60% (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 10.96 (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 bodes 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 www.portlandic.com/prices

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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