OUR DIVIDEND GROWTH NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
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*Study: Valuentum released a new study on its **fair value estimates**! Please download the paper at the following link:*

https://www.valuentum.com/downloads/20171031/download

INSIDE THIS ISSUE

1 Dividend Growth Giant: Boeing!
2 Gilead Sciences' HCV Guidance Is the Star of the Show
5 **Portfolio:** Dividend Growth Ideas
6 Our Overview on Merck in Light of Recent Clinical Events
10 Stocks with High Valuentum Buying Index Ratings and Strong Dividend Growth Prospects
11 The Financially-Healthiest Dividend Payers Yielding Over 2%
12 Yields to Consider Avoiding
13 The US Dollar, GDP Expansion, and Earnings
15 GlaxoSmithKline: Not All Dividends Are Created Equal
17 Bioverativ's Takeout, Visa's Surge, and General Electric's Pain
19 Brewing the Next Dividend Aristocrat
22 Microsoft: A Dividend Growth Giant
25 How Well Do Enterprise-Cash-Flow-Derived Fair Value Estimates Predict Future Stock Prices?
26 About the Dividend Cushion™ Ratio

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"Dividend Growth Newsletter portfolio idea Boeing (BA) continues its tremendous share-price run of late, hitting all-time highs following its earnings report before market open January 31."

– Kris Rosemann

***NOTE:** The goal of the Dividend Growth Newsletter is to highlight ideas with strong dividend growth potential and update readers about new developments in the market. A simulated portfolio of dividend growth ideas is presented on page 5 of each edition.

Dividend Growth Giant: Boeing!

By Kris Rosemann

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Dividend Growth Ideas: MO, AAPL, BA, BKLN, CBRL, CSCO, CVS, XLE, GM, GILD, HAS, HBI, IDV, INTC, JNJ, MSFT, NVS, O, PG, SDY

Dividend Growth Newsletter portfolio idea Boeing (BA) continues its tremendous share-price run of late, hitting all-time highs following its earnings report before market open January 31. The aerospace giant turned in 9% revenue growth on a year-over-year basis, while GAAP earnings per share doubled from the year-ago period to $5.18. Free cash flow remained robust in the full-year 2017, advancing to ~$11.6 billion from ~$7.9 billion in 2016. The company expects operating cash flow to climb to ~$15 billion in 2018 (up from $13.3 billion in 2017), and its revenue guidance of $96-$98 billion and GAAP EPS guidance of $15.90-$16.10 for the year reflect expectations for a favorable operating environment to persist, a notion that is underpinned by its robust backlog of $484 billion (up from $474 billion at the end of 2016).

Trucking stocks motored higher during the January 31 session after Knight-Swift Transportation (KNX) reported impressive earnings results before the open. The company expects rate increases in 2018 to be in the high-single-digit to low-double-digit range in its contract business, the core driver behind the industry-wide rally, due to strength in the freight market and driver wage inflation. However, a driver shortage remains a key challenge for operators, and it could impact the ability of companies to grow capacity and take greater advantage of the higher rate environment.

Please see *Dividend Growth...*on next page

The Dividend Growth Newsletter portfolio is not a real money portfolio. Results are hypothetical and do not represent actual trading. Actual results may differ from simulated performance information being presented.

*Dividend Growth...*from previous page

Pharma giant Eli Lilly (LLY) continues to face pressure as a reduction in its 2018 earnings per share guidance accompanied an otherwise solid fourth quarter 2017 earnings report. This pressure comes on the heels of the potentially industry-disrupting announcement that came from the planned group efforts of Amazon (AMZN), Berkshire Hathaway (BRK.B), and JP Morgan (JPM) to disrupt the healthcare industry and meaningfully lower nationwide healthcare costs.

The impacts of such a development are being felt across the healthcare space (XLV), with pharmacy benefit managers (PBMs) and drugmakers susceptible to price erosion from biosimilar competition feeling the brunt of it at this point as lower costs, scale efficiencies, and improved technology are the expected core tenants of the venture. Nevertheless, new product revenue growth at Eli Lilly of more than 12% in the fourth quarter was more than able to offset weakness in other areas as recent expirations provided a ~5.4% drag on the top-line in the quarter. Innovative drug development will never go out of demand.

Enterprise Product Partners (EPD) reported a record operational quarter before the open January 31 as volumes pushed higher and improved natural gas processing margins and lower turnaround expenses in its 'Petrochemical' segment drove record quarterly operating income, gross operating margin, adjusted EBITDA, and distributable cash flow (excluding proceeds from asset sales. On a related note, crude oil inventories came in significantly higher than expected for the week ended January 31 according to the EIA, a development that may be worth monitoring following conflicting comments from OPEC leaders and the EIA regarding the impact of US production levels on inventory levels and the balance of the global oil markets.

Bitcoin (XBT, GBTC) is on track for January to be its worst month since December 2013 as concerns over regulatory scrutiny mount. Subpoenas sent to a cryptocurrency exchange by the US Commodity Futures Trading Commission, a crackdown on cryptocurrencies in South Korea (EWY) and China, and tightening regulations in Japan (EWJ) following a ~$530 million theft by hackers are all reasons for the pessimism. The digital asset remains a tremendously speculative vehicle.

Meanwhile, a meaningful moment for stock market historians may be on the horizon, according to Deutsche Bank, which is speculating that General Electric (GE) may be dropped from the Dow Jones Industrial Average. GE is an original member of the index, which is comprised of 30 companies and dates back to 1896. A shrinking portfolio, challenging global power generation markets, potential cash flow shortfalls, management turnover, and SEC investigations are a few of the obstacles the industrial giant will have to overcome in the near term to retain its position in the index.

Gilead Sciences' HCV Guidance Is the Star of the Show

Shares of Gilead Science have been held hostage due to the vagaries of the HCV business. The shares blasted through $100 as the initial sales ramp for its suite of HCV meds took the market by storm. The record revenues posted in 2015 proved to be unsustainable, however, as the curative nature of the treatment meaningfully decreased the eligible pool of patients much to the benefit of society. The Street subsequently punished shares of Gilead as the equity made a near roundtrip back down the high $60's. The investment community has maintained a near-maniacal obsession with the HCV pipeline with the latest fear of a new competitor stealing share. Let's examine these key points a bit further.

By Alexander J Poulos

The JP Morgan Healthcare conference is a week-long affair featuring over 450 private and public healthcare companies. The conference offers a unique platform, allowing executives to detail the progress over the past year. Many have utilized the conference to offer forward guidance or release critical new data. The conference, in our opinion, can have market-moving ramifications. We were not at all disappointed as Gilead Sciences (GILD) provided some assuring 2018 guidance.

Please see *Gilead Sciences...*on next page

*Gilead Sciences…*from previous page

The executive making the presentation was John Milligan, the CEO of Gilead who seized the opportunity to provide interesting color on the market dynamics of the HCV marketplace. We've always viewed the HCV market as a lucrative yet wasting asset that will spin-off copious amounts of free cash flow with minimal additional capital spending. We based our opinion on the recent new HCV product approvals with a slightly shorter overall course of therapy as the final product to address the HCV market. Gilead discontinued additional research in the field as the current therapies were deemed sufficient to handle the epidemic. With the absence of R&D dollars devoted to additional follow-up therapies, the HCV product suite has become a proverbial cash cow that will remain an important, but ever-shrinking, percentage of Gilead's revenue and profit.

The share price of Gilead sold off post the enthusiasm garnered via the acquisition of Kite Pharma this summer. The sell-off has intensified post the third quarter earnings release where yet again the focus was placed on the FDA's approval of Mavyret which can treat all six genotypes in as little as eight weeks. The fear is a new competitor will enter the HCV market which may further depress prices, thus placing additional pressure on Gilead's revenues and profitability. Milligan, in a few eloquent sentences, vanquished this notion, helping to quash investor fears.

> *But as we enter 2018, we consider that the marketing -- the pricing has become stable. So for 2018 and beyond, we think the market prices will be stable. We think that the market share will be split between 2 companies, and we'll see how we battle out between ourselves and our competitor, AbbVie. And a more predictable but slightly declining patient flow into the future. So what this means for Gilead is HCV will be an important component of what we do. It will be a smaller component of what we do, and we think that the growth in our HIV and other businesses will be the main driver of what you'll see for Gilead going into the future.*
>
> Source: JP Morgan Jan 8th, 2018 conference

The emergence of a stable pricing regime for the HCV market would be a welcome occurrence for payers and providers alike as it allows for greater visibility and treatment flexibility. One of the greatest challenges is projecting demand, thus allowing for adequate resources to pay for the therapy. From a provider's perspective, enhanced visibility will allow the management team at Gilead greater insights into the dynamics of the marketplace while allowing for more accurate quarterly guidance. We feel the team at Gilead may have gotten a bad rep for their inability to provide quarterly guidance.

Pivot to the Clinical Pipeline

The relentless focus on the declining HCV marketplace has overshadowed the crown jewel of Gilead's product portfolio—namely the HIV franchise and the exciting CAR-T line acquired via the takeout of Kite. Let's offer our overview of each division.

Gilead continues to expand its dominance in the field of HIV with the recent approval of TAF-based products such as Genvoya. The newly-formulated combination therapies have expanded the lifecycle of the HIV franchise, thus helping to support continued growth. GlaxoSmithKline (GSK) remains a distant second place, but GSK hoped to jumpstart its flagging sales via a new doublet therapy marketed under the tradename Juluca. Juluca is a combination of GSK's Tivicay and Merck's (MRK) Endurant into a single once a day dosage. The issue with Juluca is the doublet itself—by not adding an additional nucleoside reverse transcriptase inhibitors, GSK is leaving the door open for possible resistance, a non-starter for clinicians. GSK's in-house NRTI's have a problematic side-effect profile, thus allowing Gilead to dominate the market with its far better-tolerated product suite.

Please see *Gilead Sciences…*on next page

Gilead Sciences...from previous page

Gilead has utilized one of the priority review vouchers it acquired to expedite approval of Bictegavir in combination with emtricitabine/tenofovir alafenamide to form a potent triplet therapy. We feel the new formulation with an expected higher price tag and longer total patent life will allow Gilead to increase its HIV franchise revenue stream meaningfully. The PDUFA date for the triplet therapy is February 12, 2018—less than one month away!

In our view, the most exciting portion of the Gilead investment thesis is the potential of the oncology division now that a viable CAR-T therapy has been added to the fold. Gilead's ambition in oncology has been well-documented, but leading up to the Kite acquisition a rather futile affair, as Zydelig is a costly commercial flop due to an unacceptable level of toxicity along with a host of phase two failures.

2018 will mark Gilead's maiden voyage in the CAR-T field as it begins the roll-out of Axicabtagen ciloleucel the novel treatment acquired in the Kite Pharma purchase. We expect the initial ramp to take time as additional infusion centers are brought into the fold. We do not expect the treatment to have a meaningful impact on revenue in 2018. Instead, we view it as a key piece of the clinical pipeline going forward. We expect the treatment will receive additional indications which will expand the overall patient population.

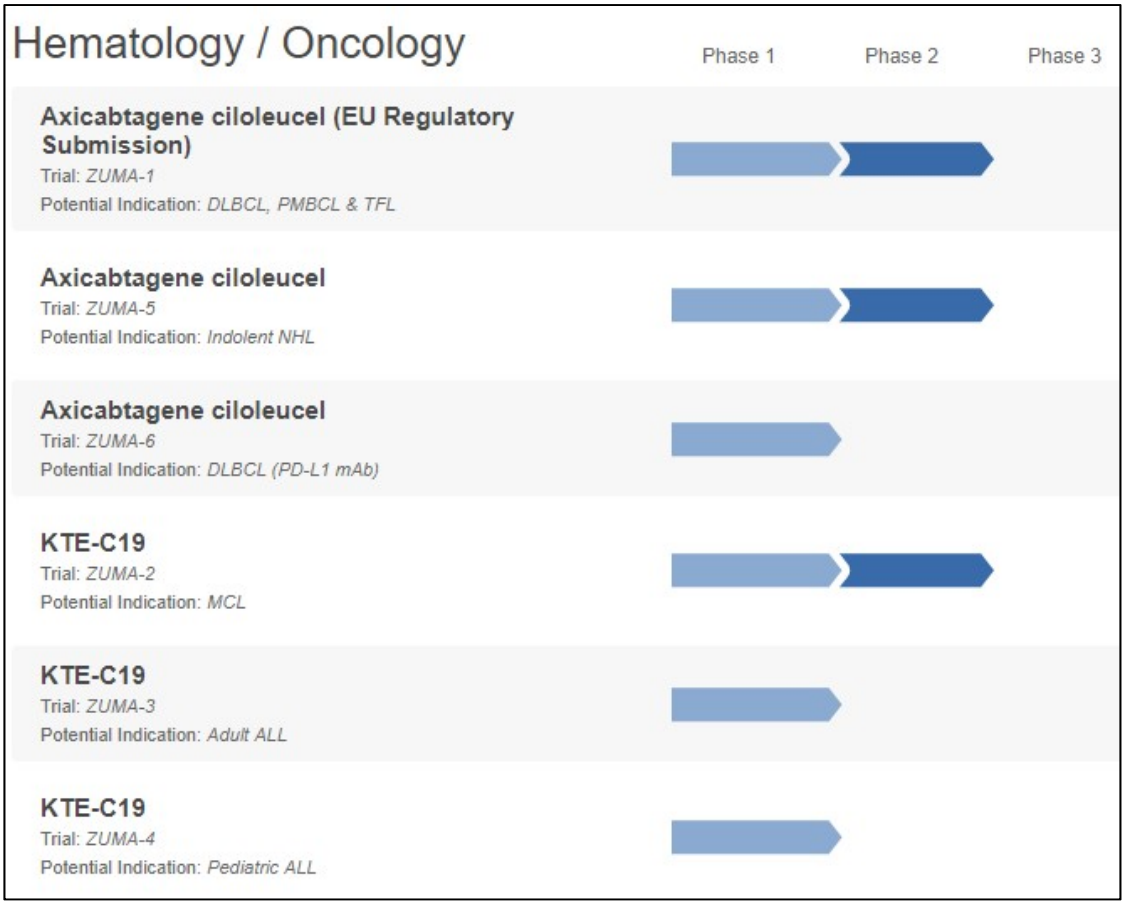

Image Source: Gilead Sciences

The management team at Gilead should be commended for wisely purchasing a platform technology instead of spending its tremendous cash hoard for a few interesting assets. While the investment community has clamored for a deal during the past few years, the management team's reluctance of overpaying has paid off in spades as Gilead has now vaulted past Novartis (NVS) into the lead in the CAR-T field. In essence, by writing a very large check, Gilead has accomplished its long-held goal of making a splash in the field of oncology—Well Done!!!

Please see *Gilead Sciences*...on page 6

Dividend Growth Ideas

By Valuentum Analysts

Note: This edition of this newsletter, the February 2018 edition, features ideas in list-and-weighting format, as announced several months ago.

*Study: Valuentum released a new study on its **fair value estimates**! Please download the paper at the following link:*

https://www.valuentum.com/downloads/20171031/download

Why the Simulated Newsletter Portfolio Format Changes?

We're constantly improving at Valuentum and incorporating members' suggestions as we go.

What we have found from members' feedback is that a meaningful percentage of subscribers are having a different experience than what is reflected in the newsletters.

In some cases, what we've found is that the showcasing of the measurements is not helping our readership as much as we previously thought. Because of this and incorporating feedback, we believe we needed to make a change to a different presentation style--one that makes it easier to find our best ideas--so we've opted for the list-and-weighting format, as shown in the table below. We think this makes the most sense, too, as it gets our favorite ideas at the top.

We also continue to conduct extensive studies on our research methodologies. Pasted below, for example, are links to two of the most recent papers we've put together on our calculated fair value estimates and Valuentum Buying Index ratings, respectively. These ratings are included in each company's 16-page reports and are a core part of our product offering. Both of these papers were written in 2017:

Fair Value Estimates (pdf): https://www.valuentum.com/downloads/20171031/download

Valuentum Buying Index ratings:
https://www.valuentum.com/articles/Value_and_Momentum_Within_Stocks_Too

Ideas may not add up to 100% on either the low % or high % due to rounding and/or other combinations / permutations.

DIVIDEND GROWTH IDEAS -- as of February 1, 2018

Company Name	Yrly Div's Paid ($) / Shr	Div Yield %	Fair Value	VBI Rating	Price/FV	Last Close	% of Portfolio
Intel (INTC)	1.20	2.52%	$48.00	7	0.99	47.65	5.5%-10%
Johnson & Johnson (JNJ)	3.36	2.40%	$130.00	7	1.08	140.02	5.5%-10%
S&P Dividend ETF SPDR (SDY)	2.10	2.19%	-	UR	-	95.76	5.5%-10%
Apple (AAPL)	2.52	1.50%	$201.00	6	0.83	167.78	4%-5.5%
Cisco (CSCO)	1.16	2.78%	$43.00	5	0.97	41.70	4%-5.5%
iShares Int'l Select Dividend (IDV)	1.53	4.31%	-	UR	-	35.47	4%-5.5%
Proctor & Gamble (PG)	2.76	3.21%	$77.00	4	1.11	85.85	4%-5.5%
Energy Sector SPDR (XLE)	2.19	2.90%	-	UR	-	75.62	4%-5.5%
Boeing (BA)	6.84	1.92%	$276.00	5	1.29	356.94	2.5%-4%
PowerShares Senior Loan (BKLN)	0.80	3.44%	-	UR	-	23.26	2.5%-4%
CVS Health (CVS)	2.00	2.54%	$88.00	4	0.90	78.79	2.5%-4%
General Motors (GM)	1.52	3.58%	$45.00	7	0.94	42.43	2.5%-4%
Microsoft (MSFT)	1.68	1.78%	$79.00	6	1.19	94.26	2.5%-4%
Novartis (NVS)	2.72	3.00%	$80.00	5	1.13	90.55	2.5%-4%
Cracker Barrel (CBRL)	4.80	2.73%	$165.00	6	1.07	175.90	1.5%-2.5%
Gilead Sciences (GILD)	2.08	2.49%	$109.00	7	0.77	83.49	1.5%-2.5%
Hasbro (HAS)	2.28	2.38%	$87.00	3	1.10	95.74	1.5%-2.5%
Hanesbrands (HBI)	0.60	2.80%	$27.00	7	0.79	21.45	1.5%-2.5%
Altria (MO)	2.64	3.78%	$58.00	6	1.21	69.93	1.5%-2.5%
Realty Income (O)	2.63	5.10%	$57.00	3	0.91	51.59	1.5%-2.5%
Cash Consideration	-	-	-	-	-	-	5%-30%

UR = Under Review

This portfolio is not a real money portfolio. Data as of February 1, 2018.

Standard Disclaimer: Our Dividend Growth Newsletter 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 Dividend Growth Newsletter and accepts no liability for how readers may choose to utilize the content.

Gilead Sciences...from page 4

Role of the Dividend

Though there are many ideas out there, we think Gilead represents a unique asset in the biotech field as it combines the appealing aspect of a rich pipeline (which appeals to growth-oriented investors), while satisfying the demands of income-oriented investors with a hefty current quarterly payout of $0.52 per share ($2.08 annualized) for a yield north of 2.5%.

Gilead initiated its dividend in 2015 with an initial payout of $0.43 per share, which it subsequently raised to $0.47 in 2016. Gilead's dividend-hike history suggests that an increase in the second quarter is likely. The nearest biotech competitor that can emulate the dividend history of Gilead is Amgen (AMGN), in our view, but we remain less-than-enthused with the progress of the clinical pipeline at Amgen. It is not very often we include a company in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio, but we feel the near-term income attributes of Gilead combined with the promise of the pipeline bodes well for future share price appreciation and income growth.

Independent Contributor Alexander J. Poulos is long Gilead Sciences.

Our Overview on Merck in Light of Recent Clinical Events

Clinical data reads can have an outsize impact on the fortunes of the research-based pharma industry, irrespective of the size of the organization. We came away very impressed with the recent release from Merck and felt a timely overview of the various pharmaceutical products developed by the company would be of value to readers.

By Alexander J Poulos

Third Quarter Results

Third-Quarter Revenue Performance

The following table reflects sales of the company's top pharmaceutical products, as well as total sales of Animal Health products.

$ in millions	Third Quarter			
	2017	2016	Change	Change Ex-Exchange
Total Sales	$10,325	$10,536	-2%	-3%
Pharmaceutical	9,156	9,443	-3%	-4%
JANUVIA / JANUMET	1,525	1,554	-2%	-2%
KEYTRUDA	1,047	356	194%	192%
GARDASIL / GARDASIL 9	675	860	-22%	-22%
PROQUAD, M-M-R II and VARIVAX	519	496	4%	5%
ZEPATIER	468	164	185%	184%
ZETIA / VYTORIN	462	944	-51%	-52%
ISENTRESS / ISENTRESS HD	310	372	-17%	-18%
ZOSTAVAX	234	190	23%	23%
PNEUMOVAX 23	229	175	31%	31%
Animal Health	1,000	865	16%	14%
Other Revenues	169	228	-26%	-13%

Image Source: Merck

Please see *Our Overview*...on next page

*Our Overview...*from previous page

On October 27, Merck (MRK) released its third-quarter results. The results were met with an immediate sell-off in the shares as the pace of the clinical pipeline disappointed. To say the least, we were surprised by the aggressiveness of the sell-off--the catalyst for the leg down in the share price, in our view, is the declaration of an amendment to the clinical trial design for Keytruda.

> *Merck is amending the KEYNOTE-189 study to include overall survival as a co-primary endpoint. The updated completion date is Feb. 2019 and there will be opportunities for the company to conduct interim analyses. KEYNOTE-189 is a Phase 3 study of platinum-pemetrexed chemotherapy with or without KEYTRUDA in patients with first-line metastatic non-squamous non-small cell lung cancer (NSCLC).*
>
> Quote Source: Merck

We think the inclusion of overall survival data will be a key differentiator in what remains the early stages of the buildout of immune-oncology. Investors may view Merck as a stable behemoth with an attractive dividend--an assessment we share--, but what most may not realize is the enormous reliance of Merck on the prospects for Keytruda to jumpstart its flagging revenue. Let's review the various medication franchises to gain a further understanding of the outsized importance of Keytruda.

Metabolic and Cardiovascular Franchise

Merck has remained at the forefront of combating cardiovascular disease since the introduction of Mevacor to help combat elevated levels of cholesterol. Merck followed up its initial success with Mevacor with Zocor which remains a widely prescribed agent even though patent protection was lost some time ago. Merck managed to remain in the vanguard with the acquisition of Schering-Plough in 2009 with the crown jewel of the purchase remaining the cholesterol-lowering agent Zetia.

Zetia remains a unique entity--it is the only "non-statin" that is dosed at once a day. The statin class which includes popular remedies such as Zocor and Mevacor may lead to severe muscle pain which will cause a patient to discontinue therapy. By acquiring Zetia, it opened an additional avenue to maintain Merck's dominance in the area of cholesterol-lowering agents including line extension by combining Zetia with Zocor to form Vytorin. As is the norm in the industry, patent protection for Zetia has lapsed, which is placing top-line growth pressure on Merck as it looks to leverage its clinical pipeline for next-gen therapies that can advance the top-line.

Merck's core Metabolic franchise is suffering from patient defection from Januvia to the SGIT2 class with Jardiance gaining particular favor due to a recent stellar outcomes trial. Jardiance lowered cardiovascular deaths in diabetics (a notable accomplishment as cardiac issues are particularly difficult to treat in the diabetics). We feel the data will lead to a slow drain away from Merck's Januvia and Johnson and Johnson's (JNJ) Invokana which will pressure the top-line of each of the pharma heavyweights.

Infectious Disease

Merck is a very late entrant into the Hepatitis C marketplace with its treatment Zepatier for Genotypes 1-4. The sales ramp of Zepatier is impressive but the good times will not last as Abbvie (ABBV) recently received approval of Mavyret for all six genotypes. The overall total course of therapy for Mavyret can be completed in as little as eight weeks versus the current standard for twelve weeks. The eight-week course is for those who have not been treated previously, with the bulk of the patients with a higher fibrotic score already been treated we feel Mavyret has a nice opportunity before it in the HCV market.

We would like to stress yet again the HCV market is no longer a growth market, but a significant number of patients still need to be treated, which will set up a nice annuity stream for Abbvie and industry leader Gilead Sciences (GILD). We expect the bulk of Mavyret's gain will come at the expense of Merck's Zepatier, thus further depriving Merck of an attractive growth asset.

Please see *Our Overview...*on next page

*Our Overview...*from previous page

Merck has decided to terminate further development of two clinical phase 2 assets in the field of HCV. We believe the decision to terminate the products in combination with Gilead's proclamation to shift R&D dollars away from the field of HCV underscores we have hit a critical milestone in the quest to eradicate HCV. While Merck still has a nice asset in Zepatier, the era of growth has lapsed and Zepatier should now be considered a wasting asset.

Moving on the HIV, Merck's Isentress continues to lose ground to newer therapies. Merck does have a few molecules in phase 3 testing, but we can't help but feel it will be impossible for Merck to displace industry leader Gilead or its primary rival in Viiv Healthcare (a partnership with GlaxoSmithKline (GSK) and Pfizer (PFE).

Vaccines

The vaccine business remains an area of continued innovation at Merck. Merck's Gardasil remains a star with continued growth as healthcare providers push for widespread adoption. For the first nine months of 2017, sales of Gardasil are up even with a huge year-over-year sales variance in the third quarter. As is the norm in the ultra-competitive vaccine market, a new entrant is poised to steal significant market share from Zostavax (Merck's treatment for Herpes Zoster).

GSK recently gained approval for Shingrix a refrigerated product that has demonstrated superior clinical outcomes. Zostavax requires being kept frozen which has limited widespread adoption as healthcare providers are loath to shoulder the extra cost burden of a special unit just to store Zostavax. Merck does have a few interesting new treatments in phase 2-3 as the company continues to invest R&D dollars into vaccines.

Oncology

After reviewing the main growth drivers of Merck, one might come away with the conclusion new areas of focus to drive growth are necessary. The primary growth driver for Merck going forward remains Keytruda, its novel PD-1 therapy for the treatment of a wide range of cancers.

A bit of an overview: the consensus is the PD-1 class has the potential to radically reshape how cancer is treated, at least that was the initial thesis. The excitement was fueled by a string of impressive FDA approvals, but the first signs of doubt emerged in 2016 when Bristol Myers (BMY) competitive treatment Opdivo failed in a widely expected test for lung cancer. The miss was a shock as the share price of Bristol plummeted over 15% on the news. We are bringing this point up to underscore just how closely the future fortunes of Merck, Bristol-Myers and to a lesser extent Roche (RHHBY) are to the PD-1 and PD-L1 marketplace.

We had the distinct feeling of déjà vu when the shares of Merck plummeted last quarter upon the release of a change to the trial design for its combo of Keytruda. Keytruda posted nine-month sales in 2017 of $2.5 billion versus $919 million for the first nine months of 2016. The immediate fortunes of Merck are directly tied to further market share gains for Keytruda. Merck is looking to expand the prescribing label rapidly in order to capitalize on the enormous potential of the therapy.

> *Merck (NYSE:MRK), known as MSD outside the United States and Canada, today announced that the pivotal Phase 3 KEYNOTE-189 trial investigating KEYTRUDA® (pembrolizumab), Merck's anti-PD-1 therapy, in combination with pemetrexed (Alimta®) and cisplatin or carboplatin, for the first-line treatment of patients with metastatic non-squamous non-small cell lung cancer (NSCLC), met its dual primary endpoints of overall survival (OS) and progression-free survival (PFS). Based on an interim analysis conducted by the independent Data Monitoring Committee, treatment with KEYTRUDA in combination with pemetrexed plus platinum chemotherapy resulted in significantly longer OS and PFS than pemetrexed plus platinum chemotherapy alone. The safety profile of KEYTRUDA in this combination was consistent with that previously observed.*
>
> Quote Source: Merck

Please see *Our Overview...*on next page

*Our Overview...*from previous page

In our view, the decision to include overall survival data is a masterstroke as Keytruda has now vaulted out into the pole position in the largest overall oncology market, non-small cell lung cancer. The second key point is that the side-effect profile is consistent with what is previously observed. We can read through that no new safety signals were detected, though the final confirmation will come when the entire data is released at an upcoming conference. We feel Keytruda has now opened up a commanding lead that will be difficult to displace by existing therapies.

As is the norm in the pharma/biotech (XLV, IBB, XBI) world, however, a new molecule may come to market, but we view this possibility as one that would only come many years down the road, offering Keytruda ample time to cement its role as the industry norm. A recent example of the stickiness of first-to-market is the market share held by Gilead Sciences in HCV. Even though new entrants have entered with one even coming up with a superior product due to a shorter course of therapy, Gilead has maintained over 80% market share. We feel Keytruda is solidifying itself as the PD-1 of choice for lung cancer, the most lucrative of all of the oncology disease states.

Role of the Dividend

We have assigned a Dividend Safety ratio of GOOD for Merck as its cash-flow profile amply covers the dividend. We do not foresee any sort of reduction in the near future. As for dividend growth, the potential is good, with Merck raising the dividend at roughly a 2% clip during the past few years. Merck is heavily investing in expanding the prescribing label for Keytruda, and if successful, we expect the cash-flow profile of Merck to improve markedly.

Animal Health Division

In keeping with our theme of 2018 shaping up to be the year of the merger in the pharma/biotech realm, Merck CEO Ken Frazier dropped noticeable hints as to the pharma giant's appetite for additional deals. Just to add some context, Merck views Animal Health as a key pillar of growth along the lines of the Oncology division—big stuff!

> *We're also looking carefully at other potential products in our pipeline, determining which opportunities have the highest potential to address unmet needs. For instance, we recently made the decision to prioritize certain opportunities in our pipeline for vaccines and for HIV. We believe these represent areas of long-term growth and could sizably add to our other key pillars of growth, namely oncology and Animal Health.*
>
> Quote Source: Merck Q3 2017 Earnings Presentation

We interpret "business development" as code for looking to make deals.

> So, we are focused on driving long-term growth through innovation generally, and we see Animal Health as the innovation that we can create through that portal as a pillar of growth for the company. As we've noted this quarter, it surpassed $1 billion for the first time inside our portfolio, which is meaningful, and we continue to see it going forward as a key growth driver because it has healthy margins as well as a strong market outlook. So, from our perspective, we see it fitting very nicely in augmenting our growth as an overall company, **and we intend, where we find opportunities, to further augment that business with additional business development. So, it's an important part of our business,**
>
> Quote Source: Merck Q3 2017 Earnings Presentation

It will be interesting to see if Eli Lilly (LLY) does spin-out its animal health division called Elanco, and then would Merck become interested in an outright acquisition post a potential spin-out? There remain lots of plausible possibilities. All in, we're keeping a very close eye on Merck's tremendous opportunities, almost across the board.

Independent Contributor Alexander J. Poulos is long Gilead Sciences and Merck.

Stocks with High Valuentum Buying Index Ratings and Strong Dividend Growth Prospects

By Valuentum Analysts

The table showcases stocks in our coverage universe that have high Valuentum Buying Index™ ratings and strong dividend growth prospects. The table represents a list of interesting dividend-paying stocks that may be *among* the most timely dividend growth ideas to consider based on our stock-selection methodology. You'll see that many of them are already ideas included in the Dividend Growth Newsletter portfolio (see page 5).

Though our dividend-growth portfolio may be fully-invested at times, we may swap in firms on this list or firms on our dividend-growth watch list (see the next page) at the right price or if our analyst team believes that a new add may have more potential total return opportunity than a current idea already within the newsletter portfolio. At any time, however, our favorite dividend growth ideas are included in the Dividend Growth Newsletter portfolio.

Company Name	Symbol	Est Div Yield	VBI	Div Growth	Div Cushion
General Dynamics	GD	1.6%	7	EXCELLENT	2.9
General Motors	GM	3.5%	7	GOOD	2.8
Magna Intl	MGA	2.0%	7	GOOD	3.3
Coca-Cola	KO	3.2%	7	EXCELLENT	1.4
Intel	INTC	2.3%	7	EXCELLENT	2.8
Silicon Motion Technology	SIMO	2.2%	7	GOOD	3.4
Amdocs	DOX	1.3%	7	EXCELLENT	5.0
CSG Systems	CSGS	1.7%	7	EXCELLENT	3.7
j2 Global	JCOM	2.1%	7	EXCELLENT	2.6
DowDuPont	DWDP	2.1%	7	EXCELLENT	1.4
PPG Industries	PPG	1.5%	7	EXCELLENT	2.5
Intl Flavors	IFF	1.9%	7	EXCELLENT	1.4
NewMarket	NEU	1.6%	7	EXCELLENT	1.7
QUALCOMM	QCOM	3.3%	7	EXCELLENT	2.6
W.W. Grainger	GWW	2.8%	7	EXCELLENT	1.4
Lennox	LII	1.1%	7	EXCELLENT	2.6
Watts Water	WTS	1.1%	7	EXCELLENT	3.7
Ametek	AME	0.5%	7	GOOD	5.9
Franklin Electric	FELE	0.9%	7	EXCELLENT	3.7
Littelfuse	LFUS	0.7%	7	EXCELLENT	4.0
Core Labs	CLB	2.3%	7	GOOD	1.5
NASDAQ	NDAQ	2.0%	7	EXCELLENT	1.3
Western Union	WU	3.3%	7	EXCELLENT	2.3
Fresh Del Monte	FDP	1.2%	7	GOOD	2.9
Tyson Foods	TSN	1.1%	7	EXCELLENT	2.1
Archer-Daniels-Midland	ADM	3.0%	7	EXCELLENT	2.1
Choice Hotels	CHH	1.3%	7	GOOD	1.7
Johnson & Johnson	JNJ	2.4%	7	EXCELLENT	2.2
Infosys Ltd	INFY	2.7%	7	GOOD	3.1
Nike	NKE	1.3%	7	EXCELLENT	3.7
AGCO Corp	AGCO	0.8%	7	EXCELLENT	1.6
Crane Co	CR	1.5%	7	GOOD	2.6
Dover	DOV	2.0%	7	EXCELLENT	1.2
Ingersoll-Rand	IR	2.0%	7	GOOD	1.9
Exxon Mobil	XOM	3.5%	7	EXCELLENT	1.4
Interpublic	IPG	3.4%	7	GOOD	2.0
Medtronic	MDT	2.3%	7	EXCELLENT	1.6
Thermo Fisher Scientific	TMO	0.3%	7	GOOD	5.3
Buckeye Partners	BPL	8.9%	7	GOOD	1.3
Spectra Energy Partners	SEP	6.7%	7	EXCELLENT	1.7
Sonoco	SON	2.9%	7	EXCELLENT	1.1
Gilead Sciences	GILD	2.6%	7	EXCELLENT	5.0
Merck	MRK	2.9%	7	GOOD	2.0
Kansas City Southern	KSU	1.3%	7	EXCELLENT	1.5
Brunswick	BC	1.1%	7	GOOD	6.4
Cheesecake Factory	CAKE	2.7%	7	EXCELLENT	2.5
Hanesbrands Inc	HBI	2.7%	7	GOOD	1.0
Dun & Bradstreet	DNB	1.7%	7	GOOD	1.2
Applied Materials	AMAT	0.7%	7	GOOD	8.4
Insperity	NSP	1.4%	7	GOOD	5.0
Manpower	MAN	1.6%	7	EXCELLENT	3.5
Robert Half	RHI	2.0%	7	EXCELLENT	3.2
American Tower	AMT	2.0%	7	EXCELLENT	2.1

At any time, our favorite dividend growth ideas are included in the Dividend Growth portfolio, page 5.

The Financially-Healthiest Dividend Payers Yielding Over 2%

By Valuentum Analysts

There are a number of ways to evaluate the health of a company's dividend. We think a minimum threshold for a company's yield is par for the course in any income-oriented screen, and we peg the dividend yield hurdle rate for this screen at 2%. For firms that make this cut, we want to find those that generate free cash flow at a pace that is far larger than the cash paid out as dividends and have a strong balance sheet to boot, or companies that have high Dividend Cushion ratios.

Enter stocks that have the highest multiplicative combination of their dividend yield and Dividend Cushion ratio. We exclude the business models of master limited partnerships and real estate investment trusts in this screen and focus exclusively on corporates. We also make a few other tweaks with respect to business model risk considerations. Income investors have a lot to choose from, and this screen is one of our favorites -- it focuses on identifying the financially-healthiest dividend-payers with yields over 2%. We've overlaid the screen with an Economic Castle assessment to consider business-model risk, too!

Company Name	Symbol	Est Div Yield	Div Cushion	Economic Castle	Multiplier
Gilead Sciences	GILD	2.6%	5.0	Very Attractive	13.02
Chico's FAS	CHS	3.3%	3.8	Attractive	12.82
GameStop	GME	7.9%	1.6	Attractive	12.55
Cooper Tire & Rubber	CTB	1.2%	9.1	Neutral	11.02
Abercrombie & Fitch	ANF	4.0%	2.7	Unattractive	10.81
NuStar	NS	12.6%	0.8	Unattractive	10.60
Finish Line	FINL	3.4%	3.1	Unattractive	10.48
Ford	F	5.0%	2.1	Neutral	10.25
General Motors	GM	3.5%	2.8	Attractive	9.96
Chicago Rivet	CVR	2.6%	3.8	Neutral	9.74
Holly Energy	HEP	8.0%	1.2	Attractive	9.42
QUALCOMM	QCOM	3.3%	2.6	Very Attractive	8.73
Guess	GES	4.9%	1.8	Attractive	8.70
American Eagle	AEO	2.7%	3.1	Attractive	8.45
CA Tech	CA	3.0%	2.8	Highest Rated	8.44
Graham Holdings Co	GHC	0.9%	9.5	Attractive	8.38
Foot Locker	FL	2.6%	3.2	Attractive	8.36
Big 5	BGFV	9.0%	0.9	Neutral	8.35
AVX Corp	AVX	2.4%	3.5	Attractive	8.26
Resources Connection	RECN	3.1%	2.6	Attractive	8.19
Fluor	FLR	2.0%	4.2	Attractive	8.13
Apple	AAPL	1.4%	5.6	Highest Rated	8.03
Ralph Lauren	RL	2.3%	3.4	Attractive	7.75
Western Union	WU	3.3%	2.3	Neutral	7.72
Paychex	PAYX	3.3%	2.3	Very Attractive	7.60
Ventas	VTR	4.8%	1.6	Neutral	7.58
Williams-Sonoma	WSM	2.9%	2.5	Attractive	7.45
Garmin	GRMN	3.7%	2.0	Attractive	7.45
Cisco	CSCO	2.8%	2.7	Very Attractive	7.41
Gentex	GNTX	2.0%	3.8	Attractive	7.39
Insperity	NSP	1.4%	5.0	Neutral	7.25
Pfizer	PFE	3.5%	2.1	Attractive	7.24
Hewlett-Packard	HPQ	2.4%	2.9	Very Attractive	7.09
Rio Tinto	RIO	4.0%	1.8	Neutral	7.07
NTT Docomo	DCM	3.1%	2.3	Attractive	7.01
McKesson	MCK	1.0%	7.3	Very Attractive	7.00
Gap	GPS	2.6%	2.6	Attractive	6.96
Honda	HMC	2.3%	3.0	Neutral	6.89
AmerisourceBergen	ABC	2.0%	3.4	Very Attractive	6.87
Best Buy	BBY	2.1%	3.2	Attractive	6.84
Amgen	AMGN	2.5%	2.7	Very Attractive	6.82
Interpublic	IPG	3.4%	2.0	Very Attractive	6.78
Baker Hughes	BHGE	2.0%	3.4	Neutral	6.78
Helmerich & Payne	HP	5.5%	1.2	Neutral	6.71
Cheesecake Factory	CAKE	2.7%	2.5	Attractive	6.71
Lear Corp	LEA	1.2%	5.8	Attractive	6.68
Xerox	XRX	3.1%	2.1	Very Attractive	6.59
Meridian	VIVO	3.4%	1.9	Attractive	6.56
Intel	INTC	2.3%	2.8	Attractive	6.52
Xilinx	XLNX	2.1%	3.1	Highest Rated	6.48

Note: The 'Multiple' in this list considers a company's dividend yield and Dividend Cushion ratio as a multiplicative combination. Though it is a robust and largely objective measure, there could be exogenous or secular dynamics that could impact the business, where a dividend may not be as strong as the financials indicate.

For example, GameStop (GME) is dealing with a secular shift toward digital gaming, while Abercrombie & Fitch (ANF) is navigating changing consumer preferences as millennials seek 'experiences' not 'things' (e.g. fashion). The Dividend Cushion is only one factor that we use in assessing the overall health of a company's dividend.

Data as of February 1, 2018.

Yields to Consider Avoiding

By Valuentum Analysts

As many investors know, firms can often become cheap for good reasons. That is, they are not trading cheaply because of Mr. Market's irrational behavior, but instead are trading at depressed levels due to deteriorating underlying fundamental characteristics that actually justify their current share price, even if traditional valuation techniques suggest the company's shares are inexpensive. On a similar note, companies that boast high dividend yields may do so because the market has little confidence in the sustainability of its dividend and believes a cut may be just around the corner.

Though we fall short of saying the following list of companies will slash their respective dividends anytime soon, our dividend-cut predictive indicator--the Valuentum Dividend Cushion™--indicates that the firms below are at significant risk for a dividend cut in coming years. We think the more conservative dividend-growth investor may want to consider steering clear of the following firms' shares:

Company Name	Symbol	Industry	Est. Div Yield	Div Safety	Div Cushion
Range Resources	RRC	Independent Oil & Gas	0.5%	VERY POOR	-49.4
Ensco	ESV	Energy Svcs - Offshore Drilling	0.6%	VERY POOR	-49.4
KB Home	KBH	Homebuilders	0.4%	VERY POOR	-27.1
Lennar	LEN	Homebuilders	0.3%	VERY POOR	-22.5
Frontier Comm	FTR	Telecom Services - diversified	26.1%	VERY POOR	-16.7
Devon Energy	DVN	Independent Oil & Gas	0.6%	VERY POOR	-14.5
Superior	SUP	Auto Parts Suppliers	2.2%	VERY POOR	-12.3
R.R. Donnelley	RRD	Commercial Services	5.9%	VERY POOR	-7.1
Ryder System	R	Rental and Leasing	2.4%	VERY POOR	-6.7
Anadarko	APC	Independent Oil & Gas	0.4%	VERY POOR	-5.6
Intl Game Technology	IGT	Leisure	3.0%	VERY POOR	-5.3
Noble Energy	NBL	Independent Oil & Gas	1.5%	VERY POOR	-3.6
NiSource	NI	Utilities	2.7%	VERY POOR	-3.3
Yamana Gold	AUY	Metals & Mining - gold	0.7%	VERY POOR	-3.2
Centurylink	CTL	Telecom Services - diversified	15.0%	VERY POOR	-3.2
Rent-A-Center	RCII	Rental and Leasing	2.9%	VERY POOR	-2.9
Newell Brands	NWL	Household Durables	3.6%	VERY POOR	-2.7
Wendy's Co	WEN	Restaurants - Fast Food & Coffee	1.9%	VERY POOR	-2.4
Viacom	VIA	Media - CATV	2.3%	VERY POOR	-2.3
Orchids Paper	TIS	Paper Products	10.1%	VERY POOR	-2.3
Casey's General	CASY	Food Retailers	0.9%	VERY POOR	-2.2
MDC	MDC	Homebuilders	3.0%	VERY POOR	-2.0
CF Industries	CF	Chemicals - agriculture	3.3%	VERY POOR	-1.9
DineEquity	DIN	Restaurants - Fast Cas & Full Svc	8.2%	VERY POOR	-1.8
Olin Corp	OLN	Chemicals - mid/small	2.3%	VERY POOR	-1.7
Molson Coors	TAP	Beverages - alcoholic	2.1%	VERY POOR	-1.7
First Energy	FE	Utilities - Large	4.5%	VERY POOR	-1.5
Ashland	ASH	Chemicals - broad	1.3%	VERY POOR	-1.5
Deltic Timber	DEL	Building Materials	0.4%	VERY POOR	-1.5
Teekay	TGP	Shipping	3.3%	VERY POOR	-1.5
Service Corp Intl	SCI	Personal Services	1.7%	VERY POOR	-1.3
Regal	RGC	Media - entertainment	5.2%	VERY POOR	-1.3
Apache	APA	Independent Oil & Gas	2.5%	VERY POOR	-1.2
Ball Corp	BLL	Containers & Packaging	1.0%	VERY POOR	-1.1
PG&E	PCG	Utilities - Large	4.0%	VERY POOR	-1.1
PPL	PPL	Utilities - Large	4.1%	VERY POOR	-1.0
SCANA	SCG	Utilities	3.8%	VERY POOR	-1.0

The Dividend Cushion Beats the Dividend Aristocrats:
http://www.valuentum.com/articles/20150506

Data as of February 1, 2018.

The Valuentum Dividend Cushion™ has an excellent track record of predicting dividend cuts. For more information, please select the following link (login required):

http://www.valuentum.com/articles/20130528

The US Dollar, GDP Expansion, and Earnings

Investors wouldn't think news flow is that robust given that stock market volatility in recent months has been practically nil, but news is coming in fast. Let's check up on the performance of the US dollar, the rate of GDP growth as well as key companies reporting fourth-quarter earnings. Intel's quarterly report was fantastic, for one!

By Kris Rosemann

The US dollar (UUP, UDN, USDU) hit a three-year low against the euro, but US Treasury Secretary Steven Mnuchin suggests a weaker dollar may be good for the US, which is a change from traditional US policy, though he was sure to note that the government is not concerned about short-term fluctuations in the currency. Meanwhile, of course, the euro (FXE) is headed in the opposite direction, reaching its highest mark against the US dollar since December 2014 after the ECB left its benchmark interest rates unchanged in its January policy event January 25.

US GDP slowed in the final quarter of 2017 to 2.6%, missing estimates for 3.0%, though this is just the initial read on the data. We might expect an upward revision when all is said and done, as is customarily the case. Consumer spending climbed 3.8%, its strongest pace in nearly two years, but a decline in inventories and that imports increased at nearly double the pace of exports held the overall measure back in the quarter. The US dollar's slide could help US exports, but President Trump's comments at the World Economic Forum at Davos (that he'd like a strong dollar) conflicted with interpretations of Treasury Secretary Steven Mnuchin's comments earlier in the week.

Let's have a look at some key earnings reports. Dividend Growth Newsletter portfolio and Best Ideas Newsletter portfolio idea Intel (INTC) rallied considerably after an impressive earnings report after the close January 25 in which fourth quarter revenue hit a company record thanks in part to robust growth in its data center business. The company sees 2018 non-GAAP earnings per share growing to ~$3.55 from $3.46 in 2017, and free cash flow is expected to hit $13 billion. A 10% dividend hike accompanied Intel's quarterly report, and we couldn't be more pleased with the pace of growth in the payout. At last check, Intel registered a Dividend Cushion ratio of 2.8, and the upper bound of its fair value range is $58.

Caterpillar (CAT) exceeded consensus estimates on both the top and bottom lines in its fourth quarter report, results released before the open January 25, as 2017 marked a year of improvement in key markets for the heavy-equipment manufacturer after four challenging years. The company expects momentum to continue in 2018 as strong order rates, lean dealer inventories, and an increasing backlog are reasons for optimism in addition to expectations for positive economic indicators to persist in most of its end markets in 2018. Caterpillar expects adjusted profit per share in 2018 to be in a range of $8.25-$9.25. Its end markets will always be cyclical, and investors should be cautious.

Shares of Union Pacific (UNP) are falling after the company's fourth-quarter report, results released before the open January 25, revealed it missed consensus earnings-per-share estimates by a penny. However, the railroad operator made progress in its operating ratio, which fell to 58.7 from 62.2 in the year-ago period, despite a 23% increase in average quarterly diesel fuel price. Weakness in automotive, agricultural products, and coal freight revenues was more than offset by strength in industrial products, chemicals, and intermodal freight revenues. Management expects 2018 to bring another year of volume growth, and inflation plus core pricing coupled with productivity initiatives should help boost margin performance in the year. We like the moaty aspects of the railroad business, but they are quite capital intensive.

Biopharma giants Celgene (CELG) and Biogen (BIIB) reported fourth-quarter results before the open January 25. Both companies reported solid top-line growth in the period, but charges related to the Tax Cuts and Jobs Act impacted bottom-line results. Top-line growth is expected to continue in 2018 for both firms, and Celgene is anticipating ongoing strength in key drug Revlimid, which it expects to account for ~65% of total 2018 revenue. Biogen issued 2018 GAAP diluted EPS guidance in a range of $22.20-$23.20 compared to $21.81 in 2017, and Celgene expects adjusted diluted earnings per share to increase ~18% over 2017 levels to a range of $8.70-$8.90.

Please see *The US Dollar...*on next page

*The US Dollar...*from previous page

AbbVie (ABBV) continues to plow ahead despite concerns over its patent protection of leading drug Humira, which saw its 2017 fourth quarter sales grow an impressive 14% on a reported basis. The company's 2018 guidance suggests it expects the positive momentum to continue as it raised its adjusted EPS guidance to a range of $7.33-$7.43 from $6.37-$6.57, which is good for 32% growth over 2017 levels at the midpoint of the range. AbbVie is set to launch multiple products in the next 12 to 18 months that management believes will fuel meaningful growth in coming years.

Honeywell (HON) reported solid earnings growth in its fourth quarter report as the industrial bellwether continues its transformation to a software industrial leader. The company expects to spin-off its Homes and Global Distribution business and its Transportation Systems business in 2018 to further this transformation and position it for margin expansion. Management boosted its 2018 earnings per share guidance by 20 cents to a range of $7.75-$8.00 thanks to the US Tax Cuts and Jobs Act of 2017, and its Aerospace division continues to be a source of strength for Honeywell.

Raytheon (RTN) capped off 2017, a year marked by record sales levels, with a solid earnings report before the open January 25. The company expects 2018 earnings per share from continuing operations is expects to grow to a range of $9.55-$9.75 from $6.94 in 2017 as bookings strength--full-year book-to-bill ratio came in at 1.09x in 2017--has it well-positioned for the coming year. Peer Northrop Grumman (NOC) reported a similarly strong quarter before the open January 25, and the firm remains optmistic on the potential of its pending acquisition of Orbital ATK (OA). Northrop expects 2018 diluted earnings per share to come in a range of $15.00-$15.25, while free cash flow is projected to be $2-$2.3 billion, up from nearly $1.7 billion in 2017.

Though Raytheon and Northrop Grumman moved higher after their respective reports, L3-Communications (LLL) felt some selling pressure despite raising its 2018 guidance and turning in a book-to-bill ratio of 1.04x in the full-year 2017. Sales, operating income, and operating margin all declined on a year-over-year basis in the fourth quarter as organic sales to international and commercial customers fell by 12% in the period. Nevertheless, 2018 diluted earnings per share from continuing operations guidance was raised to a range of $9.30-$9.50 (was $8.60-$8.85) and free cash flow guidance was boosted to $900 million from $865 million. Since defense companies are dependent on the US government to a large degree, it is worth noting that they are susceptible to potential government budget changes, factors completely out of their control.

Shares of Starbucks (SBUX) faced selling pressure after its comparable store sales growth disappointed in the fourth quarter of 2017. The measure came in at 2%, well below consensus estimates of 3%. Pricing added two percentage points of growth, but transactions remained flat in the quarter. Nevertheless, the company's outlook for 2018 looks solid after it raised its earnings per share guidance to a range of $2.48-$2.52 from $2.30-$2.38, and global comparable sales are expected to grow 3%-5%, though the lower end of that range may be more appropriate.

Perhaps unsurprisingly, drama continues in the Tesla (TSLA) story after the company denied a CNBC report that further delays and quality issues have plagued its Model 3 series. This isn't the first we've heard of issues impacting Tesla's production, and investors may be starting to take notice. Nevertheless, the exciting potential of the company that one day hopes to be a large-scale auto manufacturer keeps its market capitalization at nose bleed levels as it continues to burn through cash.

Department stores have faced some selling pressure, after S&P Global (SPGI) downgraded Sears Holdings' (SHLD) credit rating further into junk territory with a rating of CC and a negative outlook. Homebuilders (XHB) are also facing pressure after new home sales in the month of December missed estimates. Though the measure fell from levels witnessed in November, it still marked a 14.1% increase from December 2016. Kroger (KR), the US' largest supermarket chain, is reportedly exploring a partnership with Alibaba (BABA), which operates cashier-less supermarkets similar to the recent launch of Amazon Go (AMZN), after executives from Kroger and Alibaba met in China last month.

GlaxoSmithKline: Not All Dividends Are Created Equal

Many seeking ideas to generate dividend income may be drawn to slow-growing entities with large dividend yields. However, without proper examination of the balance sheet and competitive position, an investor may enter a position banking on a steady dividend stream only to be caught by a sudden cut in the dividend. It is growing increasingly likely that GlaxoSmithKline may be ready to sacrifice the dividend on the altar in the name of additional M&A, in our view.

By Alexander J. Poulos

GSK Overview

GlaxoSmithKline (GSK) remains a venerable European entity with a number of business lines similar to its US rivals such as Pfizer (PFE). At GSK's core is its heavy reliance on research to bring forth additional novel branded treatments. We tend to group the research-based entities such as GSK into areas where they have a dominant franchise. In GSK's case, this would amount to its Respiratory and HIV franchises. Let's examine the unique aspects of each franchise to gain further insight into its growth prospects.

Respiratory Franchise

GSK remains a leader in the respiratory space due to its reliance on Advair for the treatment of asthma. The challenge that faces all research-based entities is the loss of patent exclusivity--the loss of protection is what fuels the need for constant innovation to the benefit of patients. GSK is not immune to the industry patent challenge as Advair's patent protection has lapsed--in our view due to the difficulty in replicating the dispensing mechanism a generic challenger has yet to emerge--a temporary phenomena.

We were struck on the recent conference call by CEO Emma Walmsley's forecast of a 15-20% worldwide decline in sales of Advair for 2017 even though a generic competitor in the US has not emerged. In the third quarter of 2017, the overall respiratory franchise posted flat revenue performance on a constant-exchange-rate basis thanks in large part to the continued growth of Breo, Anoro and the introduction of Nucala. We had been optimistic the bulk of the decline was behind the franchise but by Walmsley's admission, it seems we have not seen the bottom yet.

Please see *GlaxoSmithKline...*on next page

GlaxoSmithKline...from previous page

HIV Franchise

The HIV franchise continues to perform admirably with a stellar jump of 13% on a constant currency basis in the third quarter fueled in large part to the growth of Tivicay and Triumeq as GSK attempts to gain ground on its primary rival Gilead Sciences (GILD). Just when things are beginning to look up, however, a further review of the numbers paints a far different picture as nearly 40% of the Tivicay Rx's may be at risk as they are prescribed with Gilead's Descovy, thus generating two co-payments.

The fear is that once Bictegavir gains approval in mid-February, prescribers will switch patients off the Descovy-Tivicay combo onto the Bictegavir-Descovy single dose product. The new single dose product would only generate a monthly co-payment versus the two co-payments for the current Descovy-Tivicay regiment, thus adding compliance while saving the patient some money.

We feel the growth of the HIV franchise may be at risk once Gilead launches its next-generation product containing Bictegavir. GSK is attempting to stave off the competition with its doublet Juluca which combines GSK's Tivicay and Johnson and Johnson's (JNJ) Endurant into a single once-a-day dosage, but we believe there is nothing new, whereas Gilead is coming to market with a novel market that is poised to steal share.

Vaccines

To GSK's credit, it has built a formidable vaccine franchise through internal development and timely exchange of assets with Novartis (NVS). Our issue with the franchise is the initial decision to swap oncology assets with Novartis to gain vaccine assets only to pivot, and now state Oncology is an area of focus. We are amazed at the disjointed effort at GSK which culminated with the "retirement" of Andrew Witty in March of 2017.

The Vaccine division remains GSK's fastest-growing segment posting a 5% revenue growth at a constant currency rate for the nine months ending September 2017. Further parsing of the data reveals a slowdown in the group's growth to a flat year over year figure in the third quarter of 2017—we suspect the stockpiling of vaccine by the US CDC may have led to an unsustained advance.

GSK hopes to revive the fortunes of the vaccine division with its breakthrough vaccine for Shingles. We are impressed with the initial data read and expect Shingrix to gain favor over Merck's (MRK) Zostavax rapidly. We view the vaccine business as a complementary business but it is not able to steer the giant ship that is GSK by itself. For this to occur, additional breakthrough treatments in the pharmaceutical division will need to be brought to market.

Consumer Health Division

CEO Walmsley's background as the head of the Consumer Health Division before ascending to the role of CEO, in our opinion, will allow this Division to become a priority for additional resources. We suspect Walmsey may look to radically transform GSK to a more consumer-oriented company with a few key acquisitions.

The primary acquisition we suspect the company will undertake is the acquisition of Novartis' portion of the current consumer healthcare JV venture. Walmsley was in charge upon the consummation of the venture. She is intimately aware of the results, and we suspect she remains very inclined to bring it entirely into the fold for GSK.

The second potential acquisition revolves around Pfizer's mention of its willingness to explore options for its consumer health division, which contains such well-known brands as Advil under its corporate umbrella. We think GSK would be a very-willing buyer but such audaciousness carries a very heavy price.

To fund such a lavish slate of acquisitions, GSK would need to leverage up its balance sheet further

Please see *GlaxoSmithKline*...on next page

*GlaxoSmithKline…*from previous page

which, in our view, would place the dividend into further danger. Walmsley did not win any fans from the dividend growth crowd with her commentary of a flat dividend for 2017 and 2018. For US-based investors the actual dividend received will be lower than last year due to the weakening of the British Pound.

The Dividend

The role of the dividend plays an increasingly important role for those investing in GSK. The past few years have not been kind as the equity has managed to lose ground since peaking in the $50 range at the beginning of 2014. At the current quote of $37 per share at the time of this writing, GSK is trading at a level last seen in early 2011.

GSK is not faced with an unenviable decision—does it attempt to jumpstart growth by bulking up the consumer health division while allowing ample time for the clinical pipeline to develop? The choice seems clear-cut but overlay the increase in leverage, and interest payments will constrain GSK's ability to continue to pay its dividend, and the quandary becomes readily apparent. In our view, the choice is clear--shave the dividend to a more-manageable level and reset the company to become a viable competitor going forward. *The fear of a dividend cut was the highlight of the Q&A session post the recent earnings release.*

Conclusion

We feel there are far better opportunities in the market from a capital gain and income producing perspective than GSK. Until we have a definitive handle on the impact of Gilead's launch in the first quarter of 2018 of a competing product coupled with the timing of a generic Advair entry into the US market, we maintain very cautious on GSK's fundamentals at this time. As part of our overall view of the US tax law change, we feel it will unleash a torrent of M&A activity, and we would not be surprised if GSK makes one or two acquisitions in consumer health, thus further constraining the balance sheet and placing the dividend at risk. Buyer beware.

Independent contributor Alexander J. Poulos is long Gilead Sciences.

Bioverativ's Takeout, Visa's Surge, and General Electric's Pain

By Kris Rosemann and Brian Nelson, CFA

It's hard to believe this but our best idea in the Best Ideas Newsletter portfolio, Visa (V), is now a $124+ per share stock. We know how to pick 'em, would you say? We don't get everything correct, of course, but if you've read anything on our website, we can only hope that you've witnessed Visa's meteoric rise. The high end of our updated fair value estimate range for Visa is north of $130 per share. What a wild ride it has been, to say the least, and how about Dividend Growth Newsletter portfolio idea Boeing (BA)? Incredible, no? Unfortunately, not all stocks have been in favor, despite this incredible bull-market run.

Industrial bellwether General Electric (GE), for example, continues to make headlines as shares faced additional pressure following an announcement that included a $6.2 billion charge related to its legacy reinsurance business. Liquidity concerns are creeping up for the conglomerate as GE Capital is not expected to pay dividends to the parent company in coming years as it works to rebuild its reserves. Some observers suggest a capital raise may be on the way, but cash flow shortfalls at the company were a key reason we decided to remove the idea from our newsletter portfolios in May 2017.

Biopharma giant Celgene (CELG) has agreed to acquire Juno Therapeutics (JUNO) for $87 per share in cash, or ~$9 billion, confirming previous reports of a potential deal in the works. Shares of Celgene continue to face pressure on the deal news, as they did upon initial reports as well. The two companies already have a ten-year partnership in which Celgene took a 10% stake and, "the two companies will leverage T cell therapeutic strategies to develop treatments for patients with cancer and autoimmune diseases with an

Please see *Bioverativ's…*on next page

*Bioverativ's...*from previous page

initial focus on Chimeric Antigen Receptor Technology (CAR-T) and T Cell Receptor (TCR) technologies." In other news, it was announced that one of our favorite biotech ideas Bioverativ (BIVV) will be acquired by Sanofi (SNY) for $11.6 billion.

Food retail investors are holding their breath after the first Amazon Go (AMZN) grocery store opened in Seattle. The cashier-less store tracks shoppers with scanners, cameras, and sensors to determine what goods they choose, then charge their Amazon accounts automatically. Prices at the store are between those of a convenience store and mainline grocer, according *The Seattle Times*. If the pilot goes well, some grocers are concerned the concept will be rolled out across the entire Whole Foods store base. We're not ruling out anything when it comes to Amazon—it continues to generate tremendous free cash flow to invest across a plethora of new initiatives.

US trade partners are not happy with the Trump administration after its decision to add steep tariffs to solar panel (TAN) and washing machine imports. China has tabbed the tariffs as "an abuse," South Korea (EWY) plans to file a complaint with the WTO, and Mexico (EWW) stated its intentions to use all legal means possible to make the US meet its international commitments. Shares of Whirlpool (WHR) and a number of solar firms have benefit from the news as the solar tariffs are not as punitive as some industry observers had anticipated. First Solar (FSLR) has performed remarkably well since we placed a near-$50 fair value estimate on it in April 2017 when the equity was trading below $30. It has now more-than-doubled since then.

In other world news, Bank of America Merrill Lynch thinks world oil (USO, OIL) demand could peak as soon as 2030 due to the rapid uptake of electric vehicles thanks in part to Tesla (TSLA). The bank expects 40% of all car sales to be electric vehicles by 2030. South Korea has taken another shot at the global cryptocurrency markets (XBT, GBTC) as it plans to ban the use of anonymous bank accounts for cryptocurrency trading beginning January 30. This move brings the country, which is believed to be the world's third largest crypto-trading market, more in-line with financial rules across global markets.

Halliburton (HAL) reported a strong finish to 2017 and issued an optimistic outlook before the open January 22. Earnings leapt nearly 50% on a year-over-year basis as the rebalancing global crude oil market supports increasing activity in North America, where the company generates ~55% of its revenue. Management also noted "positive discussions" with its international customers, a sentiment that was echoed last week by rival Schlumberger (SLB), which expects 2018 to mark the first year of growth in its international operations since 2014. Crude oil prices have been bouncing really nicely of late, too.

Netflix's (NFLX) results came in after the close January 22, and shares are surging to all-time highs after the company beat consensus estimates for subscription numbers. This leap in share price comes despite expectations for the firm's spectacular cash BURN to accelerate to $3-$4 billion (free cash flow of negative $3-$4 billion) in 2018 from $2 billion in 2017. As we've been saying for some time, it is not a done-deal that Netflix's business model is scalable, and its net debt position and junk credit rating may come back to bite it, should equity markets come around to the risks embedded in its prevailing price. We think the only thing that will save Netflix's shares from a collapse is a buyout from another media company, but its $100 billion market cap would make it a huge deal.

Wireless telecom giant Verizon (VZ) reported a strong quarter as it relates to Verizon Wireless customer growth and retention before the open January 23, and management is optimistic on the next-generation network services it plans to roll out in 2018 and beyond. Low-single-digit revenue growth expectations and an estimated $3.5-$4 billion boost to cash flow from operations from tax reform make for a sound outlook for 2018, but investors should note that free cash flow came up short in covering 2017 dividends paid, a consideration that becomes increasingly concerning after considering its massive total debt position of nearly $118 billion. Verizon yields ~4.5% at the time of this writing.

Best Ideas and Dividend Growth Newsletter idea Johnson & Johnson (JNJ) turned in solid quarterly results before the open January 23 as operational sales advanced 9.4% on a year-over-year basis in the

Please see *Bioverativ's...*on next page

*Bioverativ's...*from previous page

quarter thanks to its 'Pharmaceutical' segment continuing to drive overall growth. Management expects top-line operational growth to slow to a range of 3.5%-4.5% in 2018, but its adjusted earnings per share guidance of $8.00-$8.20 suggests mid-to-high single digit operational growth from 2017 levels. Johnson & Johnson's shares are now trading north of $140 each, if you can believe it, and we're still huge fans of its dividend health. The company boasts a Dividend Cushion ratio of 2.2, with shares yielding ~2.3% at the time of this writing.

Shares of Dividend Growth Newsletter idea Procter & Gamble (PG) faced pressure following its earnings report before the open January 23 despite organic sales growth accelerating to 2% (from 1% in previous quarter) and an increase in fiscal 2018 earnings per share growth guidance to 5%-8% from 5%-7%. Volume grew 2% in the quarter, but the positive impact of sales growth in higher-priced categories was offset by a negative 1 percentage-point impact from pricing. Management was quick to point to strong productivity cost savings--operating margin held solid at 23% in the quarter as 150 basis points of productivity savings, 30 basis points of sales growth leverage, and SG&A efficiencies were offset by commodity cost increases, unfavorable geographic and product mix, unfavorable pricing impacts, and innovation reinvestments--and cash flow--cash from operating activities advanced more than 21% in the first half of the fiscal year. Shares of P&G yield ~3% at the time of this writing.

Consumer staples giant Kimberly-Clark (KMB) also reported before the open January 23, and its ho-hum results were accompanied by a global restructuring initiative and multi-year savings target for its cost savings program as it works to compete more effectively in a challenging market. The programs, which include cutting 12%-13% of its workforce, are expected to generate more than $2 billion in total cost savings over the next four years. The firm anticipates a return to organic sales growth in 2018, as well as double-digit growth in adjusted earnings per share. Shares of Kimberly-Clark yield ~3.4% at the time of this writing.

Just a few more items as we wrap things up in this news-oriented piece. Talk has picked up again about Mattel (MAT) and Hasbro (HAS), and we hope that Hasbro will keep the price in mind, if it does go forward with a buyout. We're thinking the value of Mattel's Barbie franchise may be permanently impaired, in part, as the new generation goes for Elsa and Anna *Frozen* dolls instead. We're also watching how changes to Facebook's (FB) news sources may impact revenue performance, but readers shouldn't forget that Facebook generates revenue from businesses that want to reach consumers, and this won't change, so the news feature may be more noise than substance. In somewhat of an ironic twist, H&R Block (HRB) is catching a bid after its own results will benefit considerably from tax reform. How about that?

Brewing the Next Dividend Aristocrat

Most income-minded investors would love to find the next Dividend Aristocrat before it earns such a title, but many continue to focus on the stars of the past instead of working to identify up and coming dividend track records, which often carry higher dividend growth rates than the most established Dividend Aristocrats.

By Alexander J Poulos

McDonald's Is Pretty Good...

Starbucks (SBUX) has a number of qualities that we look for in identifying companies that can sustain a growing dividend over time, one that has the potential to develop into a Dividend Aristocrat. The company's dividend track record is still a young one as the payout was initiated in 2010, but forward-looking analysis will always be the most important analysis. Starbucks' business is relatively well-understood and well-covered, owning to its well-known brand that engenders customer loyalty (and consistent repeat business), but its dividend potential may not be as widely regarded. Let's compare and contrast Starbucks' dividend with that of McDonald's (MCD), a far from a perfect comparison but still a reasonably close peer in the global restaurant space.

Please see *Brewing the Next...*on next page

***Brewing the Next…*from previous page**

McDonald's dividend track record is hard to overlook due in large part to its run of 40+ consecutive annual increases as of 2017, but as all investors know, past performance does not guarantee future results (look at General Electric, for example). McDonald's impressive dividend growth history comes alongside impressive overall expansion for the company, too, as it now has more than 36,000 restaurants around the globe (over 31,000 are franchised). The relentless global development has enabled the company to boost its dividend in the 1970s to its current rate of $1.01 per quarter for a current annualized dividend yield of ~2.3% at the time of this writing. The company we know today is a vastly different entity than the upstart restaurant that went public in 1965, however, and while McDonald's still has decent growth opportunities, the biggest part of McDonald's growth phase is likely behind it.

After all, nearly 75% of the population in the US, France (EWQ), the UK, Germany (EWG) and Canada (EWC) lives within three miles of a McDonald's. "The company is already one of the largest providers of delivered food in the world, with annual system-wide delivery sales of nearly $1 billion across various markets including China, South Korea and Singapore…no other food company in the world has this reach…" McDonald's is still opening up a tremendous number of restaurants, with the company targeting about 900 new restaurants during 2017, a number that includes about 500 restaurants that do not require capital spending (development licensee markets), but it's already huge, and it's tougher for a big company to get bigger.

That said, we've been most impressed with McDonald's all-day-breakfast initiatives, as we had been led to believe that such efforts would be a disaster given some of the talk of inefficiencies by franchisees. This turned out to be far from the case and set us up wrong on our original thesis for the restaurant chain in most recent years. We're not afraid to admit it that McDonald's proved us wrong. The company is also doing a great job with menu innovation and simplification initiatives, and it may very well have side-stepped, or at least pushed the threat of minimum-wage legislation to its operators, given McDonald's refranchising strategy. Almost by definition because of its success, however, growth at the burger-and-fries giant will become more and more difficult to achieve. That's really all that we're trying to say.

Management has been working to capitalize on today's ultra-accommodative interest rates to leverage up the balance sheet and return cash to shareholders in the form of dividends and share repurchases. Shareholders have been well-rewarded, too, and frankly, we like the company's long-term financial targets. System-wide sales growth of 3%-5%, operating margin in the mid-40% range, earnings per share growth in the high-single-digits and return on new invested capital in the mid-20% range, implying economic value creation. As McDonald's refranchising efforts have gained steam, it's worth emphasizing that capital spending as a portion of revenue has declined while operating margins have increased. We're less concerned about revenue growth, provided that operating income and free cash flow continue to move in the right direction.

Though McDonald's dividend metrics aren't as strong as they could be, we are not at all worried about the health of McDonald's payout at the moment, even as we calculate a Dividend Cushio ratio of 0.5 at last update. McDonald's recently raised its payout more than 7% in September, and the market loved it. Furthermore, its free cash flow per share easily covers dividends per share, but we note that the Dividend Cushion considers this relationship on a forward-looking basis, including growth in the payout, as well as the balance sheet impact, something that a free cash flow coverage metric alone might miss. For example, total debt at McDonald's has exploded to nearly $26 billion at year-end 2016 from half of that in 2011. In times of tight credit, McDonald's will have to turn a bit more conservative when it comes to dividend growth, in our view.

McDonald's Free Cash Flow Per Share

In millions, except per share amounts ($)	2011	2012	2013	2014	2015	2016
Cash Flow from Operations	7,150	6,966	7,121	6,730	6,539	6,060
Capital Spending	2,730	3,049	2,825	2,583	1,814	1,821
Free Cash Flow	4,420	3,917	4,296	4,147	4,725	4,239
Shares Outstanding	1,021	1,003	990	963	907	819
Free Cash Flow per Share	4.33	3.91	4.34	4.31	5.21	5.18
Dividends per Share	2.53	2.87	3.12	3.28	3.44	3.61
Free Cash Flow / Dividends per Share	1.71	1.36	1.39	1.31	1.51	1.43

Please see *Brewing the Next…*on next page

*Brewing the Next...*from previous page

...But Is Starbucks Better?

Starbucks remains firmly entrenched in its growth phase as it continues to open new locations that help drive sales growth. Starbucks in its most recent 10-K highlighted the expectation of an increase in 2,300 new restaurants for fiscal 2018. We feel the flexibility of Starbucks' product offering remains a key differentiator between it and McDonald's. Its emphasis on beverages compared to McDonald's menu of predominantly food offerings allows for optimization of the store sizes. Starbucks can tailor offerings to the unique sales floor of the client such as upscale hotel lobbies by limiting selection, something McDonald's is more limited in. Starbucks has consistently grown sales over the past five years while expanding operating margins as economies of scale are realized.

Starbucks initiated its dividend in March 2010 with a quarterly payout of $0.05, and it has hiked the annual payout each year since then as the business grows and continues to generate an impressive free cash flow stream (free cash flow averaged more than $2.7 billion in fiscal 2015-2017, easily covering annual dividend obligations of $1.45 billion over the same time period). The company's balance sheet holds a net debt position of ~$1.2 billion as of the end of fiscal 2017, before considering long-term investments of more than $540 million, and its cash balance of nearly $2.7 billion provides nice 'optionality' value. Compared to McDonald's significant net debt load north of $20 billion, Starbucks' balance sheet health could be viewed as relatively healthier in this respect (the less net debt, the better). Though Starbucks' payout is more than 30 years younger, shares of Starbucks yield only ~0.3 percentage points less than McDonald's.

Our inclusion of McDonald's in this note is to illustrate the forward path Starbucks may embark upon once--or if--its tremendous growth prospects begin to wane in coming decades. We feel the ramp for continued store growth of the core Starbucks brand is robust--that's not to say if the Princi bakery concept won't take off, and we're viewing this as a source of upside, too. In any case, we wanted to put Starbucks on your radar as the share price of Starbucks remains range bound during the past few years—missing out on the impressive bull run! Is it a pressure cooker, ready to take off? In our opinion, the enthusiasm for Starbucks in late 2014 galvanized a near 50% plus run in 2015 led to the share price overshooting its fair value with the equity struggling to grow into its valuation over the past few years. Our interest in highlighting Starbucks besides the dividend is the potential for shares to undergo a similar run as investors may become enthused by the equity once again.

Though we're not calling for this to happen, if the pace of store growth expansion at Starbucks begins to taper significantly sometime in the middle of the next decade, the coffee giant may become more aggressive in the refranchising front--a hidden source of potential upside (just like it was for McDonald's!). Management currently lists further global expansion as a top priority, and enhancing the guest experience via an increase in technology spend will remain a key initiative. Starbucks' utilization of its technological prowess to offer individually-tailored offers has enhanced the frequency of customer visits, thus helping to build endearing loyalty. We expect future tech rollouts such as the order-ahead feature to aid in guest visit frequency as well, ultimately translating to higher overall sales.

Concluding Thoughts

The dividend growth potential of Starbucks coupled with the resilience of the business model supported by a fantastic brand name makes for an interesting consideration for income-minded investors. Unlike the traditional dividend stalwarts, Starbucks' dividend growth trajectory remains unimpeded by a lofty hurdle to clear in terms of inflated annual dividend obligations that may result from decades of dividend growth, as in the case of McDonald's, for example. The dividend growth potential, coupled with strong free cash flow generation and a reasonable balance sheet, lay the foundation for what could be many years of sustained income growth for Starbucks.

That said, Starbucks is trading near the upper bound of our fair value estimate range for shares, and the market is still pretty excited about the company, even if it didn't quite keep up with bull-market moves

Please see *Brewing the Next...*on next page

*Brewing the Next...*from previous page

recently, "Euphoria Running Rampant: Investigating Some of the Hottest Names Around." So while we love Starbucks, the company, love its dividend growth prospects, and think the stock still has potential should this aging bull market hold up, its valuation is not as inexpensive as we would like it to be. We assign Starbucks an Economic Castle rating of Very Attractive, a quality that becomes even more attractive considering the stage of growth Starbucks is currently in--when capital investment may be greatest due to store unit expansion. Starbucks' Dividend Cushion ratio is currently 1.9, and shares yield ~2% as of this writing.

Independent Contributor Alexander J Poulos is long Starbucks.

Microsoft: A Dividend Growth Giant

Microsoft is no longer a tech dinosaur. Estimates suggest it is beating Amazon at its own game. We're huge fans of Microsoft's free cash flow generation and balance-sheet health and what that means for the dividend. There's not a lot to dislike about Microsoft, and while the risks are many, few companies have a stronger business model.

By Brian Nelson, CFA

Many of you know Microsoft (MSFT) well. The company's products run the gamut in technology and include operating systems, cloud services, server applications, desktop and server management tools, software development tools, video games, and online advertising, among other things. It also designs, manufactures and sells hardware, including PCs, tablets, gaming consoles, and other smart accessories that integrate with its cloud offerings. What I find to be one of the more compelling things about Microsoft, however, is not so much what it is today, but what it might be in the years ahead, as technology continues its breakneck pace of innovation.

I think many investors thought Microsoft was a tech dinosaur, perhaps as recently as a few years ago, but momentum behind new devices and platforms, Windows 10, Office 365 and Azure continues to build. The company's cloud-based product suite, Office 365 and Azure, continues to gain popularity among both consumers and enterprises at impressive rates. This momentum helped Microsoft achieve its goal of $20 billion in commercial cloud annual recurring revenue well ahead of schedule. According to estimates, Microsoft's cloud revenue is even greater than that of Amazon (AMZN) Web Services, meaning that if you like Amazon, you probably must love Microsoft, right? Cloud-based revenue at Microsoft is even growing at a faster clip than Amazon's. I find these statistics incredible given the buzz around Amazon these days.

As you may already be aware, Microsoft recently acquired LinkedIn for over $26 billion in cash, and we weren't exactly thrilled with the transaction as Microsoft may have overpaid a bit, but we're not too worried about it. The deal is expected to be dilutive to earnings per share in coming years, but Microsoft's impressive financial profile continues to give us confidence in the enterprise moving forward, and its tremendous free cash flow generating capacity has not wavered. Microsoft's net cash from operating activities has advanced to $39.5 billion in fiscal 2017 from $29.7 billion in fiscal 2015, implying tremendous growth for this behemoth (where it counts), while additions to property plant and equipment have been relatively contained under $9 billion during the past two years. In fiscal 2017, Microsoft generated traditional free cash flow of $31.4 billion, a measure that is a multiple of the cash dividends it paid during the year, $11.8 billion, implying tremendous dividend coverage with traditional free cash flow alone.

What's more, Microsoft can't scoop up its own shares fast enough through its massive buyback program. In the fiscal first-quarter of 2018 (the calendar third quarter of 2017), Microsoft returned $4.8 billion to stockholders in the form of share repurchases and dividends, just an incredible sum of money for a company even of any size. The software and cloud giant floats debt with the best credit quality, too,

Please see *Microsoft...*on next page

*Microsoft...*from previous page

and we can't think of another company with a better financial profile, save for maybe Apple (AAPL). Financial discipline and strong execution remain hallmarks of Microsoft's business. At the end of fiscal 2017, Microsoft ended the year with total cash and short-term investments of $133 billion and total short and long-term debt of ~$86 billion, revealing a nice net cash position that covers annual dividends a multiple of times, too!

I think you're getting the gist of this article. Even if we look at Microsoft's free cash flow generation alone, the company has room to keep raising the dividend payout, but it has incremental cushion on the balance sheet, even after netting out its debt position. Microsoft's financial statements reveal that it has tremendous dividend growth potential, and we would not be surprised to see an acceleration in the pace of dividend expansion above the near-8% hike in the payout last September. To a large extent, it comes down to how the executive team feels about the tradeoff between dividend growth and buybacks because with Microsoft's free cash flow generation and balance-sheet health, there's just a lot of cash in the business that may eventually find its way into shareholder hands one way or another.

Valuation Analysis

Valuation Assumptions

In Millions of USD (except for per share items)	5-year Projections	
Revenue CAGR %	7.0%	
Avg. EBIT Margin %	32.3%	
Avg. Cash Tax Rate %	15.0%	
Earnings Before Interest CAGR %	7.8%	
Earnings Per Share CAGR %	17.5%	
Free Cash Flow to the Firm CAGR %	7.5%	
Earnings before interest = Net operating profits less adjusted taxes	Long-term Projections	
Phase II --> III FCFF CAGR %	3.2% (II)	3% (III)
Cost of Equity %	9.8%	
After-tax Cost of Debt %	5.4%	
Discount Rate (WACC) %	9.3%	
Synthetic credit spread = 2%	Results	
Phase I Present Value	133,982	
Phase II Present Value	267,250	
Phase III Present Value	183,512	
Total Firm Value	584,744	
Net Balance Sheet Impact	46,787	
Total Equity Value	631,531	
Diluted Shares Outstanding	8,013.0	
Fair Value per Share	$79.00	

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Microsoft and the break down to the firm's total equity value, which we estimate to be about 631.53USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $79 per share fair value estimate.

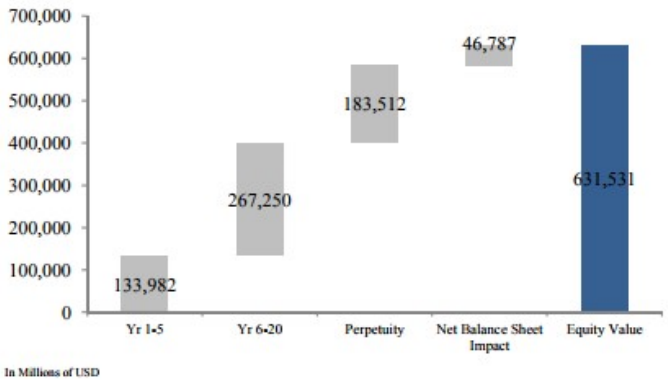

Image Source: Valuentum's 16-page Report

But investors should still keep their heads about them. Our valuation of Microsoft is not too aggressive, but we think it is optimistic, and we're arriving at a discounted cash-flow fair value estimate of ~$79. We're modeling in 7% compound annual growth during the next 5 years on solid average operating margins, resulting in a rather strong pace of earnings expansion. We're using a weighted average cost of capital assumption of 9%+, so we could be a bit high in the discount rate, but even considering sensitivity analysis, we'd put the high end of Microsoft's fair value estimate at ~$95 at the moment. Shares aren't necessarily cheap, but as the company continues to haul in more and more cash, its value has all the potential to grow into its price. If the team hikes the dividend in a big way, then the marketplace may simply go bananas over Microsoft! Some are even saying that Microsoft could fetch a market capitalization of $1 trillion in coming years.

Please see *Microsoft...*on next page

***Microsoft*...from previous page**

Let's cover a couple risks. The first, of course, is that technology is fast-changing, and while this spells opportunities, it also spells threats. Not everything that Microsoft dreams up will work out, but we think it is in the right spot long-term with cloud-based revenue. Rivals in that area will only get stronger, but given recent trends, Microsoft looks to be the one to beat. After the LinkedIn deal, we're a little cautious management may jeopardize the health of its balance sheet with another reckless acquisition during the frothiest times the market has yet seen, but we hope not. We're using evidence of the net cash buffer as an indication of management's prudence. Once net cash turns to net debt on the balance sheet, if it ever does, then we'd start to worry about the pace of growth in the dividend. There's not a lot that would make us worry about the health of the actual dividend at this point, however, only the rate of expansion. Some are saying that Microsoft could make a huge security acquisition, but we're not much for speculation, even if a deal does end up coming to fruition.

All things considered, here's what you need to know about Microsoft: it is no longer a tech dinosaur--if it ever was one--its cloud business is growing like a weed, it generates tremendous free cash flow that covers the dividend nicely, its balance-sheet health is top-notch, it has solid revenue prospects--especially for a company of its size--and its dividend growth prospects are fantastic, in my view. We're hoping Microsoft steps up the pace of dividend growth in coming years, and maybe scales share repurchases back a bit, but we're big fans of the executive team and respect their judgment. Shares of Microsoft yield ~2% at the time of this writing. We continue to like this software and cloud giant!

How Well Do Enterprise-Cash-Flow-Derived Fair Value Estimates Predict Future Stock Prices?

Valuentum released a study on its Enterprise-Cash-Flow-Derived Fair Value Estimates! To download the paper in PDF form:

https://www.valuentum.com/downloads/20171031/download

How Well Do Enterprise-Cash-Flow-Derived Fair Value Estimates Predict Future Stock Prices?

And Thoughts on Behavioral Valuation

Brian Nelson, CFA
Kris Rosemann
Tatiana Dmietrieva

First Version: October 2017

Abstract

This paper attempts to solidify the efficacy of the predictive power of fair value estimates for stocks, as derived by the discounted enterprise cash flow (free cash flow to the firm) process. The piece emphasizes the difference between share prices and estimated fair (intrinsic) values and offers an overview of the discounted enterprise cash flow model, what causes fair value estimates to change, and what drivers may be most important within the context of the discounted enterprise cash flow model. The work examines the importance of both art and science in discounted enterprise cash flow valuation, and introduces the topic of behavioral valuation. An explanation of the methods used in the study include the creation of price-to-fair value comparisons and subsequent share-price performance of companies relative to their respective price-to-fair value ratios. The study in this work measures the predictive power of fair value estimates through eight subsequent time periods, or approximately 3 years. The subsets of data are broken into "undervalued" and "overvalued" stock groupings, and the predictive power of fair value estimates is then evaluated for each category.

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Brian Nelson, MBA Booth School of Business, University of Chicago, formerly Director of Training and Methodology Development at Morningstar, is President of Equity Research and ETF Analysis at Valuentum, an independent investment research publisher serving individual investors, financial advisors, and institutional money-managers. Special thanks to Tatiana Dmitrieva, Data Scientist at Valuentum, and Kris Rosemann, Head of Data and Associate Investment Analyst at Valuentum for their work and diligence on this project. The views expressed herein are those of the authors and may not reflect the views of any company or organization mentioned.

About the Valuentum Dividend Cushion™ Ratio

By Valuentum Analysts

History has revealed that the best performing stocks during the previous decades have been those that shelled out ever-increasing cash to shareholders in the form of dividends. In a recent study by Ned Davis Research, S&P 500 stocks that initiated dividends or grew them over time registered roughly a 9.6% annualized return since 1972 (through 2010), while stocks that did not pay out dividends or cut them performed poorly over the same time period.

Such analysis is difficult to ignore, and we believe investors may be well-rewarded in future periods by finding the best dividend-growth stocks out there. As such, we've developed a rigorous dividend investment methodology that uncovers firms that not only have the strongest dividends but also ones that are poised to grow them long into the future.

How did we do this? Well, first of all, we scoured our stock universe for firms that have cut their dividends in the past to uncover the major drivers behind the dividend cut. This is what we found out: The major reasons why firms cut their dividend had to do with preserving cash in the midst of a secular or cyclical downturn in demand for their products/services or when faced with excessive leverage (how much debt they held on their respective balance sheets) during tightening credit markets.

The Importance of Forward-Looking Dividend Analysis

Informed with this knowledge, we developed the forward-looking Valuentum Dividend Cushion™, which is a ratio that gauges the safety of a dividend over time.

Most dividend analysis that we've seen out there is backward-looking – meaning it rests on what the firm has done in the past. Although analyzing historical trends is important, we think assessing what may happen in the future is even more important. The S&P 500 Dividend Aristocrat list, or a grouping of firms that have raised their dividends for the past 25 years, is a great example of why backward-looking analysis can be painful. One only has to look over the past few years to see the removal of well-known names from the Dividend Aristocrat List (including General Electric and Pfizer) to understand that backward-looking analysis is only part of the story. After all, you're investing for the future, so the future is what you should care about more.

We want to find stocks that will increase their dividends for 25 years into the future, not use a rear-view mirror to build a portfolio of names that may already be past their prime dividend growth years. The Valuentum Dividend Cushion™ ratio measures just how safe the dividend is in the future. It considers the firm's net cash on its balance sheet (cash and cash equivalents less debt) and adds that to its forecasted future free cash flows (cash from operations less capital expenditures) and divides that sum by the firm's future expected dividend payments. At its core, it tells investors whether the firm has enough cash to pay out its dividends in the future, while considering its debt load. If a firm has a Valuentum Dividend Cushion™ above 1, it can cover its dividend on the basis of our estimates, but if it falls below 1, trouble may be on the horizon.

In the study, the Valuentum Dividend Cushion™ process caught every dividend cut made by a non-financial, operating firm that we have in our database, except for one (Marriott). But interestingly, the Valuentum Dividend Cushion™ indicated that Marriott should have never cut its dividend, and sure enough, two years after the firm did so, it raised it to levels that were higher than before the cut.

Please see *About Our Valuentum Dividend Cushion…*on next page

***About Our Valuentum Dividend Cushion…*from previous page**

Here are the results of the study (a Valuentum Dividend Cushion™ below 1 indicates the dividend may be in trouble). The Valuentum Dividend Cushion™ ratio shown in the table below is the measure in the year before the firm cut its dividend, so it represents a predictive indicator. The measure continues to do well by members in walk-forward analysis (beyond the limitations of a backtested academic study).

The following link, for example, provides more information of the Dividend Cushion ratio tested in a robust out-of-sample walk-forward study across our coverage universe from its inception in 2012 through 2017:

Our Dividend Growth Methodology Is Rocking! http://www.valuentum.com/articles/20130528

The Valuentum Dividend Cushion Caught These Dividend Cuts in Advance

A Valuentum Dividend Cushion Score Below 1 Indicates a Firm's Dividend is At Risk in the Years Ahead

Dividend Cutter	Cut Date	Dividend Cushion (Before Cut)	Reason for Dividend Cut
Avery Dennison (AVY)	31-Jul-09	0.66	Reduced dividend to support debt-reduction efforts.
ConAgra Foords (CAG)	16-Mar-06	-0.59 (1)	Restructuring, divestitures.
Constellation (CEG)	18-Feb-09	-4.36	Refocus on core business of generating and selling power.
DR Horton (DHI)	6-May-08	-0.03	Housing turmoil.
Gannett Co. (GCI)	25-Feb-09	-0.06	Excessive debt; preserve cash amid downturn of newspaper industry.
La-Z-Boy (LZB)	17-Feb-09	0.89	Suspended dividend to preserve cash amid downturn in home furnishings.
Marriott Intl (MAR)	1-May-09	2.18 (2)	Suspended dividend in the wake of weak business travel, but dividend achieved record highs again, May 6, 2011.
Masco Corp (MAS)	11-Feb-09	-0.74	Cut dividend to ensure ability to fund operations and service debt coming due.
New York Times (NYT)	20-Nov-08	0.04	Effort to preserve cash. Downturn in newspaper industry. Loss of investment-grade credit rating.
Pfizer (PFE)	26-Jan-09	0.54	Bought Wyeth to diversify revenue base. Raised $22 billion+ in debt.
Sara Lee Corp (SLE)	8-Aug-06	0.70	Streamlining operations, business unit divestitures to raise cash.
Sunoco Inc. (SUN)	6-Oct-09	-0.85 (3)	Poor margins, overseas competition.
SuperValu (SVU)	20-Oct-09	-5.78	Rising unemployment, competition from Wal-Mart, etc.
Valero Energy (VLO)	27-Jan-10	0.15	Lower demand for gas and diesel.
Vulcan Materials (VMC)	14-Oct-11	-1.42	Free up much-needed cash amid downturn in aggregate demand.

(1) Forecast period for ConAgra, 2007 through 2011.

(2) Marriott is an instance where management prematurely cut its dividend, in our opinion. The Cushion reflected little risk at the time of cut, and sure enough Marriott restored its payout to record high

(3) Forecast adjusted to reflect Sunoco's poor free cash flow trends beyond last reported year.

Backtesting Methodology: Net balance sheet (year prior to dividend cut). Free cash flow for years beginning in year of dividend cut through reported years. If reported years do not total five, last reported year is extrapolated for remainder of forecast period. Dividends paid reflects what the dividends would be ex dividend cut.

Please see *About Our Valuentum Dividend Cushion…*on next page

*About Our Valuentum Dividend Cushion…*from previous page

At the very least, using the Valuentum Dividend Cushion™ can help you avoid firms that are at risk of cutting their dividends in the future. And we are the only firm out there that does this type of in-depth analysis for you. We provide the Valuentum Dividend Cushion™ ratio in the dividend reports and monthly Dividend Growth Newsletter, and we also scale the safety of a firm's dividend based on this measure in simple terms: Excellent, Good, Poor, Very Poor.

Here's a glimpse of the Valuentum Dividend Cushion™ ratio (as of November 2011) for a sample set of firms in our coverage universe. Please note that the current score on these and hundreds more are available with a membership to our website:

Company Name	Symbol	Sector	Div Cushion
Coca-Cola	KO	Consumer Staples	1.4
PepsiCo	PEP	Consumer Staples	1.2
Air Products & Chemicals	APD	Materials	1.3
Ecolab	ECL	Materials	1.2
PPG Industries	PPG	Materials	2.5
Cintas Corp	CTAS	Industrials	2.7
3M	MMM	Industrials	1.6
W.W. Grainger	GWW	Industrials	1.4
Emerson Electric	EMR	Industrials	2.1
Hormel Foods	HRL	Consumer Staples	2.2
McCormick	MKC	Consumer Staples	1.7
Archer-Daniels-Midland	ADM	Consumer Staples	2.1
Sysco	SYY	Consumer Staples	1.4
Target	TGT	Consumer Staples	1.4
Walgreens Boots Alliance	WBA	Consumer Staples	2.0
Wal-Mart	WMT	Consumer Staples	1.6
Leggett & Platt	LEG	Consumer Discretionary	1.3
Clorox	CLX	Consumer Staples	1.2
Colgate-Palmolive	CL	Consumer Staples	1.8
Johnson & Johnson	JNJ	Consumer Staples	2.2
Kimberly-Clark	KMB	Consumer Staples	1.2
Procter & Gamble	PG	Consumer Staples	1.8
VF Corp	VFC	Consumer Discretionary	1.6
Dover	DOV	Industrials	1.2
Illinois Tool Works	ITW	Industrials	1.6

Understanding Dividend Growth

It takes time to accumulate wealth through dividends, so dividend growth investing requires a long-term perspective. We assess the long-term future growth potential of a firm's dividend, and we don't take management's word for it. Instead, we dive into the financial statements and make our own forecasts of the future to see if what management is saying is actually achievable. We use the Valuentum Dividend Cushion™ as a way to judge the capacity for management to raise its dividend – how much cushion it has – and we couple that assessment with the firm's dividend track record, or management's willingness to raise the dividend.

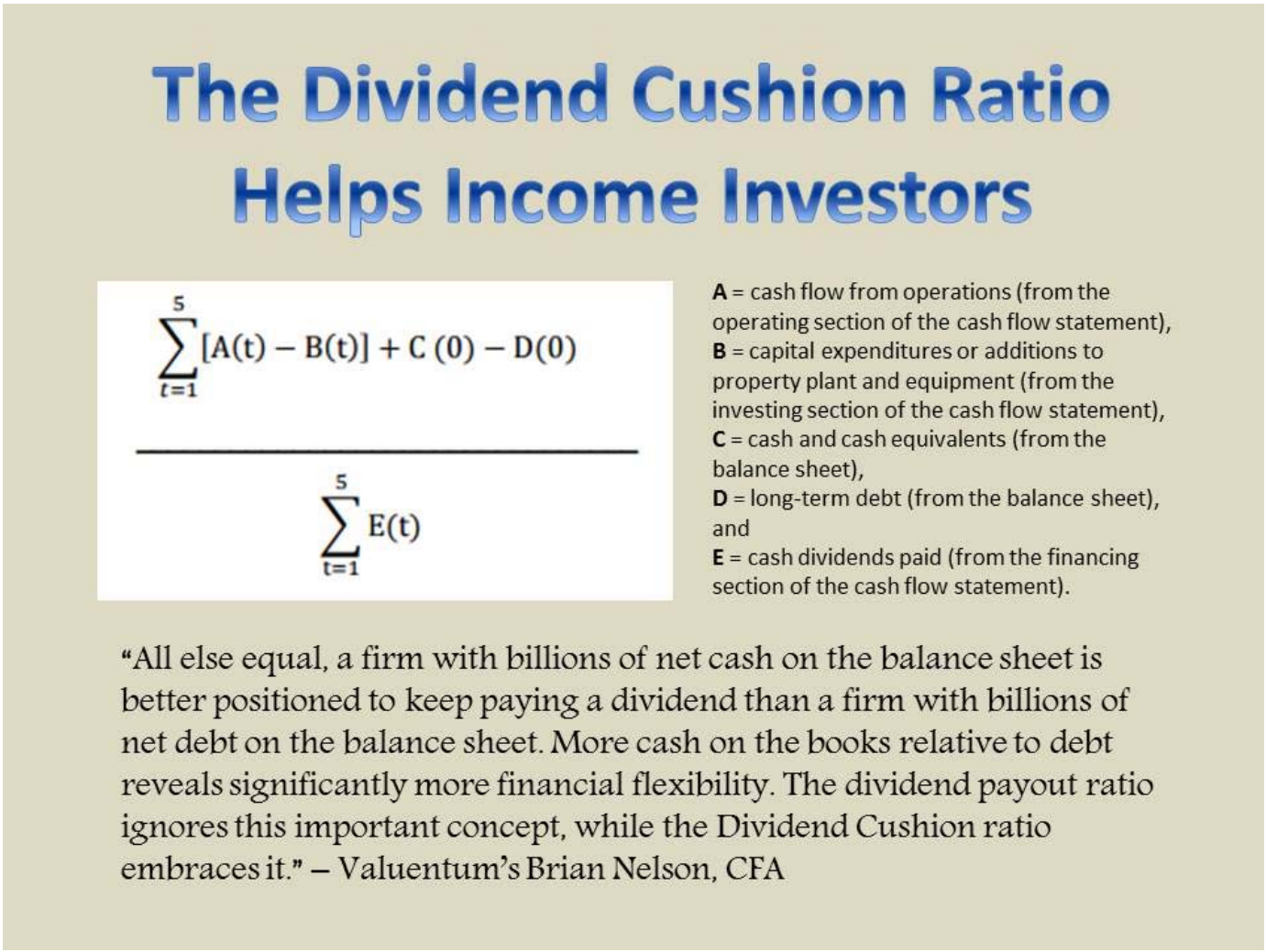
Please see *About Our Valuentum Dividend Cushion…*on next page

***About Our Valuentum Dividend Cushion...*from previous page**

In many cases, we may have a different view of a firm's dividend growth potential than what may be widely held in the investment community. That's fine by us, as our dividend-growth investment horizon is often longer than others'. We want to make sure that the firm has the capacity and willingness to increase the dividend years into the future and will not be weighed down by an excessive debt load or cyclical or secular problems in fundamental demand for their products/services. We scale our dividend-growth assessment in an easily-interpreted fashion: Excellent, Good, Poor, Very Poor.

What Are the Dividend Ideas We Seek to Deliver to You in Our Newsletter?

First of all, we're looking for stocks with dividend yields that are greater than the average of the S&P 500, or about 2% (but preferably north of 3%). This excludes many names, but we think such a cutoff eliminates firms whose dividend streams aren't yet large enough to generate sufficient income. Second, we're looking for firms that register an 'EXCELLENT' or 'GOOD' rating on our scale for both safety and future potential growth. And third, we're looking for firms that have a relatively lower risk of capital loss, as measured by our estimate of the company's fair value.



The Valuentum Dividend Cushion™ ratio has an excellent track record of predicting dividend cuts. For more information, please select the following link (login required):

http://www.valuentum.com/articles/20130528

Valuentum Dividend Growth Newsletter: Volume 7, Issue 2

Valuentum's Dividend Growth Newsletter is published monthly. To receive this newsletter on a monthly basis, please subscribe to Valuentum by visiting our website at http://www.valuentum.com. Or contact us at info@valuentum.com.

Fair Value Range. The fair value range represents an upper bound and lower bound, between which we would consider the firm to be fairly valued. The range considers our estimate of the firm's fair value and the margin of safety suggested by the volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow (the determinants behind our ValueRisk™ rating).

ValueRisk™. This is a proprietary Valuentum measure. ValueRisk™ indicates the historical volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow. The standard deviation of each measure is calculated and scaled against last year's measure to arrive at a percentage deviation for each item. These percentage deviations are weighted equally to arrive at the corresponding fair value range for each stock, measured in percentage terms. The firm's performance is measured along the scale of LOW, MEDIUM, HIGH, and VERY HIGH. The ValueRisk™ rating for each firm also determines the fundamental beta of each firm along the following scale: LOW (0.85), MEDIUM (1), HIGH (1.15), VERY HIGH (1.3).

Dividend Track Record. We assess each firm's dividend track record based on whether the fundamentals of the firm have ever forced it to cut its dividend. If the firm has ever cut its dividend (within the last 10 years), we view its track record as RISKY. If the firm has maintained and/or raised its dividend each year (over the past 10 years), we view its track record as HEALTHY.

Dividend Safety. We measure the safety of a firm's dividend by adding its net cash to our forecast of its future cash flows and divide that sum by our forecast of its future dividend payments. This process results in a ratio called the Dividend Cushion™. Scale: Above 2.75 = EXCELLENT; Between 1.25 and 2.75 = GOOD; Between 0.5 and 1.25 = POOR; Below 0.5 = VERY POOR.

Valuentum Dividend Cushion™. This is a proprietary Valuentum measure that drives our assessment of the firm's Dividend Safety rating. The forward-looking measure assesses dividend coverage via the cash characteristics of the business.

Dividend Growth Potential. We blend our analysis of a firm's Dividend Safety with its historical Track Record, while also considering historical dividend growth trends. We believe such a combination captures a firm's capacity (cash flow) and willingness (track record) to raise its dividend in the future. Scale: EXCELLENT, GOOD, POOR, VERY POOR.

Risk of Capital Loss. We think capital preservation is key for the dividend investor. As such, we evalute the risk of capital loss by assessing the intrinsic value of each firm based on our discounted cash-flow process. If a firm is significantly OVERVALUED, we think the risk of capital loss is HIGH. If a firm is FAIRLY VALUED, we think the risk of capital loss is MEDIUM, and if a firm is UNDERVALUED, we think the risk of capital loss is LOW.

Dividend Strength. Our assessment of the firm's dividend strength is expressed in a matrix. If the safety of a firm's dividend is EXCELLENT and its growth prospects are also EXCELLENT, it scores high on our matrix (top right). If the firm's dividend safety and the potential future growth are VERY POOR, it scores lower on our scale (bottom left).

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