OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
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Portfolio Return	Benchmark Return	Outperformance
124.0%	91.9%	32.1pts

The Best Ideas Portfolio (see page 8): AAPL, MO, BWLD, BRK-B, CSCO, CVS, DG, FB, XLF, GE, GM, GOOG, GOOGL, XLV, INTC, JNJ, KBE, KMI, KORS, PYPL, PCLN, SDY, TEVA, UNP, XLE, XLU, VRNT, V

See page 8.

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Goals of the Best Ideas Newsletter: We want to deliver positive returns, year after year, in addition to outperforming the market benchmark. We may not always be successful, however. Our Best Ideas portfolio is generally found on page 8 of each edition.

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"It's easy to understand why many have chosen Valuentum over bloggers and commentators. We're actually doing the financial analytical work!"
- Brian Nelson, CFA

Trash As A Source of Cash and 2 New Additions to the Best Ideas Newsletter Portfolio

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By Kris Rosemann and Brian Nelson, CFA

It's time to take out the trash… that is, trash hauler Republic Services (RSG) from the Best Ideas Newsletter portfolio (it's not "trash" – it's actually a fantastic company and has been a great stock, but boy is it pricey now). We're also adding ~1.5% positions in two new ideas, Dollar General (DG) and Verint Systems (VRNT), in the Best Ideas Newsletter portfolio as both have attractive valuations, in our view. Dollar General's 27 consecutive years of same-store-sales growth are impressive, and Verint is now at the low end of its short-term uptrend, offering an interesting entry point for consideration.

KEY CONCEPT: Stocks in the Best Ideas portfolio (see page 8), which have generally registered a 9 or 10 on the VBI when added, should be considered our best ideas at any point in time. After adding firms to the Best Ideas portfolio, we may tactically trade around these positions when they have VBI ratings between 3 and 8 depending on the size of their weighting in the portfolio or the attractiveness of them relative to other opportunities (a score of 3 through 8 is equivalent to a 'we'd hold'). We tend to remove firms from the Best Ideas portfolio when they register a 1 or 2 ("we'd sell"). Contact us for more details about how the team utilizes the Valuentum Buying Index to run the portfolio.

Just a quick reminder – our best ideas are already included in the newsletter portfolios, so these two ideas are incremental 'best ideas' as it relates to fit in the context of broader market dynamics, which are quite frothy. Let's talk about why we're making these changes to the Best Ideas Newsletter portfolio, including a discussion of our thought processes supporting the two new ideas, which will collectively account for a relatively minor weighting in the newsletter portfolio. How heavily we weight each holding is key to understanding our conviction in each idea.

Please also note that these changes are to the Best Ideas Newsletter portfolio, the newsletter of which will be released Saturday, the 15th, not to the Dividend Growth Newsletter portfolio, the newsletter of which will be released Monday, May 1. You get two newsletters with a membership to Valuentum – and that's in addition to the 1,000+ 16-page reports and dividend reports, fair value estimates/ranges, and proprietary, forward-looking Dividend Cushion ratios. It's easy to understand why many have chosen Valuentum over bloggers and commentators. We're actually doing the financial analytical work!

That said, the decision to remove Republic Services from the Best Ideas Newsletter portfolio wasn't an easy one – we love the company!

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But Republic's valuation--and for the most part, valuations across much of the environmental services industry--have become extremely stretched. We've let this winner run for some time, collecting lots of dividend checks, but as both its chart and valuation have now become increasingly extended, we feel most comfortable locking in some major profits.

Republic Services was added to the Best Ideas Newsletter portfolio on May 19, 2011 at $31.42 per share, and upon the removal of the position intraday April 13 (shares are changing hands at $62.41), the removal price amounts to roughly double the cost basis of the position. This will be reflected in the newsletter portfolio at the release of the next edition of the Best Ideas Newsletter portfolio.

We're taking a portion of the cash from the position in Republic Services and adding 1.5% positions (this is their respective weightings in the Best Ideas Newsletter portfolio) in two new ideas: Dollar General and Verint Systems. The position in Dollar General consists of 50 shares at $68.83, and 87 shares of Verint Systems at $38.95.

Let's take a look at the two ideas in depth. Even if you're not following the Best Ideas Newsletter portfolio or Dividend Growth Newsletter portfolio closely, incremental idea generation is a valuable part of our service, as are the full reports for each company in our coverage. These are core attributes of any investment research company.

Dollar General

Consumers across the US are familiar with Dollar General. Its track record of same-store sales growth is impressive, and we're adding this idea to the Best Ideas Newsletter portfolio as the economic environment remains uncertain, despite optimism surrounding the new Trump administration. Dollar stores are often seen as a defensive "play" as cost-conscious consumers look to save money in any of the broad range of products offered by multiline discount retailers such as Dollar General. So what sets Dollar General apart from its peers?

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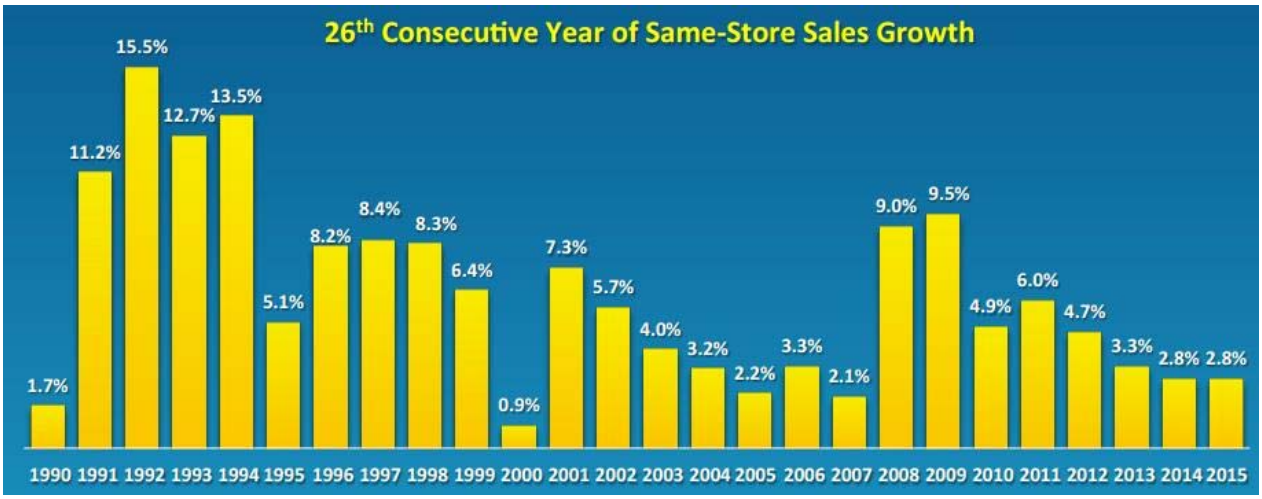

Image Source: Dollar General

First and foremost is its tremendous track record of same-store sales performance. 2016 marked the 27th consecutive year in which it reported positive same-store sales growth, and the measure has come in below 2% only twice over that 27-year stretch (1990 and 2000). Performance often improves in times of macroeconomic pressure, including during the Great Recession of 2008 and 2009 when same-store sales leapt 9% and 9.5%, respectively. Dollar General's business is recession resistant.

In addition to impressive same-store sales growth, the largest discount retailer in the US in terms of store count also has substantial room for store unit growth, which has been strong in recent years as well. Its current store base is over 13,000 across 44 states, and management anticipates adding as many as 1,000 stores in 2017 alone, after adding 900 in 2016, as it believes it has the potential to roughly double its store count over time. However, the majority of these new stores will be smaller format stores that will enable the retailer to optimize merchandise mixes and reduce occupancy costs. As a result of these expectations, Dollar General is targeting $30 billion in annual sales in 2020, compared to just under $22 billion in fiscal 2016 (ended January 31, 2017).

Though Dollar General's balance sheet health is not what we would like it to be for a retailer in the midst of such a growth plan--net debt stood at more than $3 billion as of the end of fiscal 2016--its free cash flow generation should be sufficient in handling the debt load and expansion plans, in our view. During the past three years (fiscal 2014-2016), free cash flow has averaged more than $960 million, good for a ~4.7% free cash flow margin over the three-year period, even after a material ramp in capital spending in recent years--capital expenditures grew to $560 million in fiscal 2016 from less than $375 million in fiscal 2014. Such free cash flow generation and an impressively-consistent track record give us confidence in management's ability to effectively execute its growth plan.

Shares of Dollar General also offer potential from a valuation point of view as they are trading in the lower half of our fair value range, below our fair value estimate of $75 per share. Management's guidance of non-GAAP diluted earnings per share to be in a range of $4.25-$4.50 suggest shares are changing hands at just under 15.8x fiscal 2017 earnings. The company also offers an uninspiring but healthy quarterly dividend with a current annualized yield of ~1.5% at recent price levels.

We like what Dollar General has to offer as the current economic expansion grows longer in the tooth with each passing day. Its track record of same-store sales performance, thanks to its recession resistant business, is simply incredible, and we love its future growth potential and capability to fund such growth with internally generated cash flows. Such factors have given us the confidence to add 50 shares of Dollar General to the Best Ideas Newsletter portfolio at $68.83 per share.

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Verint Systems

As the era of big data becomes more and more of a reality, enterprises are being inundated with more information than ever before. An information overload can be just as useless or frustrating as a lack of information, so how can companies generate insights more efficiently and effectively?

Enter Verint Systems.

Verint Systems is the self-proclaimed leader of actionable intelligence, which it defines as crucial insights that enable decision makers to anticipate, respond, and take action. The company has 10,000+ customers in more than 180 countries and serves more than 80% of the Fortune 100. Its two operating segments, 'Customer Engagement Solutions' and 'Cyber Intelligence Solutions,' split its total addressable market of actionable intelligence, which has grown to ~$8 billion as of 2016 from ~$3 billion in 2012.

Verint's 'Customer Engagement Solutions' segment is a leading provider of analytical software that is deployable on-premises or in the cloud, helping organizations optimize customer engagement and increase loyalty while generating operational efficiencies and reducing risk. The segment's solutions facilitate the modernization of customer-centric organizations' customer engagement operations in our increasingly digital world. The company's 'Cyber Intelligence Solutions' addresses a wide range of security and intelligence challenges via its broad portfolio of data mining solutions.

The 'Customer Engagement Solutions' segment is the larger of Verint's two segments--it accounted for roughly two thirds of fiscal 2017 (ended January 31) revenue--and boasts higher margins than the 'Cyber Intelligence Solutions' segment. Though both segments have a high level of repeat business, nearly 60% of the 'Customer Engagement Solutions' segment's revenue is of the recurring variety. We're big fans of the visibility in future revenue, and management anticipates this level continuing to grow as cloud-based revenue grows as a percentage of 'Customer Engagement Solutions' segment revenue--it accounted for more than $100 million of ~$716 million in revenue in fiscal 2017 and is expected to outpace overall company growth in fiscal 2018 at 25%+. Other sources of recurring revenue include recovery resources and maintenance, and even though management is unable to classify its on-premises software products as recurring revenue, it is confident in the 'stickiness' of these products and the level of repeat business from its customer base.

Verint's growth potential and ability to continue advancing the proportion of recurring revenue within its business are supported by its thirst for innovation. The firm has plowed more than $1 billion into research and development over the past decade, an impressive level when considering it surpassed the $1 billion in revenue mark as recently as fiscal 2015. As a result, it boasts more than 800 patents and applications, the defense of which will be necessary to maintain its position as the leader of actionable intelligence.

Such a drive for innovation is expected to help Verint Systems deliver mid-single-digit revenue growth in its 'Customer Engagement Solutions' segment and high-single-digit revenue growth in its 'Cyber Intelligence Solutions' segment in fiscal 2018. We expect the recent reorganization of Verint's formerly three operating segments into two to help reinvigorate overall growth via a renewed focus and improvement in its go-to-market processes. Slight operating margin expansion, a trend we expect to continue as economies of scale are realized in its growing actionable intelligence platform, is projected to help drive non-GAAP earnings per share to ~$2.70 in fiscal 2018 compared to $2.51 in fiscal 2017.

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	FYE 18
Customer Engagement Revenue Growth	Mid-single digits
Cyber Intelligence Revenue Growth	High-single digits
Total Revenue	$1.14 billion +/- 2%
Operating Margins	Slight expansion
EPS at Midpoint of Revenue Guidance	$2.70

Image Source: Verint Systems

Though we are largely positive on Verint's current outlook, its financial position could be better. As of the end of fiscal 2017, the company had nearly $320 million in cash and cash equivalents compared to just under $750 million in total debt, but its net debt-to-adjusted EBITDA was a reasonable 2.1x. We think the company's credit ratings are due for an upgrade, as the most recent credit actions regarding its debt took place in mid-2014 when Moody's and S&P upgraded it to Ba3 and BB, respectively. At the time of Moody's upgrade, it cited debt-to-EBITDA improving to 4.2x from 5.3x as rationale being the rating adjustment, and that measure sat at a more healthy level of 3.2x at the end of fiscal 2017.

Organic growth, which we are expecting to return in a meaningful way, and the maintenance of leverage at more recent levels should result in a credit upgrade, according to Moody's credit ratings rationale. Free cash flow generation has been solid in recent years as well, further supporting our growing confidence in the company's rebounding financial position. In the three-year period ending January 31, 2017, free cash flow has averaged more than 13% of revenue.

In addition to our keenness for Verint's business model, shares offer a reasonable valuation opportunity at current prices. Our fair value estimate of $50 per share indicates we see material upside potential in shares, which are trading at ~14.7x management's EPS guidance for fiscal 2018. We find such levels compelling for a company with solid growth prospects in today's frothy market environment, and as a result, we have added 87 shares of Verint Systems to the Best Ideas Newsletter portfolio at $38.95 per share.

New Taxes? Trump's Misstep and Seeming About-Face

News that Trump was considering new taxes, his failure to repeal Obamacare, and the seeming about-face on for-profit education regulations have put the probability of corporate tax reform in jeopardy, from where we stand. If we're right, the implications on the market could be considerable… and not in a good way. Let's talk about this in the context of current market valuations.

By Brian Nelson, CFA

Image Source: FactSet and Valuentum estimates (2019, 2020)

The shot across the bow has been fired. The news came and went, and many seemed to ignore its potential massive implications. What am I talking about? As you have read by now, Donald Trump's first major move as President has resulted in failure--a divided Republican House pulled legislation March 24 that would have repealed the Affordable Care Act ("Obamacare") from consideration. Obamacare appears to be here to stay for some time yet.

But what's the major investment takeaway from this--implications on healthcare (XLV) stocks, more of the same for them? Perhaps. But that's not what we think is the major takeaway. In a market (SPY, DIA) that is effectively pricing in a major reduction in corporate tax rates that will drive earnings higher during the Trump administration, could this major legislative blow foreshadow disappointment in corporate tax reform, too? It might, and if so, it's a huge deal.

Here's why: On March 31, the S&P 500 was trading at a forward price-to-earnings ratio of 17.6 times, above its 5-year average of 15 times and its 10-year average of 14.3 times. That's not all that's troubling though--the S&P 500 is trading at 16.1 times calendar 2018 earnings of $146.61, which implies growth of nearly 12% on top of double-digit growth expected in calendar 2017. If we apply a 3% bottom-line growth rate in earnings for 2019 and 2020, the S&P 500 today is trading at ~15 times 2020 earnings. Translation--the market is pulling forward years and years of growth in current prices.

New Taxes...continued on next page

New Taxes...from previous page

What's more, it's reasonable that many bottom-line forecasts for 2018 are factoring in--if not explicitly then implicitly--some probability that corporate tax reform will be successful. If more and more investors and analysts start to embrace the idea that corporate tax cuts won't come easy, just like the failed repeal of Obamacare, earnings estimates are likely to come down considerably, and that alone may spark a broader market sell-off. Though many companies have been buying back their own stock hand over fist, we doubt it will be enough to stem the declines. Market valuations are just too frothy.

But are we being too dire? After all, what's one setback in repealing Obamacare in the whole of Trump's ambitious political agenda. Can we really extrapolate just one failure to potential troubles in implementing corporate tax reform? Well, maybe because it's not the only surprise thus far. Late last month, the Trump administration "offered a forceful defense of the so-called gainful employment rule." The language appears to fly in the face of a recent March 6 announcement from the US Department of Education. The apparent about-face comes off the heels of Trump's own personal troubles with his namesake Trump University, which recently paid out millions to settle long-running litigation. For-profit education stocks may find no refuge with Trump at the helm.

Perhaps even more concerning have been reports of new taxes. The Washington Post noted that the Trump administration had been considering a carbon tax to increase revenue, a move that we find astonishing given that new taxes simply fly in the face of plans to grow tax revenue through economic growth, not by increasing the rate or via new levies. Even though the carbon tax may no longer be on the table according to a Trump administration spokesperson, it's somewhat difficult to explain how a new tax could have even been considered when the big question for investors continues to rest on whether corporate tax reform is going to happen at all. The Washington Post may have it right that this "rapid reversal illustrates a Trump administration still in the initial stages of a plan to rework the tax code."

But how early? If corporate tax reform isn't implemented before the end of 2017, my bet is that 2018 earnings numbers on the S&P 500 are probably too optimistic--and that may mean some profit taking as the market starts to price in analyst earnings adjustments several months in advance. In light of all the lobbying in Washington, modifying the tax code will be just as challenging--if not more so--than changing the healthcare laws rolled into Obamacare, something that has already failed. Is the market getting too far ahead of itself? Well, we will say this -- for this first time in Valuentum's history, there isn't one stock that registers a 9 or 10 on the Valuentum Buying Index. Yes, the market remains pricey by most measures.

Our best ideas for consideration continue to reside in the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio, or within the Nelson Exclusive publication.

Three Notable Pending FDA Approvals

The final step of the drug approval process is the filing of a new drug application (NDA), when the FDA assesses trial results before deciding if the treatment warrants marketing approval. A delay or rejection can have a meaningful impact on the equity price, so let's dig into a few notable upcoming decisions.

By Alexander J. Poulos and Kris Rosemann

Baricitinib

Baricitinib is a Janus Kinase 1&2 inhibitor that is being studied for the treatment of a wide range of inflammatory diseases, and clinical trials for the indication of rheumatoid arthritis conclusively demonstrated superiority to placebo--and Humira. The superiority to Humira, in our view, is a key differentiator in the crowded inflammatory disease market, a direct result of a significant and growing demand for treatment. According to Express Scripts (ESRX), the inflammatory disease market is the largest portion of fast-growing specialty drug budgets.

Three Notable...continued on page 9

The Best Ideas Portfolio

By Valuentum Analysts

Portfolio Return	Benchmark Return	Outperformance
124.0%	91.9%	32.1pts

Below we outline the constituents of the portfolio and their respective weightings and returns thus far (please note that many stocks have been removed since inception). Each subsequent issue discusses Valuentum's latest changes to the portfolio and analysis and trends impacting companies in our Best Ideas portfolio.

We currently have 14% of the portfolio in cash, a level we're looking to bring down in coming months. Tactically, we like to have the most cash when the market is making new highs and fully invested when the market is putting in short-term lows.

Our investment process is completely transparent and easy to implement in your own portfolio. The goal of the Best Ideas portfolio is to outperform the S&P 500 Index and to generate positive returns each year regardless of the market environment. We may not always be successful.

THE BEST IDEAS PORTFOLIO -- as of April 15, 2017 — **Best Ideas Portfolio Inception Date: May 17, 2011**

Portfolio Holdings	Symbol	Initial VBI*	Current VBI**	Fair Value	P/FV	First Purchase	Cost/Shr ($)	# Shares	Total Cost ($)	Price/Shr ($)	Current Value ($)	Cumulative Div's Rec'd	% of Portfolio	% Return (dividends included)
Bullish														
Apple Corp.	AAPL	10	7	$159.00	0.89	17-Jun-11	51.92	107	5,569.33	141.05	15,092.35	1,211.81	6.7%	192.7%
Altria Group	MO	8	3	$60.00	1.19	28-Jun-11	28.39	157	4,471.86	71.30	11,194.10	2,571.33	5.0%	207.8%
Berkshire Hathaway	BRK-B	6	6	$173.00	0.94	20-Apr-16	146.13	69	10,089.97	162.90	11,240.10		5.0%	11.4%
Buffalo Wild Wings	BWLD	6	3	$177.00	0.85	27-Aug-15	179.81	16	2,876.90	150.75	2,412.00		1.1%	-16.2%
Cisco	CSCO	9	7	$42.00	0.77	14-Nov-14	26.33	221	5,831.87	32.42	7,164.82	396.93	3.2%	29.7%
CVS Health	CVS	9	6	$104.00	0.75	6-Jan-17	81.84	79	6,472.36	77.96	6,158.84	39.50	2.7%	-4.2%
Dollar General	DG	4	4	$75.00	0.92	13-Apr-17	68.83	50	3,448.50	68.74	3,437.00		1.5%	-0.3%
Energy Select SPDR	XLE	NR	NR	NA	NMF	6-Oct-15	67.14	143	9,608.02	69.31	9,911.33	380.71	4.4%	7.1%
Facebook	FB	6	7	$172.00	0.81	29-Jan-16	112.10	50	5,612.00	139.39	6,969.50		3.1%	24.2%
Financial Select SPDR	XLF	NA	6	NA	NMF	9-Jan-11	13.46	178	2,405.83	22.92	4,084.78	305.71	1.8%	82.5%
General Electric	GE	7	6	$36.00	0.82	21-Oct-13	25.99	375	9,761.75	29.56	11,085.00	1,167.00	4.9%	25.5%
General Motors	GM	6	6	$43.00	0.78	26-Aug-16	31.65	132	4,184.80	33.39	4,407.48	150.48	2.0%	8.9%
Google - Class C	GOOG	10	7	$924.00	0.89	23-Oct-12	450.92	7	3,170.42	823.56	5,764.92	10.35	2.6%	82.2%
Google - Class A	GOOGL	10	7	$924.00	0.89	4-Apr-14	Split	7	Split	840.18	5,881.26		2.6%	+++
Health Care ETF	XLV	9	6	NA	NMF	22-May-12	36.60	125	4,582.00	74.00	9,250.00	563.86	4.1%	114.2%
Intel	INTC	6	4	$42.00	0.84	12-Sep-11	20.48	150	3,086.50	35.25	5,287.50	673.50	2.4%	93.1%
Johnson & Johnson	JNJ	6	7	$121.00	1.03	29-Jan-16	104.18	54	5,632.72	124.99	6,749.46	213.30	3.0%	23.6%
SPDR S&P Bank ETF	KBE	NR	NR	NA	NMF	9-Jan-12	21.07	100	2,114.00	41.01	4,101.00	277.14	1.8%	107.1%
Kinder Morgan	KMI	5	3	$20.00	1.07	17-Feb-16	17.29	157	2,721.53	21.39	3,358.23	78.50	1.5%	26.3%
Michael Kors	KORS	8	6	$60.00	0.63	27-Aug-15	43.44	68	2,953.80	37.56	2,554.08		1.1%	-13.5%
PayPal	PYPL	UR	6	UR	UR	17-Jul-15	Spin-off	100	Splt	42.55	4,255.00		1.9%	+++
Priceline	PCLN	10	6	$1705.00	1.02	26-Feb-15	1239.49	6	7,450.91	1738.77	10,432.62		4.7%	40.0%
SPDR S&P Dividend ETF	SDY	NR	NR	NA	NMF	20-Apr-16	81.33	124	10,091.92	86.97	10,784.28	251.28	4.8%	9.4%
Teva Pharma	TEVA	6	7	$52.00	0.62	24-Jul-13	41.22	77	3,180.94	32.06	2,468.62	390.27	1.1%	-10.1%
Union Pacific	UNP	6	6	$97.00	1.08	24-Jul-13	79.67	40	3,193.80	104.78	4,191.20	288.40	1.9%	40.3%
Utilities Select SPDR	XLU	NR	NR	NA	NMF	18-Mar-14	41.12	83	3,419.96	51.67	4,288.61	398.97	1.9%	37.1%
Verint Systems	VRNT	6	6	$50.00	0.78	13-Apr-17	38.95	87	3,395.65	38.80	3,375.60		1.9%	-0.6%
Visa	V	7	7	$84.00	1.06	30-Nov-11	26.86	188	5,064.39	88.87	16,707.56	393.71	7.5%	237.7%
Latest changes: Sold 201 shares of RSG (4/13), 50 shares of DG purchased (4/13), 87 shares of VRNT purchased (4/13).														
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.											31,356.50		14.0%	0.0%
Bearish														
For investors seeking 'short' or 'put option' exposure, please consider firms with VBI ratings with 1 and 2 as ideas.														
Best Ideas Portfolio Value								Original -->	100,000.00	Current -->	**223,963.74**			**124.0%**
S&P 500 Index (SPY)						17-May-11	132.69	754	100,000.00	232.51	175,227.97	16,648.91	91.3%	
Cash											16,648.91		8.7%	
Benchmark Portfolio Value											**191,876.89**			**91.9%**
Relative Outperformance														**32.1 pts**

Data as of April 15, 2017. The cost basis of positions includes commissions. The Best Ideas Newsletter portfolio's performance includes dividends received, but not interest received on cash balances. The Best Ideas Newsletter portfolio is not a real money portfolio. The 'Benchmark Portfolio Value' reflects dividends received and held as cash.

* VBI score at the time we added the firm to the portfolio.

** See our methodology regarding the Valuentum Buying Index (VBI). Best Ideas portfolio is not a real money portfolio.

Standard Disclaimer: Our Best Ideas portfolio is for information purposes only and should not be considered a solicitation to buy or sell any security. Valuentum is not responsible for any errors or omissions or for results obtained from the use of our Best Ideas portfolio and accepts no liability for how readers may choose to utilize the content.

*Three Notable...*from page 7

Baricitinib is owned by Incyte (INCY), a mid-stage biotech with an impressive pipeline, and Eli Lilly (LLY) under an exclusive global license and collaboration agreement dating back to 2009. Incyte currently has one approved product on the market, Jakafi for the treatment of Myelofibrosis and Polycythemia Vera. Even with a unique product in Jakafi that generated sales north of $800 million in 2016, earnings growth remains challenging for the firm. Incyte reported earnings of $0.54 per diluted share in 2016, as the focus of the company remains on its research pipeline.

2017 Guidance

	Guidance
Jakafi net product revenues	$1,020-$1,070 million
Iclusig net product revenues	$60-$65 million
Research and development expenses: ongoing	$785-$835 million
Research and development expenses: anticipated one-time items*	$205 million
Selling, general and administrative expenses	$340-$360 million
Change in fair value of acquisition-related contingent consideration	$30-$35 million

Source: Incyte 8-K Feb 2017.

Incyte expects R&D costs to virtually equal Jakakfi net product revenue—"net" is the key term, as Incyte is responsible for marketing the product in the US exclusively. The product is sold under the name "Jakavi" outside the US by Novartis (NVS), a move we applaud--the cost of marketing the product worldwide is outside Incyte's area of expertise.

In a similar move with Baracitinib, Incyte has sought and found an able partner in Eli Lilly. Lilly will pay Incyte a tiered royalty of global sales in the 20%-29% percent range on an ongoing basis. In the near term, Incyte will receive milestone payments of $100 million if the US FDA approves the product, and it recently received an additional royalty of $65 million when the product was approved in the EU in February 2017. We believe the terms of the deal with Lilly are very favorable for Incyte, reflecting the global potential of the product.

Baracitinib has a few notable advantages over Humira, the current gold standard of the therapeutic class. Baracitinib is a small molecule that is dosed as a convenient oral dosage form, and it bypasses the need for injections, in our view, a notable advantage. Lilly and Incyte reps are armed with head-to-head data pitting Humira against the results obtained with the group treated with Baracitinib, which have been taken from the RA-Beam study, and we have no doubt the results will be used to push for greater access.

However, the challenge we see before Lilly and Incyte is payer acceptance. For the product to quickly gain market share, creative pricing schemes will be necessary, and a scenario may very well develop where either Lilly and Incyte or Sanofi (SNY) and Regeneron Pharmaceuticals (REGN), with its comparable treatment Sarilumab, compete aggressively on price.

Baracitinib's original PDUFA date (deadline for a decision by the FDA) was pushed back by three months to allow the agency additional time to evaluate additional data, and we now expect a decision in the second quarter of 2017. Though the initial marketing ramp will likely take some time, we expect Baracitinib to become a blockbuster treatment.

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Brineura (Cerliponase Alfa)

Biomarin Pharmaceuticals' (BMRN) newest treatment, Brineura is targeted for the treatment of a CLN2 disease, a subsection of Batten disease, and it is poised to help expand the company's stable of medication used for the treatment of rare diseases. Brineura's current PDUFA is April 27th, 2017, after the FDA requested additional data from Biomarin this past September.

Batten Disease

Batten Disease is an autosomal recessive genetic disorder with 50 unique variants. The disease is classified as a lysosomal disorder which affects the body's ability to transport and remove waste from the cells. The inability to properly remove unusable products leads to a buildup, with common side effects being seizures, dementia, and loss of vision.

The CLN2 subsection remains an area of significant unmet need. The disease will manifest itself in the late infantile portion of life, typically characterized by seizures that will become increasingly difficult to control. As the disease rapidly progresses, the child will lose the ability to see and speak, and by the age of 6, the child will become dependent entirely on the care of others. The prognosis for CLN2 is terminal, typically between the ages of 6-12.

Due to the lack of meaningful treatments to halt the progression of CLN2, we expect Brineura to become widely accepted with little in the way of reistance from payers via aggressive reimbursements. The cost of care for those with late stage CLN2 is enormous, and around the clock care is prohibitively expensive.

Biomarin's Financials

Biomarin's focus remains on commercializing numerous treatments for rare diseases, and as a result, the company remains devoid of profit, as R&D spending remains high. While we applaud the progress the company has made, we are not fans of its equity. The intense focus on rare diseases limits the competitive field, but it also reduces the size of the overall end market.

Further complicating matters is the wide geographic dispersion of the patient population. Biomarin needs to service the needs of clinicians--a costly endeavor--but can't achieve efficiencies of scale due to the smaller, more dispersed patient population. Biomarin's market cap is currently north of $15 billion, quite lofty when considering 2017 expectations for revenue in a range of $1.25-$1.30 billion and a GAAP net loss of $140-$180 million in the year.

Though its rare disease treatment portfolio could make it an interesting takeout candidate, Biomarin's lofty price tag could keep potential suitors at bay for some time.

Keytruda in Non-Small Cell Lung Cancer

The critical need for innovative treatments in the field of oncology remains. One of the largest areas of need is Non-Small Cell Lung Cancer (NSCLC), the most prevalent form of cancer outside of prostate and breast cancer. Promising research in the field continues with the PD-1 class showing particular promise, and Bristol-Myers Squibb (BMY) initially garnered the bulk of the attention as its treatment Opdivo was the first of the class to reach the market. Opdivo racked up an impressive number of indications as the treatment consistently showed superiority over conventional therapies, and Bristol seems poised to leverage its first-mover advantage into a durable oncology franchise.

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Quietly waiting in the wings, is Merck (MRK) with its own PD-1 marketed under the name Keytruda (Pembrolizumab). Keytruda also posted impressive results, but had been viewed as a distant second with Opdivo maintaining a commanding lead. However, fortunes changed abruptly this past summer when Opdivo failed to meet its primary endpoint in the CheckMate-026 study. Prior to that study, Opdivo proved efficacious in every indication it was tested, making the news even more of a shock. Bristol's share price plummeted on the announcement. To further complicate matters, data released a few months later revealed Opdivo not only failed to meet its primary endpoint, but also failed to provide superior results when compared to a placebo.

Meanwhile, Merck methodically proved the value of Keytruda in tightly-controlled studies. The initial differentiating trial is Keynote-10, which was comprised of patients that were previously treated and possessed tumors that expressed PD-L1. Armed with positive results and the unexpected failure of Opdivo, Merck has a clear path to establish first line dominance in NSCLC. Thus far, Merck has proven Keytruda's efficacy in "patients whose tumors expressed a high amount of PD-L1," the goal is to gain approval for all patients.

The pivotal data needed for first line designation was recorded in the Keynote-21 cohort G trial with the key takeaway being that Keytruda improved the progression-free survival rate better than was expected. Based on the results of the trial, the FDA accepted Merck's application and granted the product an "accelerated review" which will speed up the overall process. The FDA indicated its comfort with the use of Keytruda irrespctive of PD-L1 expression, a key differentiator. Should Keytruda be approved in first line NSCLC, we expect it to become Merck's top selling product in a few years and inject new life in a rather uninspiring product lineup.

Conclusion

We continue to monitor the new drug approval process closely. Though larger pharmaceutical companies have diverse portfolios that can help mitigate the revenue erosion or changes in expectations associated with the approval and development process of a key treatment, we would be remiss if we did not warn investors of the potentially wild swings in equity prices of smaller entities whose outlook may rest on the success of a small number of drugs. Only you know your personal financial risk tolerance.

Disclosures: Healthcare and biotech contributor Alexander J Poulos is long Novartis (NVS) and Regeneron Pharmaceuticals (REGN).

Panera Eaten Up; SeaDrill's End, Cisco's Dividend Hike and Much More

Let's go around the horn with recent investment-related news. Let's say goodbye to Panera, talk about SeaDrill's infamous demise, follow up on the Coach dividend saga, address Cisco's payout strength and attractive valuation, update readers on Medtronic's portfolio optimization initiatives, and try to reason through Tesla's recent price surge.

By Kris Rosemann and Brian Nelson, CFA

Goodbye Panera

I think most of us were surprised a bit Wednesday morning, April 5, to see Panera Bread (PNRA) taken private by JAB Holding Company for $315 per share in cash. Shares of Panera started the year just above the $200 price tag, so the buyout is a nice payoff for investors that have been holding strong in the fast-casual concept. JAB Holding also owns Keurig Green Mountain, Peet's Coffee & Tea, Caribou Coffee, Einstein Noah, and Krispy Kreme, among other well-recognized brands, so Panera can be considered a great fit for JAB's portfolio. There are obvious synergies.

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For Panera shareholders though, the price tag is simply a gift. We had been skeptical of the long-term growth potential of the high-carb bakery and sweets concept, one that would have to overcome a trend toward a more health-conscious millennial consumer (MILN), especially as the demographic becomes a larger percentage of the overall population. We posit that Chipotle's (CMG) troubles may have been in part why Panera had become so attractive to private equity, perhaps the burrito-operation eliminating itself from private-equity consideration in light of its many, many troubles of late.

By most accounts, both Starbucks (SBUX) and Domino's Pizza (DPZ) had been in the hunt for Panera, and while many are speculating that major changes in the competitive landscape may occur as a result of this go-private deal, both the quick-service and fast-casual spaces are already ultra-competitive, stacked with strong rivals that aggressively market and price offerings. It seems like there is a new concept sprouting up every day. How things could get more competitive remains to be seen, as the need to lure traffic to locales has noticeably become more and more difficult given the many more choices consumers have to choose from.

For those keeping count, Panera ended its public life as one of the best-performing, if not the best-performing, restaurant stocks of the past 20 years – up over 8,000%. It started out as one 400 square foot cookie store in Boston. What a story.

SeaDrill's End

"SeaDrill is a name that will live in infamy, probably more because of its die-hard dividend growth base that supported the stock through thick-and-thin, only to see their capital nearly wiped out." – Brian Nelson, CFA

Seadrill (SDRL) announced April 4 that it will be pursuing Chapter 11 proceedings, and that based on several factors, "the company currently expects that shareholders are likely to receive minimal recovery for their existing shares." None of this is surprising – Valuentum had warned about SeaDrill's negative free cash flow and massive net debt repeatedly for many years, until this end. It is a shame if anybody believed SeaDrill would make it.

Related: SDLP

Coach To Pick Up Kate Spade?

We ventured into Coach (COH) in the Dividend Growth Newsletter portfolio, in part because of the aspirational brand's tremendous balance sheet cash position. However, its purchase of the Stuart Weitzman brand, and now indications that it is planning to buy Kate Spade (KATE) have us more-than-perturbed. The strength of Coach's dividend will suffer as the buyer in the transaction, and we no longer like the dividend without a substantial net cash balance sheet to protect it, unfortunately. We plan to remove the company from the Dividend Growth Newsletter in the coming weeks.

Don't Forget About Cisco's Big Dividend Hike

Let's not forget that newsletter portfolio holding Cisco (CSCO) recently hiked its quarterly payout in a meaningful way during its fiscal second-quarter results, released earlier this year.

The networking giant doesn't have the longest dividend track record, but when it comes to the past several years, few companies can rival the growth and strength of its payout. The most recent increase in the quarterly dividend was a solid 12%, bringing it to $1.16 per share on an annualized basis (its forward yield is now approaching 3.5%). The dividend will be paid on April 26 to shareholders on record as of April 6. What has us most excited about Cisco's dividend though is that it still has plenty of room for continued growth, based on its impressive Dividend Cushion ratio of 2.7.

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Further, the company has several of the most enviable characteristics of an income-based idea: a net cash-rich balance sheet, a capital-light operation enabling strong free cash flow generation, and the ongoing transition to a software and subscription based business model, which will only accentuate those characteristics. In addition to its strong dividend growth profile, we find shares of Cisco to be compelling from a valuation standpoint (one of just a few in this frothy market today)--both on a discounted cash flow and relative valuation basis. We plan to continue to include shares of Cisco in both newsletter portfolios for the foreseeable future as we expect an ongoing robust annual pace of dividend expansion.

Medtronic Back Above $80; To Sell Medical Supplies Unit?

We've been watching shares of Dividend Growth Newsletter portfolio holding Medtronic (MDT) very closely in light of the political uncertainty engulfing the healthcare sector of late. Shares have faced some added pressure from management's "changing" definition of free cash flow, something we didn't like at all, but we're giving the executive suite time to regain credibility. It has such a fine franchise, and the team is transparent.

The latest from Reuters is that Cardinal Health (CAH) may be looking to scoop up Medtronic's medical supplies business "for close to $6 billion." We're viewing this event as a significant positive for Medtronic's dividend, particularly in light of Medtronic's hefty debt load that came along with its buyout of Covidien. Reuters is saying that sources close to the deal anticipate an announcement later this month. We'll be waiting for confirmation.

Tesla's "Castle in the Air"

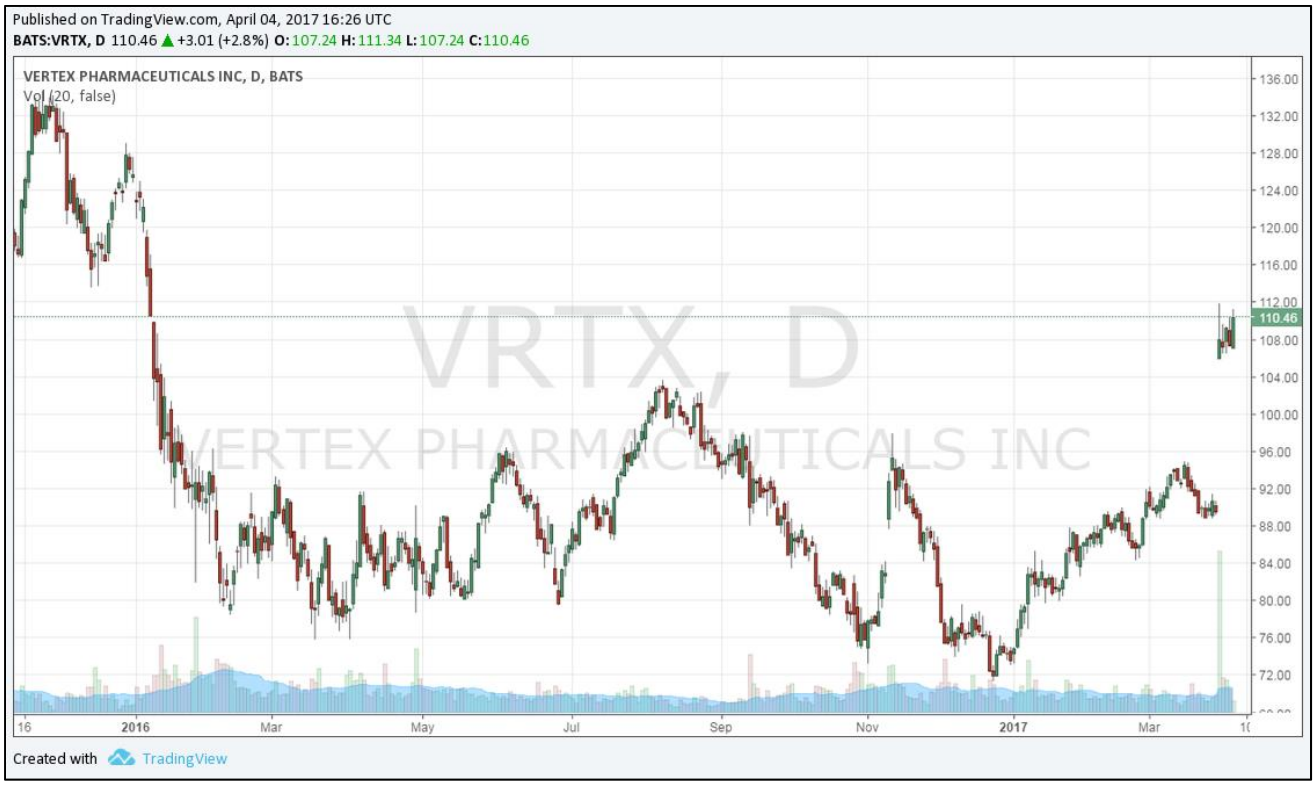
Speculators are buying up Tesla's (TSLA) shares on hopes the company may be the real deal. The company announced April 2 that it delivered "just over 25,000 vehicles" in the first quarter of 2017, a new quarterly record and nearly a 70% increase over the first quarter of last year. Shares have surged to a new all-time high, and Tesla's market capitalization of ~$49 billion is now greater than Ford's (F) and is nearly that of GM's (GM)! The market is off its rocker, and everybody wants a piece; even Tencent (TCEHY) has taken a 5% passive stake in Tesla.

Let's stick to the numbers for now. In 2015 and 2016, the company has reported an operating loss of $717 million and $667 million, respectively. Net income in each year has fared worse, cumulatively at more than a loss of $11 per share. Cash and cash equivalents stood at ~$3.4 billion at the end of 2016, less than the $6 billion in long-term debt, so the balance sheet remains far from net cash-rich. Capital expenditures have run, on average, at ~$1.5 billion during the past couple years. Where's the value? It's all "castles in the air" when it comes to Tesla. It must be "cool" to own shares, and how can anyone get comfortable when Elon Musk is addressing the "shorts" on Twitter:

Until the next update…

Can Vertex Pharmaceuticals Dominate the Race to Treat Cystic Fibrosis?

By Alexander J. Poulos



Cystic Fibrosis is a rare disease that afflicts an estimated seventy-five thousand patients worldwide. Vertex Pharmaceuticals is the first to market with a combination treatment to treat a portion of the overall patient population. Will Vertex win the race to bring forth a triple therapy to treat the vast majority of those afflicted?

Cystic fibrosis (CF) is a recessive genetic disorder. The patient that is afflicted will carry two copies of the cystic fibrosis conductance regulator protein (CFTR) gene. The CFTR gene allows the body to produce the CFTR protein, whose function is to remove chloride from the cells. Patients that have CF will suffer from a "thickening" of the body's secretions (mucus, saliva, tears and digestive enzymes). The thickening of mucus is especially burdensome; the patient will become prone to respiratory infections. Patients will frequently experience congestion with a cough often associated with it.

CF is a disease that afflicts the very young, according to the Cystic Fibrosis Foundation; 75% of those afflicted will be diagnosed by the age of 2. CF symptoms will become progressively worse as the patient ages, with most not reaching the fourth decade of life. Life expectancy has improved in recent years, but the need for additional treatments remains. The following quote from Vertex sums up the grim prognosis for those afflicted with CF.

"Today, the median predicted age of survival for a person with CF is between 34 and 47 years, but the median age of death remains in the mid-20s."

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Vertex Pharmaceuticals

Vertex Pharmaceuticals (VRTX) is a research-based biotech entity with a near-term pipeline focused on combinations to treat CF. Vertex does have two products that are approved for the treatment of CF, but the overreliance on one disease state poses an additional layer of risk for equity holders. A recent example from Vertex's past illustrates the danger. Vertex believed with the approval of Invicek (which treats HCV), the company would be able to transform itself fundamentally. Vertex thought it would make the quantum leap from a profitless upstart to a mid-stage biotech with an attractive pipeline.

Vertex was ill prepared for the "creative disruption" that was about to be unleashed into the HCV marketplace, however. Pharmasset released compelling initial data for Sofosbuvir, what proved to be the clinical backbone used to effectively "cure" HCV. Vertex failed to act in a proactive manner to defend its HCV franchise. Instead, it stood idle as Gilead Sciences (GILD) swooped in an aggressively purchased Pharmasset.

With the rights to Sofosbuvir secure, Gilead would go on to dominate the HCV marketplace, while Vertex would have to remove Invicek from the market due to lack of demand. Vertex lacked the foresight to protect its franchise; in the span of fewer than four years, the product transformed from a potential blockbuster to off the market.

Kalydeco

Vertex's lead product for the treatment of CF is Kalydeco (Ivacaftor), a CFTR potentiator. Kalydeco works by allowing the "gates" that enable the removal of chloride from the cells to remain open longer. The theory is by enabling the "gates" to stay open longer, the patient will clear chloride in a more rapid manner. The patient population that is afflicted with CF has a defective gene that regulates this process. The concept of Kalydeco is an excellent first step in the treatment process, but additional combination therapies will be needed to bring relief to the vast majority of those afflicted with CF. Vertex estimates it is receiving reimbursement for 4,000 patients that are treated with Kalydeco. The overall worldwide patient population is estimated at 75,000 patients. The need for combination therapies to treat the vast majority of patients remains largely unmet.

Orkambi

Vertex initial foray into combination therapy is Orkambi (Ivacaftor/Lumacaftor) which was approved in 2015. The mechanism of action for Lumacaftor (corrector) is to allow for additional defective F508del-CFTR proteins to reach the outer surface of the cells. When combined with Ivacaftor's ability to allow for the enhanced clearing of chloride, the combination treatment should improve the overall removal of chloride. With approval for the F508del mutation, Orkambi has expanded the eligible patient population that can be treated with the product to 25,000 patients.

There are potential drawbacks to the promise of combination therapy in CF. Challenges remain with the overall widespread adoption of Orkambi. The primary reason is the side effect profile of the medication. The most prevalent side effect is dyspnea, a particularly troublesome adverse event in the CF population. Dyspnea as a general definition is difficulty in breathing. A patient with dyspnea may suffer from shortness of breath or wheezing. With a decrease in overall lung function from CF, many have discontinued use of Orkambi. The need for additional correctors with a more favorable side effect profile remains. Fortunately for Vertex bulls, Tezacaftor seems poised to replace Lumacaftor as the corrector of choice going forward.

Tezacaftor

Vertex retains its lead in attempting to bring forth a combination therapy to expand the eligible patient population. While Lumacaftor is a positive first step, due to its side effect profile, it would not make an ideal candidate for inclusion in triple therapy. Vertex needs to bring forth a more potent corrector while

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minimizing the side effect profile. We view Tezacaftor as an important pivot that should allow Vertex to focus on triple therapy.

Vertex announced results from recently concluded clinical trials for Tezacaftor. The primary endpoint of the study was statistically significant in improvements in lung function (percent predicted forced expiratory volume in one second), or ppFEV1. The combination of Tezacaftor/Ivacaftor demonstrated an increase of 3.4% versus a decrease of 0.6% in the placebo arm. As a comparison, the ppFEV1 for Orkambi is 2.8% from the pooled data of the Traffic and Transport studies that were used to gain FDA approval.

While the increase in ppFEV1 is impressive, the key to the commercial success of the product rests in the adverse events experienced while using the therapy. Tezacaftor's primary side effects are infective pulmonary exacerbations, cough, and headache. The side effect profile is similar to the data from the placebo group, which is a positive for Tezacaftor. Based on the results from the trial, Vertex plans to file for approval in the US and Europe in the third quarter of 2017.

Revenue

Vertex reported annual CF revenues of $1.683 billion in 2016. Revenue jumped 71% as Vertex recognized a full year of Orkambi sales in 2016. Vertex issued initial CF revenue guidance of $1.79-2.01 billion for 2017 as reimbursement authorization continues to hamper overall growth. Vertex estimates that 13,000 of the 25,000 of the eligible patient population is not receiving Orkambi.

The main hold up is over the reimbursement level for the treatment. For example, in Germany, the German Federal Joint Committee announced a compensation agreement effective December 16, 2016 after the product demonstrated "considerable additional benefit." Orkambi was approved for use in November 2015. The holdup in reimbursement is illustrative of the challenge Vertex faces when negotiating with foreign governments.

Due to the costly, chronic nature of the treatment, however, Vertex will continue to face intense scrutiny over the value of the treatment.

Profitability

Vertex reported a loss of $0.46 per share in 2016 on a GAAP basis as R&D costs continue to hamper profitability. Vertex guided GAAP R&D and SG&A expenses of $1.55-1.7 billion in 2017 versus 1.48 billion in 2016. The primary reason for the increase in costs is Vertex's aggressive funding of R&D in its quest for a triple therapy. We believe the market is overlooking the cost burden faced by Vertex to gain worldwide reimbursement for its products. The 13-month delay in Germany is emblematic of the challenges faced by Vertex. For example, utilizing the same timetable of 13 months for Orkambi reimbursement, Tezacaftor/Ivacaftor would not receive payment approval until sometime late in the first quarter of 2019. Our estimates are based on a Q3 2017 new drug application filing and a six-month review before approval.

Vertex is expected to release phase two data of the next generation corrector in the second half of 2017. Assuming a favorable side effect profile, Vertex would choose the most potent corrector to combine with Tezacaftor/Ivacaftor in the long-awaited triple therapy. We estimate the second half of 2018 data read to account for the time it takes to recruit eligible patients and gain the necessary steps to conduct a clinical trial.

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The product would be fast-tracked yet we estimate it would take nearly a year for final approval accounting for the time it takes Vertex to complete the application and for the respective authorities to approve the product. We are now looking at a mid-2019 marketing approval, which is important from a patent point of view.

The patent for Ivacaftor, the clinical backbone of the therapy expires in Europe (the largest overall market) in 2025 and the US in 2027. The Tezacaftor patent expires in the US in 2027 and 2028 in Europe. We can not understate the importance of the patent life. With each therapy, an oral dosage form the loss of patent protection would devastate future profitability. With cost containment the highest priority in healthcare, we expect robust generic competition, but not for some time yet. We do view the diverse patient population as a bit of a challenge but we believe financial implications will win out in the end. Vertex will eventually have to dramatically reduce prices to retain share which will hamper the overall profitability of the company, but this may not happen for years.

Future Competition

Currently, Vertex has a commanding lead in the area of CF, but additional players have entered the market. To Vertex credit, the company is reducing the risk of creative disruption and is proactively looking to defend the CF franchise. We applaud the move to purchase CTP-656 from Concert Pharmaceuticals (CNCE). CTP-656 is an investigational cystic fibrosis transmembrane conductance regulator (CFTR) potentiator.

We believe Vertex paid a steep yet necessary price of $160 million in cash for all worldwide development and commercialization rights to CTP-656. If Vertex can gain approval of the product, an additional $90 million in milestones based on regulatory approval in the US and reimbursement in the UK, Germany or France would be paid to Concert. Vertex has removed a competitive threat in CTP-656, and it seems management has learned from its HCV fiasco.

Outlook

Shares of Vertex jumped nearly 20% on the positive results of Tezacaftor/Ivacaftor. We feel the run up may be overdone, and we continue to watch shares. Mainly, we are put off by the near $27 billion dollar market cap of the company and weak near-term earnings visibility.

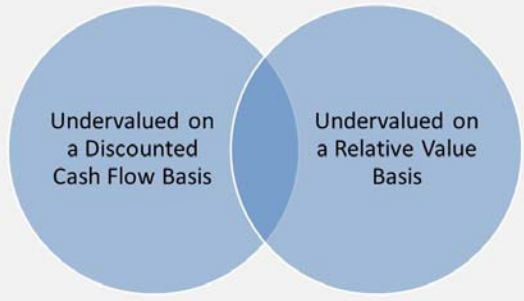
That said, we do feel Vertex CF therapies are currently the best in class, but significant earnings growth remains elusive. The lack of significant short-term profits reduces the potential for the company to become an acquisition target, too. Big pharma remains awash in cash, with notable holes in its product pipeline, but we believe the junior biotechs with market caps less than $10 billion remain the most suitable acquisition targets, far easier to swallow that Vertex.

Let's keep an eye on this one.

The Watch List

By Valuentum Analysts

The Valuentum Buying Index (VBI), which places a considerable emphasis on a firm's valuation, is the primary driver behind companies included in our Best Ideas portfolio (see page 8). However, the size of our coverage universe lends itself to a plethora of new ideas beyond the ones we seek to capitalize on. Below, we provide a unique screen that sorts companies we feel are undervalued on both a DCF and relative value basis (the first two pillars of our VBI; the third is a technical assessment).



"By overlaying a relative valuation process on a robust forward-looking discounted cash flow valuation methodology, "pure" value investors add an extra degree of conviction to their undervalued ideas. For the ideas in this screen to register the highest rating on the Valuentum Buying Index, however, the market would also have to agree that shares are undervalued, as evidenced by an advancing stock price, one that has good momentum." – Valuentum's Brian Nelson, CFA

We update this screen monthly and deliver it to you in our newsletter (for your added convenience, we also post it on our site). You'll see we often hold a number of these firms in our portfolio, and we continue to monitor the remainder for the most opportune time to add them. The names on this list are the cream of the crop for the value investor and can supplement your "shopping list" of new ideas.

Company Name	Symbol	DCF Valuation	Relative Valuation	Price/FV	Fair Value Estimate
Mellanox Tech	MLNX	UNDERVALUED	ATTRACTIVE	0.77	$53.00
Xerox	XRX	UNDERVALUED	ATTRACTIVE	0.59	$12.00
Synaptics	SYNA	UNDERVALUED	ATTRACTIVE	0.66	$77.00
CVS Caremark	CVS	UNDERVALUED	ATTRACTIVE	0.76	$104.00
Vitamin Shoppe	VSI	UNDERVALUED	ATTRACTIVE	0.67	$29.00
Express Scripts	ESRX	UNDERVALUED	ATTRACTIVE	0.70	$93.00
JAKKS Pacific	JAKK	UNDERVALUED	ATTRACTIVE	0.48	$11.00
Michael Kors Hldg	KORS	UNDERVALUED	ATTRACTIVE	0.63	$60.00
Sally Beauty	SBH	UNDERVALUED	ATTRACTIVE	0.77	$27.00
Hanesbrands Inc	HBI	UNDERVALUED	ATTRACTIVE	0.72	$27.00
CA Tech	CA	UNDERVALUED	ATTRACTIVE	0.75	$42.00

The price-to-fair value measures reflect the metric at the time of report publishing and may differ from today's metric.

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The initial table below showcases firms that fit the bill of the Valuentum investor, with each posting a 9 or a 10 on our index. These are names that we may swap into our portfolio on the long side (if not already held) should their upside potential become greater than our current holdings.

We also show firms that register a 1 or 2 on our VBI. These names represent put-option candidates. We provide the respective lists below, and each firm's report can be found on our website.

For the first time since the creation of the Valuentum Buying Index, no stocks register a 9 or 10 on the system. The market remains frothy. Please consult the Best Ideas Newsletter portfolio on page 8 for our best ideas.

Bio-Rad	BIO	Health Care	2
Chemed	CHE	Health Care	2
Clorox	CLX	Consumer Staples	2
Graco	GGG	Industrials	2
Intercontinental	IHG	Consumer Discretionary	2
KEMET Corp	KEM	Information Technology	2
Kyocera	KYO	Information Technology	2
LHC Group	LHCG	Health Care	2
Manhattan Associates Inc	MANH	Information Technology	2
MKS Instruments	MKSI	Information Technology	2
National Beverage	FIZZ	Consumer Staples	2
Northern Trust	NTRS	Financials	2
Roper Technologies	ROP	Industrials	2
Royal Caribbean	RCL	Consumer Discretionary	2
Sherwin-Williams	SHW	Consumer Discretionary	2
Ulta Salon	ULTA	Consumer Discretionary	2
Badger Meter	BMI	Industrials	1
Brown-Forman	BF.B	Consumer Staples	1
CACI Intl	CACI	Information Technology	1
CONSOL Energy	CNX	Energy	1
Emcor Group	EME	Industrials	1
Heartland	HTLD	Industrials	1
Jack Henry	JKHY	Information Technology	1
Jack in the Box	JACK	Consumer Discretionary	1
Lockheed Martin	LMT	Industrials	1
MGE Energy	MGEE	Energy	1
MSCI	MSCI	Information Technology	1
Northrop Grumman	NOC	Industrials	1
Quad/Graphics Inc	QUAD	Consumer Discretionary	1
RBC Bearings	ROLL	Industrials	1
Scotts Miracle-Gro	SMG	Materials	1
Zayo Group	ZAYO	Information Technology	1

Dollar General (DG) – Page 1 of 16

By Valuentum Analysts

Download Dollar General's 16-page report, 2-page supplemental dividend report and read Valuentum's latest commentary on its website at www.valuentum.com.

Valuentum Retail Equity Research | Visit us at www.valuentum.com | Ratings as of 28-Mar-2017 | Data as of 27-Mar-2017

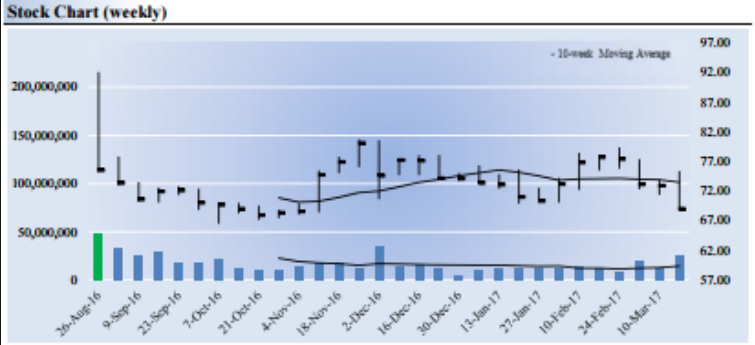
Dollar General DG FAIRLY VALUED

Buying Index™ 4 **Value Rating**

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Attractive	$75.00	$60.00 - $90.00	LARGE-CAP VALUE	Consumer Discretionary	Multiline Retail - discount

Dollar General is the largest discount retailer in the US by number of stores, and it continues to add to its store count in a meaningful way.

Stock Chart (weekly)



The week with the highest trading volume out of the last 13 weeks was a week of heavy selling, or distribution (red bar).

Investment Considerations

DCF Valuation	FAIRLY VALUED
Relative Valuation	ATTRACTIVE
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	POSITIVE
Cash Flow Generation	MEDIUM
Financial Leverage	LOW
Growth	MODEST
Technical Evaluation	VERY BEARISH
Relative Strength	WEAK
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BEARISH
Near-term Technical Resistance, 10-wk MA	73.00

DCF = Discounted Cash Flow; MFI, U/D = Please see glossary. MA = Moving Average

Business Quality

ValueRisk™ \ ValueCreation™	Very Poor	Poor	Good	Excellent
Low				
Medium				
High				
Very High				

Firms that generate economic profits with little operating variability score near the top right of the matrix.

Company Vitals

Market Cap (USD)	$19,468
Avg Weekly Vol (30 wks)	17,566
30-week Range (USD)	66.5 - 92.01
Valuentum Sector	Consumer Discretionary
5-week Return	-10.9%
13-week Return	-10.0%
30-week Return	-24.3%
Dividend Yield %	1.5%
Dividends per Share	1.04
Forward Dividend Payout Ratio	23.1%
Est. Normal Diluted EPS	5.62
P/E on Est. Normal Diluted EPS	12.3
Est. Normal EBITDA	2,971
Forward EV/EBITDA	9.1
EV/Est. Normal EBITDA	7.6
Forward Revenue Growth (5-yr)	6.4%
Forward EPS Growth (5-yr)	9.2%

NMF = Not Meaningful; Est. = Estimated; FY = Fiscal Year

Returns Summary

	3-year Historical Average
Return on Equity	21.1%
Return on Assets	10.3%
ROIC, with goodwill	14.2%
ROIC, without goodwill	27.6%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	3,212
Net Debt	3,024
Total Debt/EBITDA	1.3
Net Debt/EBITDA	1.2
EBITDA/Interest	25.0
Current Ratio	1.4
Quick Ratio	0.1

NMF = Not Meaningful

Investment Highlights

• Dollar General is the largest discount retailer in the US by number of stores with over 13,000 neighborhood stores in 44 states. It provides products that are frequently used and replenished such as food, snacks, and health and beauty aids. The company helps shoppers: 'Save time, Save money, Every day.'

• As with many of its peers, one of the biggest catalysts for Dollar General in coming periods will be suppressed prices at the gas pump. Its core demographic is more sensitive to the price at the pump than other consumers, and crude oil's fall from $100+ per barrel is welcome news.

• Dollar General has put up 27 consecutive years of same-store sales growth as of 2016. The firm continues to add new stores to its portfolio and plans to add as many as 1,000 in 2017. The company lost the battle for Family Dollar's assets to Dollar Tree, despite a higher offer. It may have been a blessing in disguise.

• Dollar General sees the opportunity for an additional 13,000 locations across the US, many of which will be developed as small format stores with less than 6,000 square feet. These small format stores enable the firm to optimize merchandise mixes in each store and reduce occupancy costs. Such growth initiatives are expected to help drive $30 billion in sales in 2020.

• In fiscal 2017, management is anticipating net sales growth of 4%-6% and same-store sales growth of slightly positive to up 2%. Diluted earnings per share guidance has been issued in a range of $4.25-$4.50, compared to $4.43 in fiscal 2016.

Relative Valuation

	Forward P/E	PEG	Price / FV
Big Lots	12.2	2.0	104.2%
Dollar Tree	16.8	1.7	95.8%
PriceSmart	28.7	1.8	122.6%
Fred's Inc	NMF	NMF	118.8%
Peer Median	16.8	1.8	111.5%
Dollar General	**15.3**	**1.7**	**92.0%**

Price / FV = Current Stock Price divided by Estimated Fair Value

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Jan-16	Jan-17	Jan-18
Revenue	20,369	21,987	23,372
Revenue, YoY%	7.7%	7.9%	6.3%
Operating Income	1,940	2,063	2,071
Operating Margin %	9.5%	9.4%	8.9%
Net Income	1,165	1,251	1,256
Net Income Margin %	5.7%	5.7%	5.4%
Diluted EPS	3.95	4.43	4.49
Diluted EPS, YoY %	13.2%	12.3%	1.4%
Free Cash Flow (CFO-capex)	887	1,044	917
Free Cash Flow Margin %	4.4%	4.8%	3.9%

In Millions of USD (except for per share items)

Structure of the Multiline Retail (discount) Industry — GOOD

The retail discount store industry provides consumable basic needs to customers primarily in the low- and middle-income brackets. More than one third of the industry's customers live in households that earn less than $20,000 per year, making the group's results counter-cyclical--as more households generate lower income due to poor economic conditions, store growth and same-store-sales opportunities increase. Still, competition is fierce among constituents and with many other retailers, including grocery stores. But given the niche low-price strategy of participants and their counter-cyclical nature, we like the group.

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Altria (MO) – Page 1 of 16

By Valuentum Analysts

Download Altria's 16-page report, 2-page supplemental dividend report and read Valuentum's latest commentary on its website at www.valuentum.com.

Valuentum Retail Equity Research — Visit us at www.valuentum.com — Ratings as of 13-Apr-2017 — Data as of 3-Apr-2017

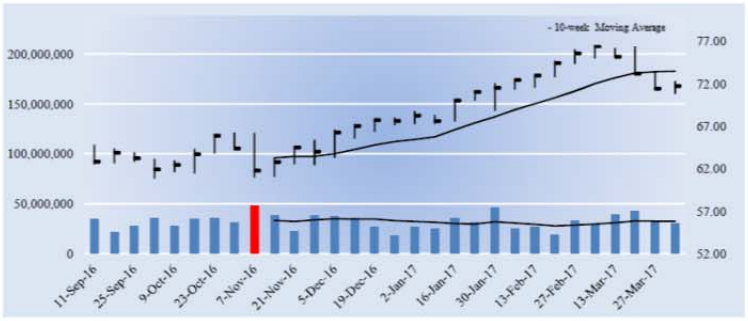
Altria Group MO FAIRLY VALUED

Buying Index™ 3 Value Rating

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Very Attractive	$60.00	$48.00 - $72.00	LARGE-CAP CORE	Consumer Staples	Tobacco

Very few firms have Altria's financial flexibility, and pricing power continues to support the profit pool of tobacco product makers as volumes decline.

Stock Chart (weekly)



The week with the highest trading volume out of the last 13 weeks was a week of heavy buying, or accumulation (green bar).

Investment Considerations

DCF Valuation	FAIRLY VALUED
Relative Valuation	NEUTRAL
ValueCreation™	POOR
ValueRisk™	LOW
ValueTrend™	NEGATIVE
Cash Flow Generation	STRONG
Financial Leverage	MEDIUM
Growth	MODEST
Technical Evaluation	VERY BEARISH
Relative Strength	NEUTRAL
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	DETERIORATING
Near-term Technical Resistance, 10-wk MA	73.00

DCF = Discounted Cash Flow; MFI, U/D = Please see glossary. MA = Moving Average

Company Vitals

Market Cap (USD)	$139,978
Avg Weekly Vol (30 wks)	31,757
30-week Range (USD)	60.82 - 76.55
Valuentum Sector	Consumer Staples
5-week Return	-5.1%
13-week Return	5.1%
30-week Return	12.9%
Dividend Yield %	3.4%
Dividends per Share	2.44
Forward Dividend Payout Ratio	71.9%
Est. Normal Diluted EPS	3.83
P/E on Est. Normal Diluted EPS	18.7
Est. Normal EBITDA	11,125
Forward EV/EBITDA	14.9
EV/Est. Normal EBITDA	13.4
Forward Revenue Growth (5-yr)	3.0%
Forward EPS Growth (5-yr)	-10.1%

NMF = Not Meaningful; Est. = Estimated; FY = Fiscal Year

Returns Summary

	3-year Historical Average
Return on Equity	167.4%
Return on Assets	22.2%
ROIC, with goodwill	4.5%
ROIC, without goodwill	5.8%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	13,881
Net Debt	9,312
Total Debt/EBITDA	1.5
Net Debt/EBITDA	1.0
EBITDA/Interest	12.0
Current Ratio	1.0
Quick Ratio	0.6

NMF = Not Meaningful

Investment Highlights

• Altria makes and sells cigarettes and smokeless products in the US. It owns the Marlboro brand, which holds ~44% retail cigarette share, and the Copenhagen and Skoal brands, which own more than 50% retail smokeless share. The company was founded in 1919 and is headquartered in Richmond, Virginia.

• Altria now has an approximate 10.2% equity interest in the new AB InBev, and it received ~$5.3 billion in pre-tax cash from the combination of AB InBev and SABMiller that has created a global beer giant. Altria supported the deal, and we think it will be a long-term positive.

• We're huge fans of Altria's long-term goals: grow adjusted diluted EPS at an average annual rate of 7%-9% and maintain a dividend payout ratio of approximately 80% of adjusted diluted EPS. Though cigarette volumes continue to decline in the US, the profit pool of tobacco makers has not thanks to material pricing gains.

• Altria is expecting 2017 full-year adjusted diluted EPS to be in a range of $3.26-$3.32, excluding facility consolidation charges. This target is in line with the firm's annual expectation of adjusted diluted EPS growth of 7%-9%. It is also undertaking a productivity initiative, expected to deliver $300 million in annualized savings by the end of 2017.

• Altria boasts a hefty dividend yield, and its Valuentum Dividend Cushion score remains above 1 (which is good). We expect continued growth in its dividend payout for many years to come. Very few firms have Altria's financial flexibility.

Business Quality

ValueCreation™

ValueRisk™	Very Poor	Poor	Good	Excellent
Low				
Medium				
High				
Very High				

Firms that generate economic profits with little operating variability score near the top right of the matrix.

Relative Valuation

	Forward P/E	PEG	Price / FV
British American	10.3	3.0	127.8%
Philip Morris	23.1	2.2	129.1%
Reynolds American	24.4	NMF	105.9%
Vector Group	32.5	3.2	92.6%
Peer Median	23.7	3.0	116.8%
Altria Group	**21.1**	**NMF**	**119.5%**

Price / FV = Current Stock Price divided by Estimated Fair Value

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Dec-15	Dec-16	Dec-17
Revenue	18,854	19,337	19,975
Revenue, YoY%	5.1%	2.6%	3.3%
Operating Income	8,361	8,762	9,832
Operating Margin %	44.3%	45.3%	49.2%
Net Income	5,245	14,239	6,555
Net Income Margin %	27.8%	73.6%	32.8%
Diluted EPS	2.67	7.29	3.39
Diluted EPS, YoY %	4.3%	172.7%	-53.5%
Free Cash Flow (CFO-capex)	5,581	3,602	7,360
Free Cash Flow Margin %	29.6%	18.6%	36.8%

In Millions of USD (except for per share items)

Structure of the Tobacco Industry — GOOD

The oligopolistic tobacco industry is attractive in a number of ways. Firms sell an "addictive" product (cigarettes and/or smokeless tobacco), have significant pricing power, generate high margins, and strong returns on invested capital. Still, declining trends in smoking in the US, threats of tobacco-related litigation, new tobacco regulation (labeling) that discourages tobacco use, and excise tax price shocks that may impact demand will always be concerns. In any case, we tend to like the structural characteristics of the tobacco industry and the shareholder-friendly policies of constituents.

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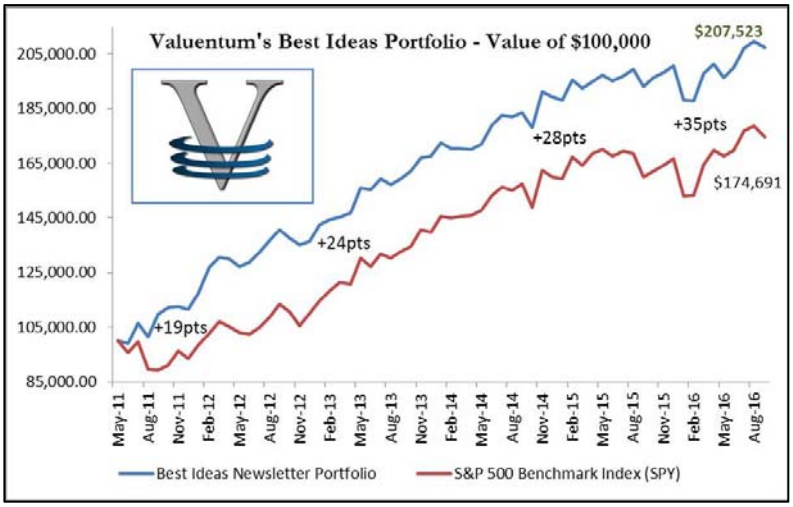
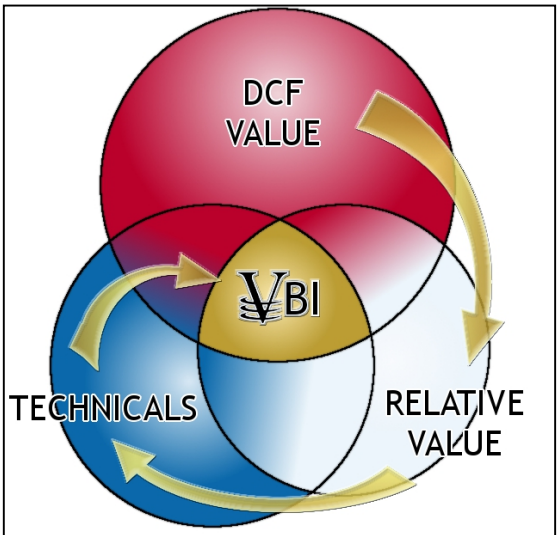
Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

At Valuentum, we think the best opportunities arise from a complete understanding of all investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value through momentum investing. We think companies that are attractive from a number of investment perspectives--whether it be growth, value, income, momentum, etc.--have the greatest probability of capital appreciation and relative outperformance. The more deep-pocketed institutional investors that are interested in the stock for reasons based on their respective investment mandates, the more likely it will be bought and the more likely the price will move higher to converge to its true intrinsic value (buying a stock pushes its price higher). On the other hand, we think the worst stocks will be shunned by most investment disciplines and display expensive valuations, poor technicals and deteriorating momentum indicators.



Stocks that meet our demanding criteria fall in the center of the Venn diagram below, displaying attractive characteristics from a discounted cash-flow basis, a relative value basis, and with respect to a technical and momentum assessment. The size of the circles reveals the relative emphasis we place on each investment consideration, while the arrows display the order of our process -- value first then technicals and momentum last. We may like firms that are undervalued both on a DCF basis and relative value basis, but we won't like firms just because they're currently exhibiting attractive technical or momentum indicators. We're not traders or speculators. We're long-term investors and want to have complete confirmation and conviction in the best ideas we deliver to our subscribers.



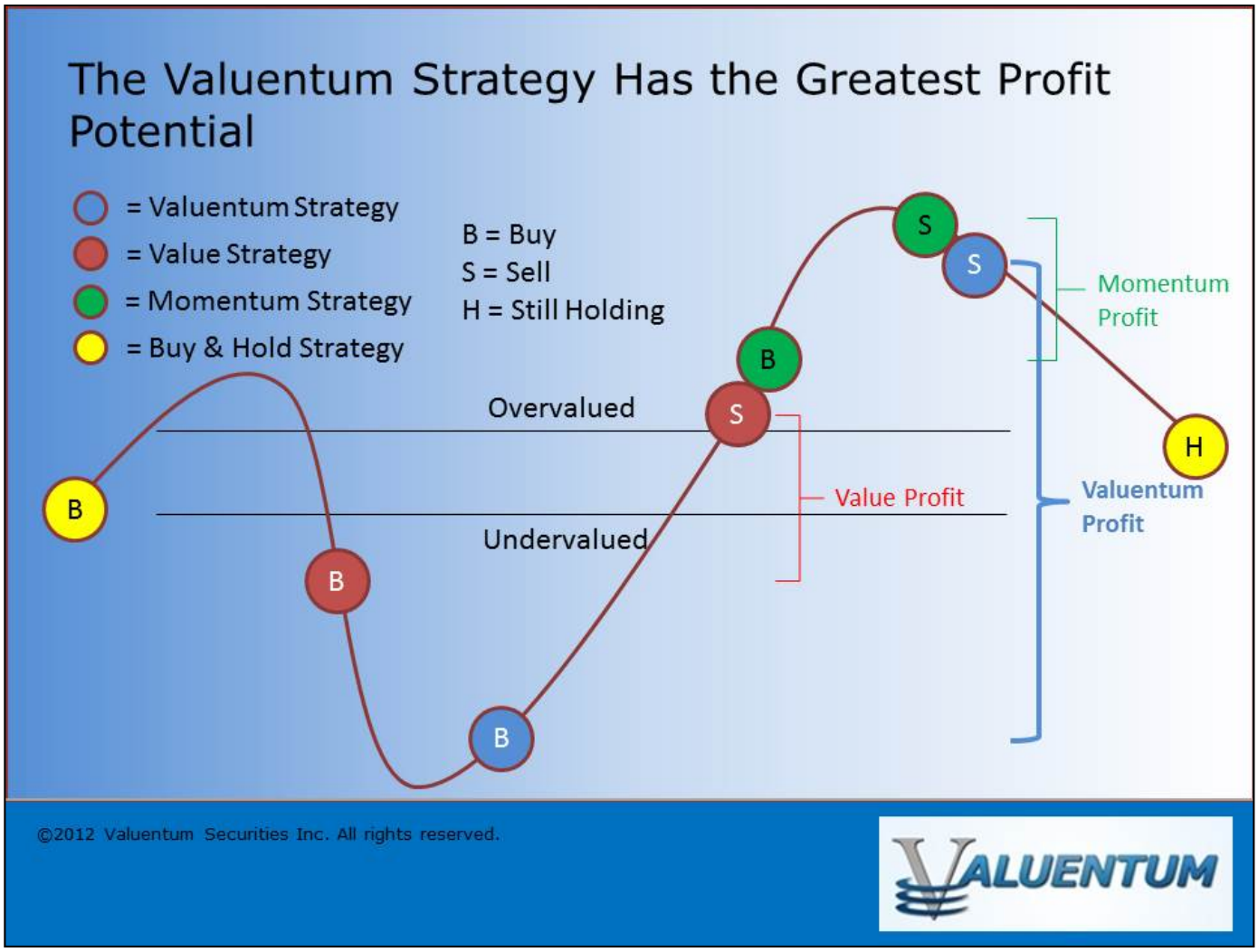
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index **continued from previous page**

The center of the Venn diagram on the previous page, the Valuentum Buying Index (VBI) combines rigorous financial and valuation analysis with an evaluation of a firm's technicals and momentum indicators to derive a score between 1 and 10 for each company (10=best). Because our process factors in a technical and momentum assessment after we evaluate a firm's investment merits via our rigorous DCF and relative-value process, we think we're better able to pinpoint the best entry and exit points on the most undervalued stocks.

Research firms that just focus on valuation may encourage investors to buy a stock all the way down (a falling knife), while those that just use technical and momentum indicators may expose portfolios to significantly overpriced stocks at their peaks. Only when both sides of the investment spectrum are combined can investors get the best stocks on the market today at the best prices, in our view.

Let's examine the chart below, which showcases how the Valuentum process has the greatest profit potential of any investing strategy. The Valuentum process targets adding stocks to actively-managed portfolios when both value and momentum characteristics are "good" and removing them when both value and momentum characteristics are "bad" (blue circles: Buy --> Sell). The Valuentum strategy captures the entire equity pricing cycle, while the value and momentum strategies individually truncate profits.



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Our Methodology – The Valuentum Buying Index **continued on next page**

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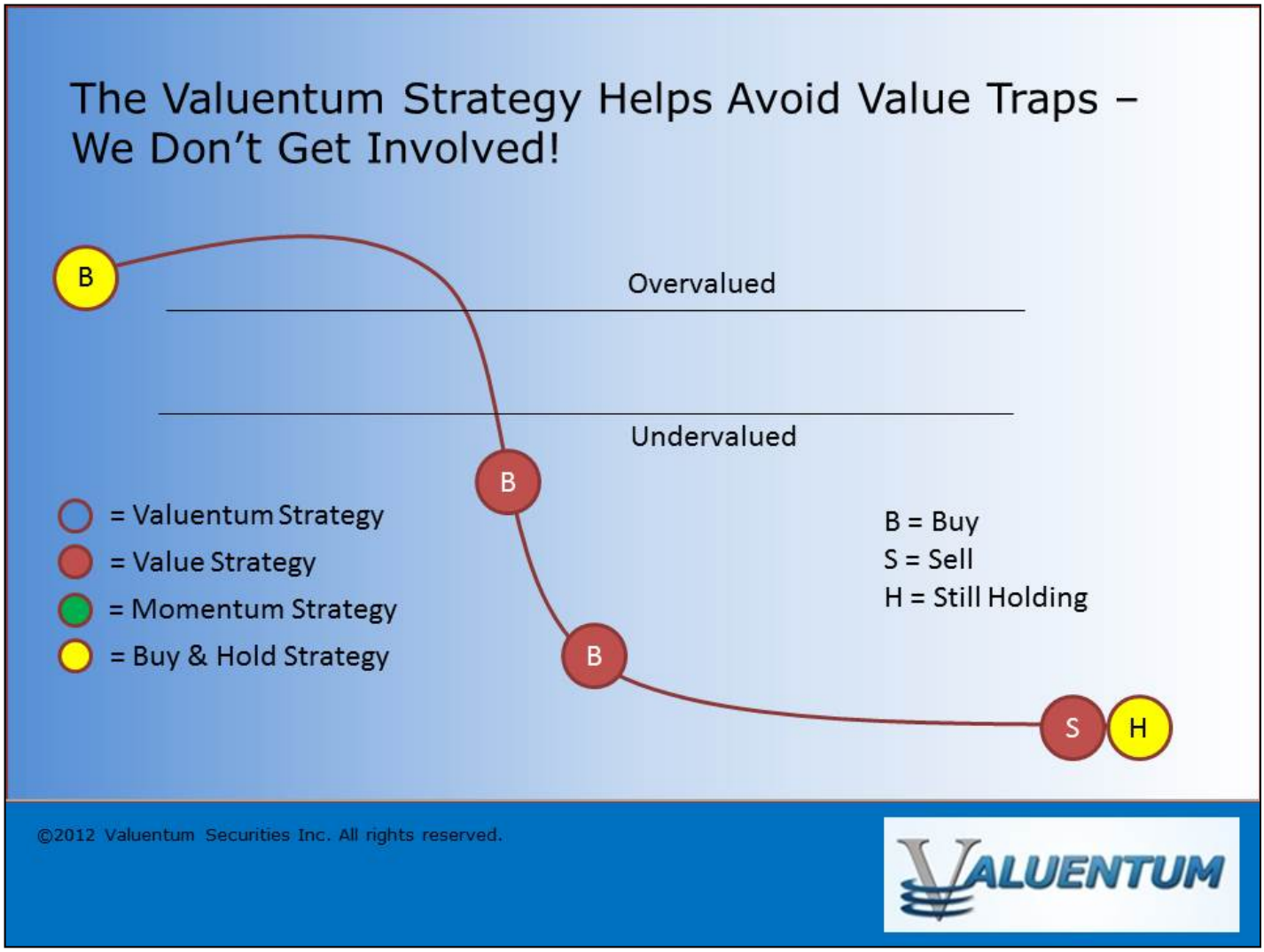
Furthermore, Valuentum subscribers are less likely to be involved in value traps because we demand material revenue and earnings growth for firms to earn a 10 on our Valuentum Buying Index. Value traps often occur as a result of secular declines in a firm's products or services, resulting in deteriorating revenue and earnings trends (and a falling stock price). Valuentum subscribers are less likely to be exposed to these "falling knives" since our process requires firms to not only be undervalued but also be exhibiting bullish technical and momentum indicators before we would consider adding them to our actively-managed portfolios.

Since the stock market is a forward-looking mechanism, price usually leads fundamentals. Without a turnaround in price, the risk that the fundamentals of an undervalued stock have not turned for the positive is higher. Where value strategies may encourage the buying of a stock all the way down regardless of whether fundamentals ever turn (red circles: Buy --> Sell), the Valuentum strategy simply steers clear of these situations. We wait for technical improvement in the equity, which often precedes fundamental changes at the company.



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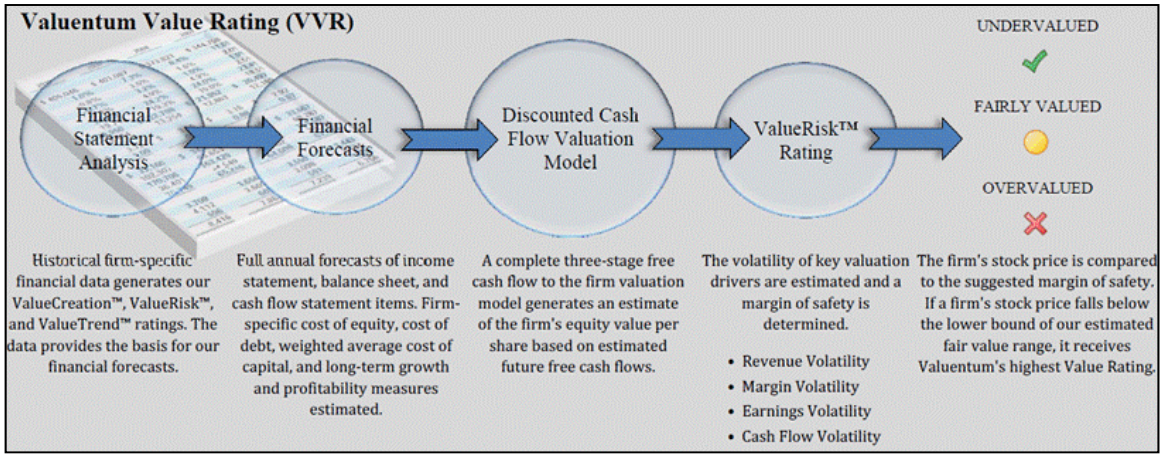
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

I. We Use a Rigorous Discounted Cash Flow Valuation Process

Our methodology starts with in-depth financial statement analysis, where we derive our ValueCreation, ValueRisk, and ValueTrend ratings, which together provide a quantitative assessment of the strength of a firm's competitive advantages. We compare a company's return on invested capital (ROIC) to our estimate of its weighted average cost of capital (WACC) to assess whether it is creating economic profit for shareholders (ROIC less WACC equals economic profit). Firms that have improving economic profit spreads over their respective cost of capital score high on our ValueCreation and ValueTrend measures, while firms that have relatively stable returns score well with respect to our ValueRisk evaluation, which impacts our margin-of-safety assessment.



After evaluating historical trends, we then make full annual forecasts for each item on a company's income statement and balance sheet to arrive at a firm's future free cash flows. We derive a company-specific cost of equity (using a fundamental beta based on the expected uncertainty of key valuation drivers) and a cost of debt (considering the firm's capital structure and synthetic credit spread over the risk-free rate), culminating in our estimate of a company's weighted average cost of capital (WACC). We don't use a market price-derived beta, as we embrace market volatility, which provides investors with opportunities to buy attractive stocks at bargain-basement levels. A forward-looking Economic Castle rating is then derived.

We then assess each company within our complete three-stage free cash flow to the firm (enterprise cash flow) valuation model, which generates an estimate of a company's equity value per share based on its discounted future free cash flows and the company's net balance sheet impact, including other adjustments to equity value (namely pension and OPEB adjustments). Our ValueRisk rating, which considers the underlying uncertainty of the capacity of the firm to continue to generate value for shareholders, sets the margin of safety bands around this fair value estimate. For firms that are trading below the lower bound of our margin of safety band, we consider these companies undervalued based on our DCF process. For firms that are trading above the higher bound of our margin of safety band, we consider these companies overvalued based on our DCF process.

We think a focus on discounted cash-flow valuation prevents investors from exposing their portfolios to significantly overpriced stocks at their peaks. The chart below reveals how pure momentum investors may expose their portfolios to pricing extremes and dramatic falls (green circles: Buy --> Sell). We stay away from these situations.

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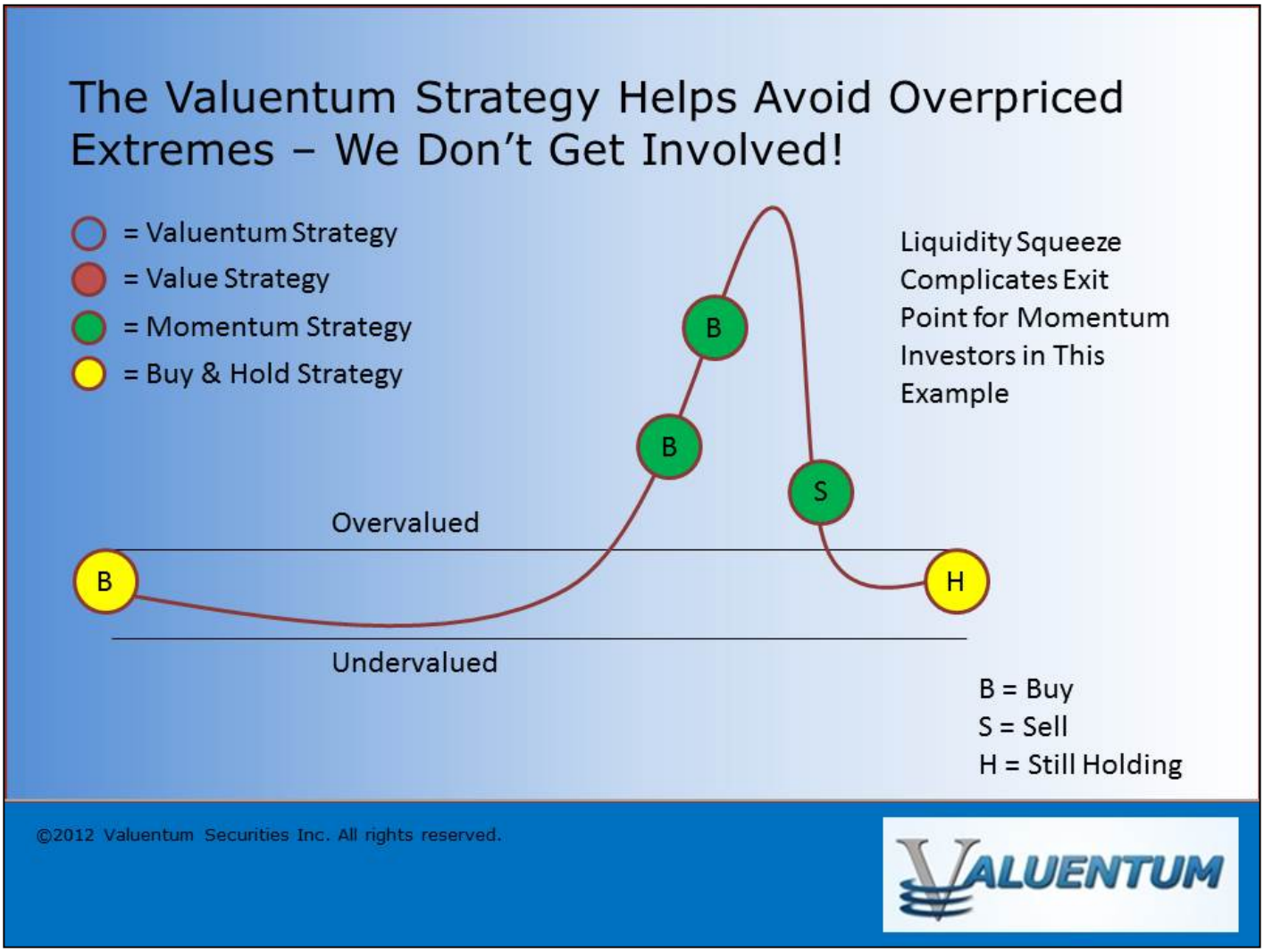

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II. We Perform a Forward-Looking Relative Value Assessment

Our discounted cash-flow process allows us to arrive at an absolute view of the firm's intrinsic value. However, we also understand the critical importance of assessing firms on a relative value basis, versus both their industry and peers. Many institutional money-managers--those that drive stock prices--pay attention to a company's price-to-earnings (PE) ratio and price-earning-to-growth (PEG) ratio in making buy/sell decisions. With this in mind, we have included a forward-looking relative value assessment in our process to further augment our rigorous discounted cash-flow process. If a company is undervalued on both a price-to-earnings ratio and a price-earnings-to-growth (PEG) ratio versus industry peers, we would consider the firm to be attractive from a relative value standpoint.

III. We Seek to Avoid Value Traps, Falling Knives and Opportunity Cost

Once we have estimated a firm's intrinsic value on the basis of our discounted cash-flow process, determined if it is undervalued according to its firm-specific margin of safety bands, and assessed whether it has relative value versus industry peers, we then evaluate the company's technical and momentum indicators to pin-point the best entry and exit points on the stock (but only after it meets our stringent

Our Methodology – The Valuentum Buying Index continued on next page

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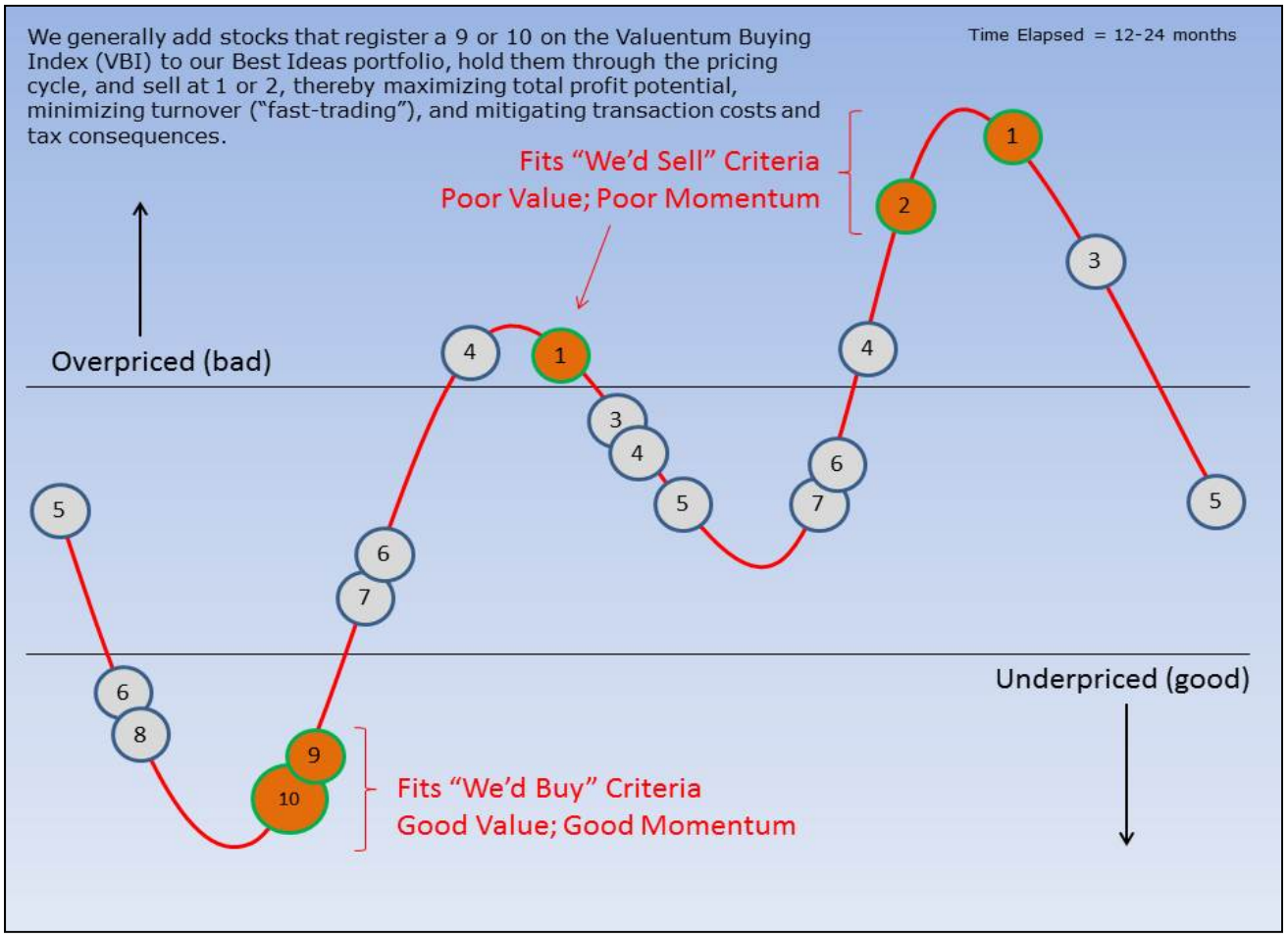
valuation criteria). Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster returns. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with respect to our technical and momentum assessment of a company's stock.

We embrace the idea that the future is inherently unpredictable and that not all fundamental factors can be included in a valuation model. By extension, we use technical and momentum analysis to help safeguard us against value traps, falling knives, and the opportunity cost of holding an undervalued equity for years before it converges to fair value. Other research firms do not consider opportunity cost as a legitimate expense for investors.

Putting It All Together - the Valuentum Buying Index

Though the time frame varies depending on each idea, we expect our best ideas to work out over a 12-24 month time horizon (on average) -- any shorter than that is mostly luck, in our view. We tend to add firms to our Best Ideas portfolio when they register a 9 or 10 on our Valuentum Buying Index (VBI) and tend to remove firms from our Best Ideas portfolio when they register a 1 or 2 on our VBI.

We like to maximize profits on every idea, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. A value strategy (10 --> 5) truncates potential profits, while a momentum strategy (4 --> 1) ignores profits generated via value assessments. We're after the entire profit potential, as shown below.



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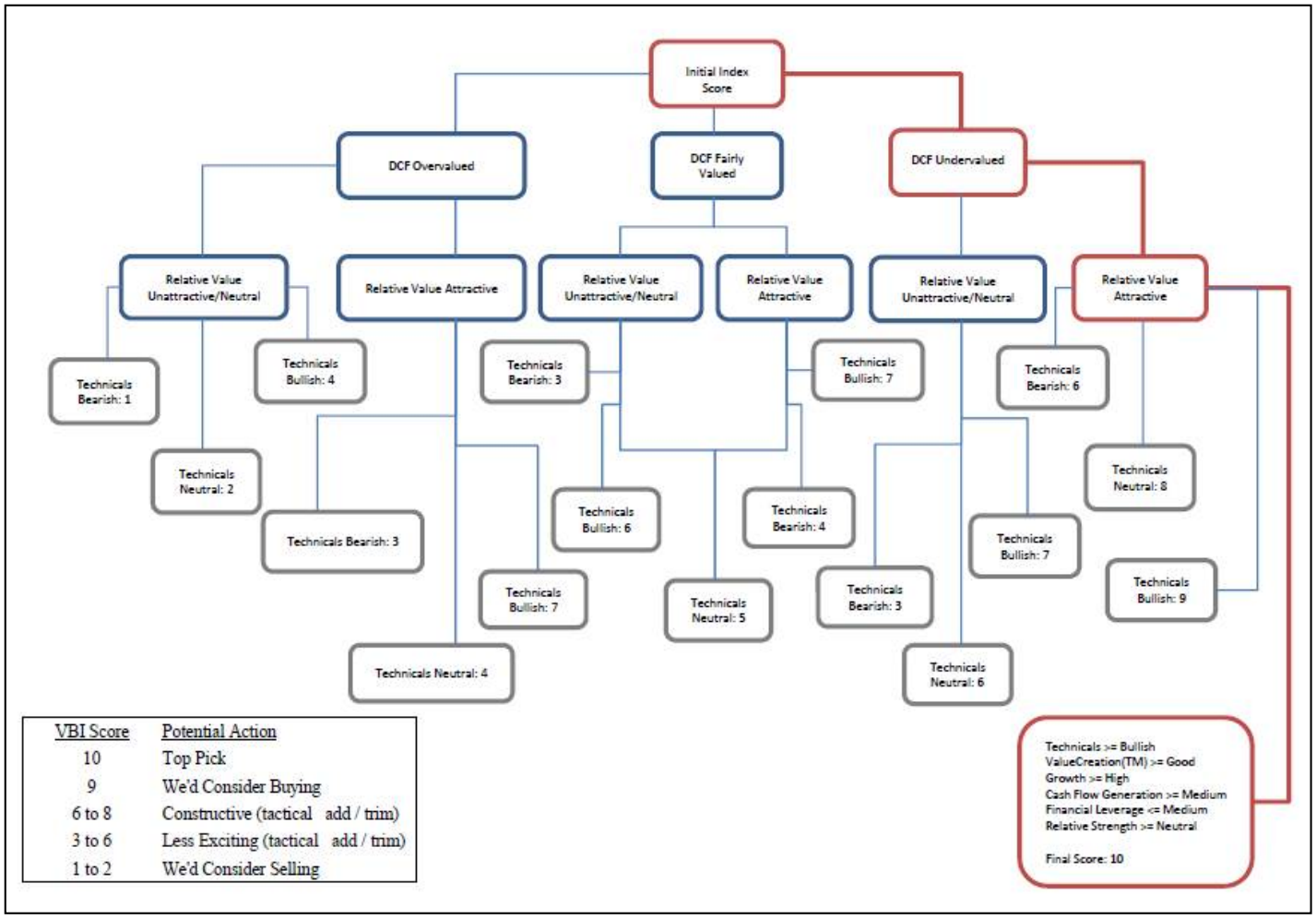
Our Methodology – The Valuentum Buying Index continued from previous page

Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on our index (a "Top Pick"). Please click here to view an enlarged pdf version. First, the company would need to be 'UNDERVALUED' on a DCF basis and 'ATTRACTIVE' on a relative value basis. The stock would also have to be exhibiting 'BULLISH' technicals. The firm would need a ValueCreation rating of 'GOOD' or 'EXCELLENT', exhibit 'HIGH' or 'AGGRESSIVE' growth prospects, and generate at least a 'MEDIUM' or 'NEUTRAL' assessment for cash flow generation, financial leverage, and relative price strength.

This is a tall order for any company, but we're looking to deliver the very best of ideas to our clients and subscribers. Firms that don't make the cut for a 10 are ranked accordingly, with the least attractive stocks garnering a score of 1 ("We'd sell"). Most of our coverage universe falls between 3 and 7, but at any given time there could be large number of companies garnering either high or low scores, especially at market lows or tops, respectively.



VBI Score	Potential Action
10	Top Pick
9	We'd Consider Buying
6 to 8	Constructive (tactical add / trim)
3 to 6	Less Exciting (tactical add / trim)
1 to 2	We'd Consider Selling

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Our Methodology – The Valuentum Buying Index continued on next page

About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

FAQ: Why do you use such a wide fair value range for certain companies?

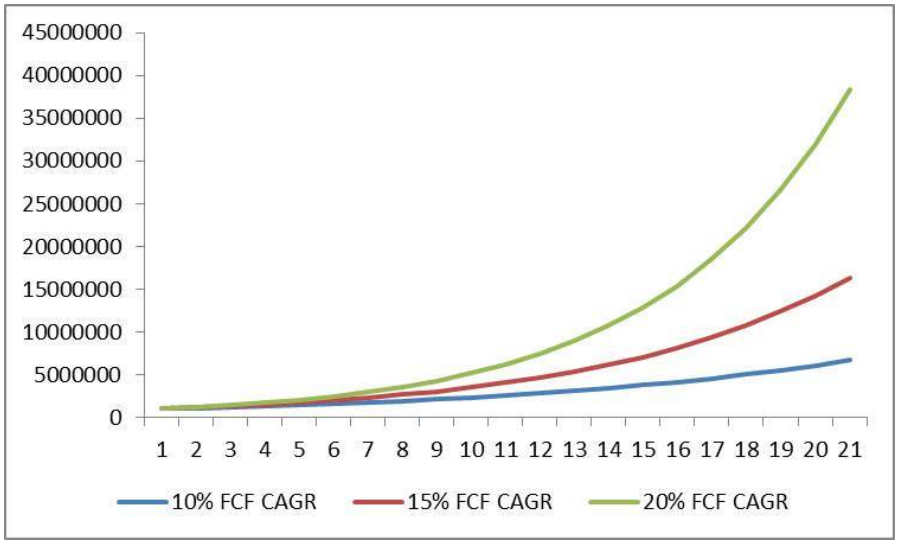
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth exactly $25 or a firm's stock is worth exactly $100. The reality is that, in the first case, the company's shares are probably worth somewhere between $20 and $30, and in the latter case, the stock is worth somewhere between $75 and $125.

Why? Because all of the value of a company is generated in the future (future earnings and free cash flow), and the future is inherently unpredictable (unknowable). If the future could be predicted with absolute certainly (knowable), then a stock analyst could say a company's shares are worth precisely this, or that a firm's stock is worth precisely that. Not *because he or she would know where the stock would be trading at*, but because he or she would know precisely what future free cash flows would be (and all other modeling facts-not assumptions in this case) and arrive at the exact and **non-debatable** value of the firm.

But the truth of the matter is that nobody knows the future, and analysts can only estimate what a company's future free cash flow stream will look like. Certain unexpected factors will hurt that free cash flow stream relative to forecasts, while other unexpected factors will boost performance. That's how a downside fair value estimate and an upside fair value estimate is generated, or in the words of Warren Buffett and Benjamin Graham how a "margin of safety" is generated. Only the most likely scenario represents the point fair value estimate. Any stock analyst that says a company is worth a precise figure--whether it's $1 or $100--falls short of understanding one of the most important factors behind valuation.

But why the large range in many cases?

Well, there are many firms in our coverage universe that have a very large range of outcomes in their future free cash flow growth. And because discounting free cash flows is an integral part of calculating the fair value estimate of a company, the range of fair values will also be large. To illustrate this point, let's take a look at the difference between the levels of free cash flows in Year 20 under three different future growth rates: 10%, 15%, and 20%. Though the growth rate between each scenario is but 5 percentage points, the magnitude of the free cash flow difference is astounding many years into the future, and our discounted cash-flow process considers the long-term intrinsic value of firms.



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Under these future free-cash-flow scenarios, if we assume an 8% discount rate and 100,000 shares outstanding (and no debt), the difference in the fair value estimate between the upside case (green line) and downside case (blue line) would be an incredible $68 per share ($82 per share less $14 per share). That's a huge fair value range (80%+), and all because of just a 10 percentage point difference in a future free cash flow growth assumption. For firms that are growing cash flows at 200% or 300% per annum, a large range of fair value outcomes is not only inevitable but also very reasonable. In other words, the Valuentum framework provides an avenue to quantify the upside and downside risks investors are taking in high uncertainty and fast-growing enterprises.

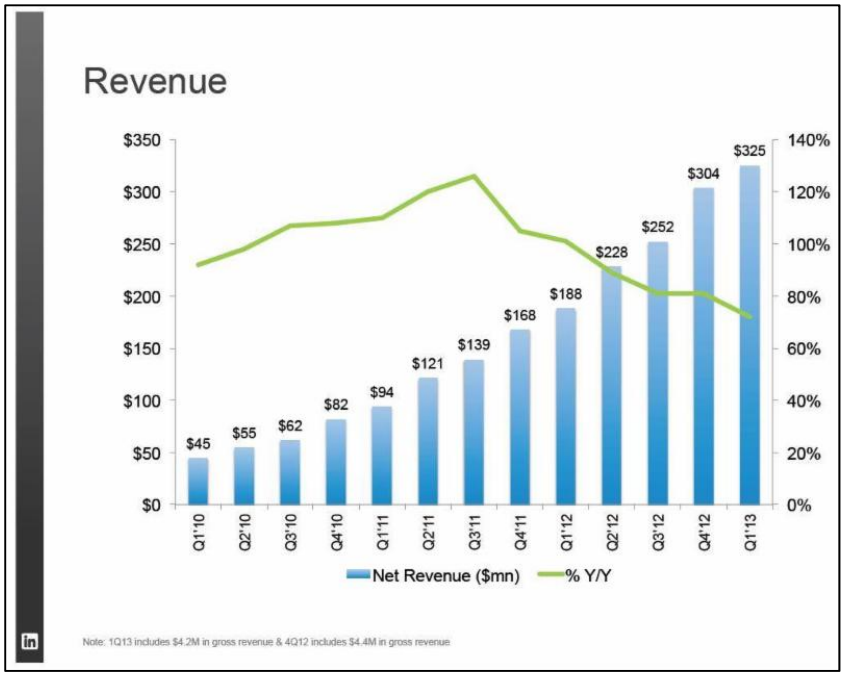

Image Source: LinkedIn

To really hit this point home, shown above is a slide of LinkedIn's (LNKD) revenue from the first quarter of 2010 through the first quarter of 2013. The green line (mapped to the right axis) shows LinkedIn's revenue growth rate. Let's assume revenue expansion translates into similar free cash flow growth expectations (not exactly a precise assumption, given the leverage in LinkedIn's business model), but bear with us for simplistic illustrative purposes. Will LinkedIn's revenue/cash flows expand at a 20% rate, a 40% rate, or a 60% rate (or an even greater pace) through year 20?

It's a very, very difficult question to answer. Remember how significant that 10 percentage point spread was in the hypothetical example above? Well, it's even more significant for LinkedIn. We know LinkedIn's free cash flows will expand, and expand fast, but just how fast is certainly debatable. To a very large extent, that's why LinkedIn's range of probable outcomes (fair value range) is so large. Understanding the cone of fair value outcomes of a company is helpful because the size of the range tends to be positively correlated to the equity's volatility. If you recall, look at what happened to LinkedIn's stock recently when investors ratcheted down their long-term growth assumptions (and by extension, the company's intrinsic value).

Shares collapsed in a huge way.

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But it was largely because of that same weakness in equity pricing that drove Microsoft (MSFT) to take the leap to buy LinkedIn's equity outright just a few months later. Over just a very short period of time, LinkedIn's shares effectively collapsed and then surged as the chart below shows (its intrinsic value range didn't change much, however). Having a fair value range that adequately captures both the upside and downside cases for a company's shares remains an integral part of stock investing. Not only does it help hone in on the potential risk-reward profile of an equity at any given time, it also helps reveal the attractiveness of various "entry" or "exit" points using a robust free-cash-flow based and fundamentally-sound intrinsic value estimate as the anchor.

We're scouring our coverage universe for firms that are trading outside of their respective fair value ranges. A firm trading below the low end of its fair value range, for example, is undervalued, while a firm trading above its fair value range is overvalued. The fair value range for each company captures the inherent uncertainty of the trajectory of that firm's unique future free cash flow stream. For the 1,000+ companies we include in our coverage universe, we provide a discounted cash flow derived fair value estimate and a corresponding fair value range -- *and a robust discounted cash-flow process is only one aspect of our service.*

How We Use the Valuentum Buying Index in the Best Ideas Newsletter Portfolio

By Valuentum Analysts

We often receive questions about how we use the Valuentum Buying Index (VBI) rating system, but we think it is equally important to mention that it is only one of the many facets of our website and services. For example, if you haven't checked out the Dividend Cushion ratios on the stocks in your portfolio or the dividend growth product (from individual reports to the newsletter and beyond), surely you are not maximizing your membership! We love dividends, but you can also trust us to make sure you're aware of the real risks of any dividend strategy in today's market.

No matter your strategy or process though, the Valuentum Buying Index rating system is still a helpful tool to have at your disposal, even if you are not using it. Admittedly, the VBI, as we call it, is not as easy to use as 1, 2, 3, or even buying 9s and 10s and selling 1s and 2s until their VBI changes upon the next update. Within any quantitative process, we value the human, qualitative overlay, which captures a wealth of experience and common sense. We want to make sure that we're surfacing the best ideas for members, and flying blind is never a good strategy, in our opinion. With prudence and care, the VBI process is carried out.

In probably one of the most obvious cases, for example, an experienced investor knows when a price-to-earnings (P/E) ratio isn't informative (as in the case of negative or negligible earnings), but a quantitative rating system that uses a P/E ratio, which the VBI does, may not know any better. Of course the VBI has checks and balances to adjust for such instances, but we believe the human, qualitative overlay is still extremely important, especially when considering various business models and unique "un-modelable" risks (particularly with respect to the banks). In our opinion, a golf club is only as good as the player that uses it, and in a similar light, a financial model or a rating system is only as good as the user that applies it.

That said, we stake so much on the performance of the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter. They represent the outcome of all of the work we do on the website, rolled into one final assessment: our best ideas for each respective strategy. Sure we have other screens on the website, but those are just screens -- listings of companies with similar data and information. The ideas in the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter have undergone a painstaking process with our analyst team to ensure that we're delivering the very best to members within a portfolio setting. The thoughts behind the weighting of each idea and the portfolio management process revealed in full transparency on a month to month basis may be worth the cost of a membership alone, even if you're not using the portfolios!

Here's why. In a market environment where more than 90% of large-cap funds have trailed the S&P 500 in the 5-year period ending August 31, 2016, the Best Ideas Newsletter portfolio has exceeded the market return by 33 percentage points over a similar time period. Absolutely phenomenal. What's more, we didn't hide behind standard quarterly reviews and updates either, sending out pre-packaged information to members. We showcased this performance in full transparency, and we had to write every single day to capture interest! When patience is the secret to success in investing, do you know how much could have gone wrong when having to produce daily? Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself.

Let's talk about how the VBI helps to inform which ideas we include in the Best Ideas Newsletter portfolio (not the Dividend Growth Newsletter portfolio as additional criteria must be met, namely as it relates to yield and Dividend Cushion ratio). That's such an important word, "informs." Notice how we didn't say "dictate" in this reference. For starters, we've noticed via our statistical backtesting that the momentum factor behind our process tends to be much more pronounced (powerful) over longer periods of time. This was one of the interesting findings of our academic white paper study. We try to replicate this dynamic with the update cycle of our reports (and the time horizon for our ideas to work out). That's why our

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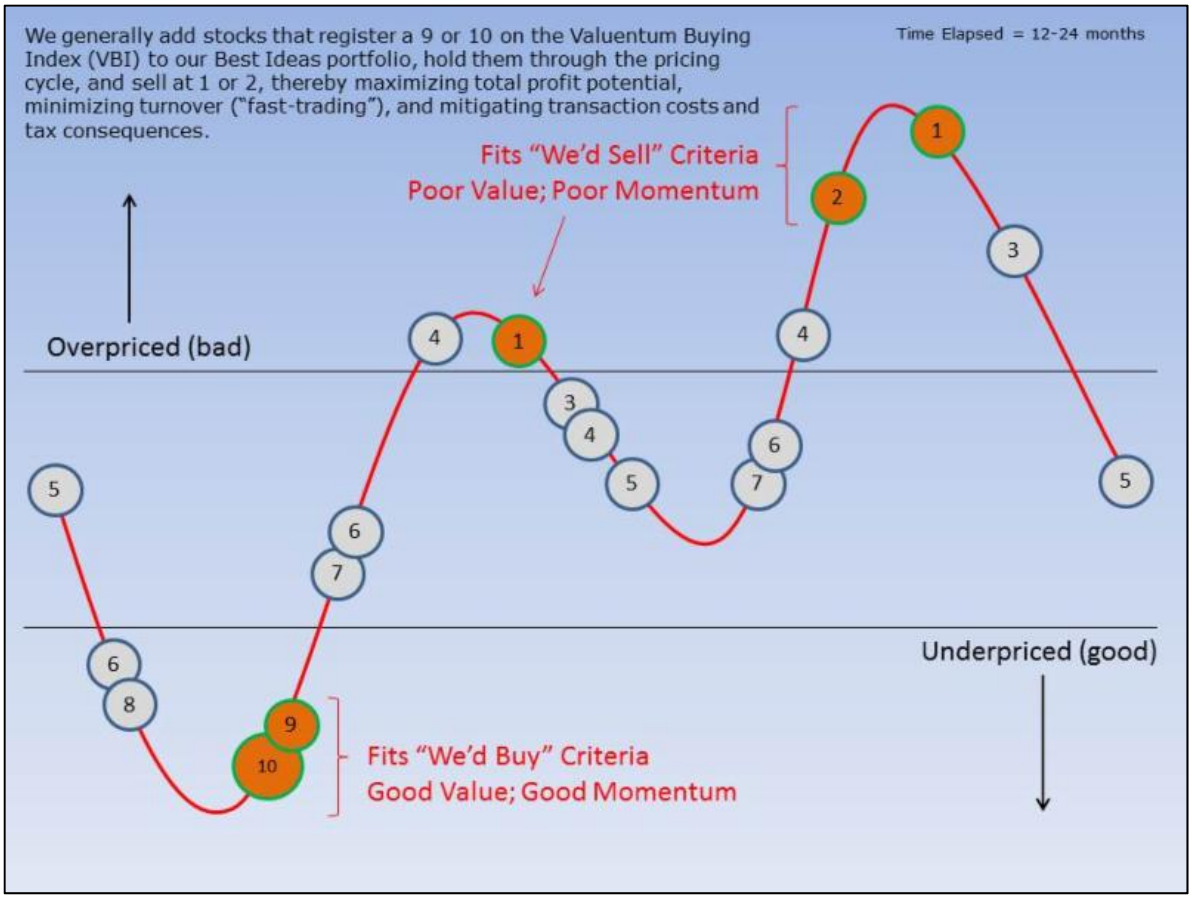
reports are updated regularly (generally on a quarterly basis) or after material events and not daily or weekly. Perhaps most practically though, we don't want to whipsaw our membership, nor do we think churn is the way to generate outperformance.

Though the time frame varies depending on each idea that we consider for the Best Ideas Newsletter portfolio, we expect our best ideas to generally work out over a 12-24 month time horizon (on average). Our holding period is targeted to be much, much longer for some ideas in the Dividend Growth Newsletter portfolio, however. Here is where the VBI rating system becomes somewhat more advanced than a simple 1, 2, 3. We tend to add stocks to the Best Ideas Newsletter portfolio when they register a 9 or 10 on the Valuentum Buying Index (VBI), hold them for some time depending on a number of variables (the VBI, market conditions, sector weightings within the portfolio itself), and then we tend to remove stocks from our Best Ideas Newsletter portfolio when they register a 1 or 2 on the VBI. You'll notice that we have a qualitative overlay for the Best Ideas Newsletter portfolio (and one for the Dividend Growth Newsletter portfolio, too, though it is based on dividend-related considerations).



But why don't we churn and burn by updating daily and trading a lot? Obviously, we don't think that's the secret to success. In quite the opposite approach, we like to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. For example, as shown in the image above, a value strategy (10 --> 5) truncates potential profits, while a momentum strategy (4 --> 1) ignores profits generated via value assessments. At Valuentum, we're after the entire profit potential of each idea. So, for example, if a firm is added to the Best Ideas Newsletter portfolio as a 10 and is removed as a 5, we would have truncated profit potential by not letting it run to lower ratings. Most of our highly-rated Valuentum Buying Index rated stocks have generated the vast outperformance of the Best Ideas portfolio, but these stocks' ratings declined over time as they were held (a good thing -- a declining VBI rating generally means the share price has advanced, assuming all else is well).

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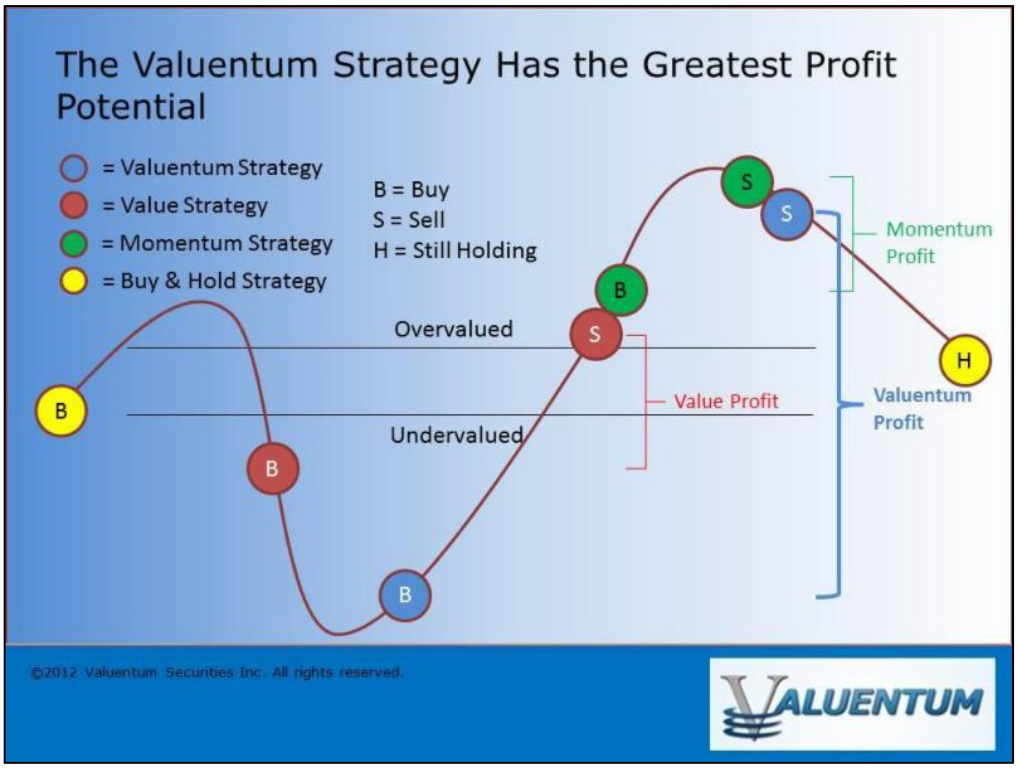

Critically, regarding the Valuentum process, as it is executed in the Best Ideas Newsletter portfolio, we do not add all firms that register a 9 or 10, nor do we add the ones we do immediately thereafter. For example, Google (GOOG, GOOGL), now Alphabet, a current Best Ideas Newsletter portfolio holding, registered a 10 on the Valuentum Buying Index, but we remained patient and didn't add the company to our portfolio until after it reported earnings at the time, providing us with an even better entry point (as new information came to light). There are more "structural/timing" instances like the one with Alphabet, for example, that are extremely difficult to capture in any model, and understandably aren't as obvious to those outside looking in.

But why not add every highly-rated stock to the Best Ideas Newsletter portfolio? Think of it as if you were to imagine a value investor not adding and holding every undervalued stock to his/her portfolio. He or she wants the very best ones -- obviously, that means having to leave some good ideas behind. And then, of course, there are always tactical and sector weighting considerations in any portfolio construction, yet another reason why the human touch remains a vital aspect of the Valuentum process. At the core of how we use the VBI in the Best Ideas Newsletter portfolio, however, is a qualitative portfolio management overlay. The VBI rating helps to inform the process, but the Valuentum team makes the allocation decisions of the newsletter portfolio on the basis of a number of other firm-specific and portfolio criteria. Sometimes, under certain market conditions, we may have to relax the VBI criteria entirely in order to achieve newsletter portfolio goals.

Okay, a couple examples. Take pre-split eBay (EBAY), which many years ago included PayPal (PYPL), as an example of our process in action. The stock initially flashed a rating of 10 in late September 2011, and we added it to the Best Ideas Newsletter portfolio. The VBI rating changed to a 6 in December 2011 and then back to a 10 in May 2012, but because the rating never breached a 1 or 2, we did not remove the position from the Best Ideas Newsletter portfolio. In the case of pre-split eBay, we sought to capture the entire pricing cycle and avoided truncating it as most pure value investors often do (and what we would had done, if we had removed the stock at that time). In many ways, pre-split eBay/PayPal has become one of the better examples to use for illustrating the prolonged outperformance driven by undervalued stocks that are beginning to generate good momentum. [We no longer include eBay in the newsletter portfolio, but its split-off PayPal is retained.]

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There have been more straightforward opportunities in the Best Ideas Newsletter portfolio, too, especially in the case of EDAC Tech, which had tripled since it was added to the newsletter portfolio (never registering below a 9 along the way), and then of course, Apple (APPL), Visa (V) and Altria (MO), but it is usually through the nuances of the process that one truly comes to understand it. The VBI ratings on each stock's most recent 16-page report, downloadable directly from the website at www.valuentum.com, reflect our current opinion on the company. The VBI rating system, as with all methodologies, helps to inform the investment decision process, but in constructing the newsletter portfolio, a qualitative overlay is not only necessary, in our view, but helps to optimize performance. If the returns of the Best Ideas Newsletter portfolio during the past 5+ years are any measure of the VBI rating system, it is performing fantastically well.

About Our Name

But how, you will ask, does one decide what [stocks are] "attractive"? Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth,"...We view that as fuzzy thinking...Growth is always a component of value [and] the very term "value investing" is redundant.

-- Warren Buffett, Berkshire Hathaway annual report, 1993

At Valuentum, we take Buffett's thoughts one step further. We think the best opportunities arise from a complete understanding of all investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value to momentum investing. And a combination of the two approaches found on each side of the spectrum (value/momentum) in a name couldn't be more representative of what our analysts do here; hence, we're called Valuentum.

Valuentum Best Ideas Newsletter: Volume 7, Issue 4

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