OUR DIVIDEND GROWTH NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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

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"The volatility of early 2018 is likely here to stay for some time, so be careful, but not fearful, out there."

– Kris Rosemann

What's Working (or NOT Working) in Today's Market?

By Kris Rosemann

Sector/Theme	Symbol	YTD %*	Forward P/E**	10-yr Avg Forward P/E**
Crude Oil	USO	13.91%	NMF	NMF
Consumer Discretionary	XLY	3.22%	20.1	16.9
Gold	GLD	2.09%	NMF	NMF
Energy	XLE	1.69%	20.6	19.5
Technology	XLK	1.68%	NMF	NMF
Financials	XLF	-0.50%	13.0	12.5
Health Care	XLV	-0.73%	15.4	13.7
S&P 500	SPY	-1.06%	16.6	14.3
Silver	SLV	-1.44%	NMF	NMF
Industrials	XLI	-2.61%	17.2	14.8
Utilities	XLU	-3.06%	16.2	14.5
Biotech	IBB	-3.28%	NMF	NMF
Dividend Growth	SDY	-3.36%	NMF	NMF
Materials	XLB	-5.07%	16.4	14.9
Energy MLPs	AMLP	-5.10%	NMF	NMF
REITs	VNQ	-9.63%	NMF	NMF
Consumer Staples	XLP	-11.42%	16.7	16.4

*Data as of April 24, 2018 (adjusted close price used)
**Source: Factset April 20 (Earnings Insight, page 24)

The stock market during the first few months of 2018 has been marked by a meaningful return to volatility. Commodity prices from crude oil (USO) to aluminum have had their moments in the sun as material supply/demand imbalances of years past continue to sort themselves out, with the help of a few key players, of course (OPEC member nations in the case of crude oil, and Chinese pollution regulations and US trade policy changes in the aluminum example). Geopolitical uncertainty is keeping both world leaders and investors on their toes as the world continues to navigate multiple denuclearization deals and potential looming trade wars, pushing some towards safe havens such as gold. Meanwhile, rising interest rates in the US continue to raise concerns over equity valuation and risk-reward trade-offs.

Though the S&P 500 (SPY) is down only slightly more than 1% year-to-date, it is off nearly 8% from its highest closing mark of the year, which came January 26, as rising

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Dividend Growth Ideas: MO, AAPL, BKLN, CBRL, CSCO, DLR, XLE, GM, GILD, HAS, IDV, INTC, JNJ, MSFT, NVS, O, ORCL, SDY

***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.

What's Working…**from previous page**

Treasury yields, among other factors, have weighed heavy on investors' minds since then. Rising interest rates have had a logical impact on the performance of REITs (VNQ), whose prices tend to be inversely-related to interest rates, at least in part as a result of a poorer risk-reward trade-off for income-minded investors that may be enticed by higher-yielding Treasuries. A similar case can be made for the utilities (XLU) and dividend growth (SDY) groups, but the biggest loser in the market thus far in 2018 has been consumer staples (XLP), which should come as no surprise to Valuentum readers.

Energy MLPs (AMLP) continue to lag the broader energy sector, too, as they have been plagued by a variety of issues, not the least of which is also related to rising rate fears (higher borrowing costs) and structural problems within the MLP business model itself, a notion that has become increasingly evident as more and more MLPs pursue simplification transactions. While the MLP space has yet to realize the benefit of rising commodity prices, many players in the basic materials sector (XLB) are facing the challenges that come with higher input costs in the form of raw materials. Others in the sector are seeing a challenging outlook as many agricultural commodities have faced meaningful pressure as a result of a potential trade war with China, a key buyer of US agricultural goods.

The industrial sector (XLI) has also been impacted by rising input costs, and President Trump's steel and aluminum tariffs, while less intense than initially indicated, will continue to have an impact on companies that are dependent on those raw materials. Strong performer Boeing (BA) is a top position in the Industrial Select Sector SPDR ETF, but General Electric (GE) is, too, and the latter's shares have been under tremendous pressure. The US healthcare space (XLV) has been stuck in rut more recently as policy uncertainty persists and payors work to reign in the rising cost of treatment. We may be witnessing the end of the pharmacy benefit manager as we know it, and a greater emphasis on generics and biosimilars may likely pressure growth and margin performance for some key players.

The financial space (XLF) has been on a bit of a roller coaster ride thus far in 2018, but it finds itself back near its starting point despite the yield curve striking less optimistic sentiment. Strong fundamentals in the US economy have helped, but US consumer debt is at record highs above $1 trillion, which may eventually come home to roost. The tech sector (XLK) has also had a bumpy start to 2018, with some key names such as Intel (INTC) and Facebook (FB) getting into hot water with the public, and concerns related to the impact of tax reform on the long-term strategies of some of the most cash rich entities in the space, as exemplified by Apple's (AAPL) recent decision to move from a $163 billion net cash position to a cash-neutral balance sheet, potentially impacting investor decision making.

The energy sector's (XLE) performance thus far in 2018 has been largely understandable given the ongoing recovery in energy resource pricing, but geopolitical concerns and ongoing unrest in the Middle East have the potential to change market dynamics at the drop of a hat. Uncertainty related to the Iran nuclear deal could drastically alter the delicate supply/demand profile of the global oil market, and tensions between Russia and the US are not being eased in the slightest by the ongoing possibility of confrontation in or over Syria. Meanwhile, US independent producers continue to grow rig counts and pump increasing levels of oil, and many estimates suggest the country will surpass Russia as the world's leading oil producer by 2019 *at the latest*.

The consumer discretionary (XLY) space, the top-performing sector thus far in 2018, has been a key beneficiary of solid consumer confidence in the US, which rose in the month of April (according to preliminary estimates) despite ongoing concerns regarding the implications of a trade war at the consumer level. Increased transportation costs via rising fuel prices have the potential to impact levels of discretionary spending in the near term, but the US economy continues to power ahead, giving consumers adequate confidence in current and future levels of disposable income to continue spending. Amazon (AMZN) and Netflix (NFLX) continue to be the bellwether in the consumer discretionary space.

The volatility of early 2018 is likely here to stay for some time, so be careful, but not fearful, out there. As always, be sure to regularly check in on the stock landing pages of portfolio holdings for the most recent updates to fair value estimates, Dividend Cushion ratios, and a number of Valuentum's other proprietary metrics.

Dividend Growth Ideas Microsoft and Intel Deliver Strong Free Cash Flow

By Kris Rosemann

Microsoft's Commercial Cloud Driving Growth

Simulated Dividend Growth Newsletter portfolio idea Microsoft (MSFT) turned in a solid fiscal third quarter report April 26 as total revenue advanced 16% from the year-ago period, operating income advanced 23%, and diluted earnings per share jumped 36%. Commercial cloud revenue growth of 58% was a key driver of the strong top-line expansion with strong growth in the US, Western Europe, and the UK, and the quarter marked the 10th consecutive quarter in which Azure posted 90%+ revenue growth.

The company's operating margin expanded by two percentage points from the comparable period in fiscal 2017, which management attributes to focused investments aimed at driving the top line. Free cash flow through three quarters in fiscal 2018 advanced ~9.5% on a year-over-year basis to $24.8 billion despite a meaningful increase in capital spending, easily covering cash dividends paid in the period of ~$9.5 billion and share repurchases of ~$8.4 billion. The company's balance sheet health remains top-notch as its net cash position at the end of the quarter sat at more than $55.1 billion.

In the fourth quarter of fiscal 2018, Microsoft expects top-line growth to remain strong, with its guidance range implying growth of ~17%-19% on a year-over-year basis. Looking ahead to fiscal 2019, management expects the key drivers of recent performance to remain intact. Execution and a differentiated hybrid position should continue to drive high-teens growth in its server product and cloud services revenue, and commercial cloud gross margin improvement is expected to continue despite revenue mix shift to Azure slowing the rate of improvement.

Microsoft remains one of our favorite dividend growth ideas, and we expect to continue highlighting the idea in the simulated Dividend Growth Newsletter portfolio for the foreseeable future. We currently value shares at $87 each, and the company's impressive Dividend Cushion ratio of 3.3 gives us confidence in its ability to continue delivering a growing stream of dividends. Shares yield ~1.8% as of this writing.

Intel Raises Guidance After Strong Quarter

After a record year in 2017, Intel (INTC) turned in record first-quarter 2018 revenue, results released April 26, as its top-line advanced 13% from the year-ago period thanks to 25% growth in its data-centric business, which now accounts for nearly half of total revenue. Operating income leapt 21% on a year-over-year basis despite gross-margin pressure as disciplined R&D and MG&A spending drove operating margin expansion in the quarter, and net income came in 30% higher than the first quarter of 2017 thanks in large part to a materially reduced tax bill.

Intel's free cash flow in the first quarter jumped more than 73% from the year-ago period to nearly $3.4 billion, which handily covered cash dividends paid of $1.4 billion and share repurchases of $1.9 billion. The company was also able to make solid headway in improving its balance-sheet health in the quarter as its net debt position fell $0.4 billion from the end of 2017 to ~$12.4 billion.

Management took the opportunity to raise its full year 2018 guidance after the impressive first quarter. Revenue is now expected to be $67.5 billion, up from $65 billion, and non-GAAP operating margin guidance was raised to 31% from 30%. Its non-GAAP earnings per share target was raised to $3.85 from initial guidance of $3.55, and most importantly, Intel's projection for free cash flow in 2018 was raised to $14.5 billion from $13 billion, suggesting the measure will continue to expand sequentially as first quarter free cash flow annualized comes in at ~$13.5 billion.

We recently raised our fair value estimate for Intel to $54 per share, and given the recent guidance raise, the upper bound of our fair value range is certainly in play for shares. Its PC business continues to navigate a challenging operating environment effectively, and its data-centric business will remain the core driver

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of growth as it pushes Intel's cloud transformation forward. The company's tremendous free cash flow generation (expected to be more than 21% of revenue in 2018) will remain the basis for its attractive dividend profile, which couples a robust Dividend Cushion of 2.4 with a yield of ~2.3%.

We expect to keep Intel as a highest weighted idea in the simulated Dividend Growth Newsletter portfolio, and it remains a core part of the simulated Best Ideas Newsletter portfolio as well. We're not reading too much into potential production timing issues either.

GM and Ford Tune Up Operations for the Future of Automaking

The US auto behemoths continue to place a greater importance on efficient operations and the health of their bottom lines as the industry may be reaching a relative peak in terms of light vehicle production for this economic cycle and as the future of the auto landscape remains uncertain.

By Kris Rosemann

Key Takeaways

Both GM and Ford are keeping a keen eye on the future of the evolving auto and personal transportation markets.

We continue to like shares of GM relative to Ford, even as we say we like the direction in which Ford appears to be heading. GM's shares are trading at an ultra-low earnings multiple, and it pays a very strong dividend with a nice 4% yield to boot. Our fair value estimate for GM is $45, and there even could be upside to that.

We believe GM is not getting enough credit for its early efforts in next-generation technology in autonomous vehicles and new mobility ideas like transportation as a service and other ride-sharing platforms.

All of GM's operating segments were profitable in the first quarter of 2018, including record performance in China and GM Financial.

Ford will stop investing in sedans for North America and shift to production of only two cars for the continent--the Mustang and the all-new Focus Active crossover. By 2020 almost 90% of its North American portfolio will be trucks, utilities, and commercial vehicles.

Ford continues to work to achieve a 10% adjusted EBIT margin in the important North American market through its 2020 "Fitness Initiatives," but GM believes it is on track to achieve such levels in full year 2018.

Shares of Ford are trading in the lower half of our fair value range, the midpoint of which is $15 per share, and its Dividend Cushion ratio is a healthy 2.1. Shares of Ford yield ~5.4% as of this writing.

General Motors Still Not Getting Respect in Autonomous

US auto bellwethers Ford (F) and General Motors (GM) reported first quarter 2018 earnings April 25 and April 26, respectively, and the two stocks moved in opposite directions (Ford rising, GM declining) during the trading session April 26. Both companies continue to evaluate their operations to maximize efficiency, strengthen their cores, and keep a keen eye on the future of the evolving auto and personal transportation markets. We continue to like shares of GM relative to Ford, even as we say we like the direction in which Ford appears to be heading. For a recent discussion on the future of the market, please read, "Who's Driving Who: The Future of the Automakers" (March 2017).

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Dividend Growth Ideas

By Valuentum Analysts

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

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

DIVIDEND GROWTH IDEAS -- as of May 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	2.25%	$54.00	7	0.99	53.33	5.5%-10%
Johnson & Johnson (JNJ)	3.36	2.67%	$133.00	3	0.95	126.01	5.5%-10%
S&P Dividend ETF SPDR (SDY)	2.21	2.43%	-	UR	-	90.91	5.5%-10%
Apple (AAPL)	2.52	1.49%	$201.00	6	0.84	169.10	4%-5.5%
Cisco (CSCO)	1.32	2.94%	$45.00	6	1.00	44.83	4%-5.5%
Digital Realty Trust (DLR)	4.04	3.85%	$96.00	3	1.09	105.01	4%-5.5%
iShares Int'l Select Dividend (IDV)	1.51	4.43%	-	UR	-	34.00	4%-5.5%
Energy Sector SPDR (XLE)	2.25	3.06%	-	UR	-	73.36	4%-5.5%
PowerShares Senior Loan (BKLN)	0.82	3.56%	-	UR	-	23.11	2.5%-4%
General Motors (GM)	1.52	4.17%	$45.00	7	0.81	36.42	2.5%-4%
Microsoft (MSFT)	1.68	1.77%	$87.00	6	1.09	95.00	2.5%-4%
Novartis (NVS)	2.98	3.91%	$80.00	3	0.95	76.28	2.5%-4%
Oracle (ORCL)	0.76	1.65%	$53.00	4	0.87	45.95	2.5%-4%
Cracker Barrel (CBRL)	4.80	2.89%	$165.00	3	1.01	166.31	1.5%-2.5%
Gilead Sciences (GILD)	2.28	3.14%	$107.00	7	0.68	72.56	1.5%-2.5%
Hasbro (HAS)	2.52	2.88%	$87.00	3	1.00	87.39	1.5%-2.5%
Altria (MO)	2.80	5.00%	$67.00	3	0.84	56.03	1.5%-2.5%
Realty Income (O)	2.63	5.14%	$56.00	6	0.91	51.18	1.5%-2.5%
Cash Consideration	-	-	-	-	-	-	10%-30%

UR = Under Review

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

Goal: 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. The simulated Dividend Growth Newsletter portfolio seeks to find underpriced dividend growth gems that generate strong levels of free cash flow and have solid balance sheets, translating into excellent Valuentum Dividend Cushion ratios. Stocks in the Dividend Growth Newsletter portfolio may have lengthy dividend growth track records spanning decades, but we focus most of our efforts on assessing the future safety and dividend growth potential of ideas.

Every person has different goals and different risk tolerances, so where before in the simulated newsletter portfolios, we would outline the specific percentage weighting, we think providing ranges make much more sense. For example, depending on someone's risk tolerances, a larger cash position in an overheated market may be prudent. On the other hand, the longer one's time horizon, perhaps a smaller cash position may make more sense. This isn't for us to decide, and frankly, we want to be relevant for as many as we can in the investment community because we think we have something for everyone!

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

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

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.

*GM and Ford…*from page 4

Shares of General Motors felt the pressure of weak quarterly results that were impacted by a ~$940 million restructuring charge related to the closing of a Korean plant aimed at strengthening its core business, as well as planned production reduction related to a coming full-size truck launch. The company also updated on its progress in autonomous vehicles, stating that it expects "to achieve commercialization at scale in a dense, urban environment in 2019." The company is building a new assembly plant to further consolidate and accelerate autonomous vehicle production. All the buzz surrounding Tesla (TSLA), despite its inability to hit production targets that are but a tiny fraction of the output GM is capable of, leaves us a bit perplexed by the market's refusal to acknowledge the position GM could hold in the next wave of personal transportation.

We are of the opinion that GM does not get enough credit for its early efforts in next generation technology in autonomous vehicles and new mobility ideas like transportation as a service and other ride-sharing platforms. The company's scale and expertise, along with what may be seen as a "first mover" advantage gives it a meaningful leg up in the coming autonomous vehicle market, which some estimate will grow to be as large as $750 billion. Though it does not have definitive long-term plans for its stake in ride-sharing business Lyft--Lyft also has partnerships with other key rivals (including Ford)--the investment should not be discounted as immaterial by investors as it is ultimately aimed at delivering a network of on-demand autonomous vehicles in the US.

Ford Giving Up On US Sedan Market? GM Puts Up Record Performance in China, GM Financial

Clearly Ford is taking note of the same trends as GM, and its first quarter report brought a number of updates to its strategy moving forward. It announced a number of "Fitness Initiatives" and has identified $11.5 billion in cost and efficiency opportunities, which drives its accelerated financial targets of an 8% adjusted EBIT margin by 2020, two years earlier than its previous target, along with ROIC in the high teens by 2020. The efficiency focus is also expected to reduce cumulative capital spending by $5 billion from 2019-2022.

Ford's strategy shift is noteworthy as well. The company will stop investing in sedans for North America and shift to production of only two cars for the continent--the Mustang and the all-new Focus Active crossover. By 2020 almost 90% of its North American portfolio will be trucks, utilities, and commercial vehicles. Ford's updated strategy consists of three more core tenets: 1) Committing to new propulsion options such as hybrid powertrains in high-volume and profitable vehicles; 2) Building a profitable autonomous technology business that offers human-centered ride-hailing and delivery services; and 3) Creating and scaling a mobility platform ultimately targeting the creation of a Transportation Mobility Cloud for cities and orchestrating digital connections from vehicle to street and business to home.

Table 1: Recap of General Motors' Q1 2018 Results

Q1 2018 RESULTS OVERVIEW	FROM CONTINUING OPERATIONS			
	Net Revenue	Income	Auto Operating Cash Flow	EPS-Diluted
GAAP	$36.1 B	$1.1 B	$(1.2) B	$0.77
Vs. Q1 2017	(3.1) %	(58.7) %	$(2.3) B	(56.0) %
	EBIT-adj. Margin	EBIT-adj.	Adj. Auto FCF	EPS Diluted-adj.
Non-GAAP	7.2%	$2.6 B	$(3.5) B	$1.43
Vs. Q1 2017	(2.3) pts	(26.6) %	$(2.8) B	(18.3)%

Image source: GM first quarter report

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While GM continues to position itself for long-term success in an evolving transportation environment, it is working through short-term speed bumps that can impact quarterly performance, to which we are not overreacting. This was the case in the first quarter of 2017 as revenue fell 3% despite 4% vehicle delivery growth in the US and a doubling of new crossover deliveries in the US and China.

GM's North American adjusted EBIT margin came in at 8% in the quarter, but management is confident that it remains on track to hit its 10% target for the measure in the full year. Adjusted auto free cash flow came in substantially negative as a result of the planned full-size truck production reduction and incremental capital spending as it gears up for launches of all-new Chevy Silverado and GMC Sierra and GEM trucks. Despite the production cuts and restructuring charges, all of GM's operating segments were profitable in the quarter, including record performance in China and GM Financial.

Table 2: Recap of Ford's Q1 2018 Results

2018 FIRST QUARTER FINANCIAL RESULTS*								
	Revenue (GAAP)	Net Income (GAAP)	Company Adj. EBIT (Non-GAAP)	EPS (GAAP)	Adjusted EPS (Non-GAAP)	Company Adj. EBIT Margin (Non-GAAP)	Cash Flows from Operating Activities (GAAP)	Company Operating Cash Flow (Non-GAAP)
1Q 2018	$42.0B	$1.7B	$2.2B	$0.43	$0.43	5.2%	$3.5B	$3.0B
B/(W) 1Q 2017	$2.9B	$0.1B	$(0.3)B	$0.03	$0.03	(1.2) ppts	$(0.8)B	$1.0B

Image source: Ford first quarter report

Ford's first quarter revenue grew 7% from on a year-over-year basis thanks to strength in North America and Europe, but company adjusted EBIT of $2.2 billion was ~$0.3 billion lower than the year-ago period due in part to commodity cost increases, an important factor worth monitoring for both it and GM, especially considering the uncertainty related to US trade policy around key raw material inputs. Nevertheless, net income grew 3% from the comparable period of 2017 thanks in large part to a materially lower tax bill.

Ford's adjusted EBIT margins remain well below that of GM, even in a period in which GM reduced production of key vehicles (5.2% compared to 7.2%). Ford continues to work to achieve a 10% adjusted EBIT margin in the important North American market through its 2020 "Fitness Initiatives," but GM believes it is on track to achieve such levels in full year 2018. We have no reason to believe GM will be satisfied with its operating improvements beyond 2018, and we continue to believe the company has a relative advantage over rival Ford in next-generation transportation concepts.

While we are not overly concerned with elevated financial-related debt levels given the health of the US economy at this juncture, we would be remiss not to mention the risk that comes with exposure to material levels of consumer debt. As of the end of the first quarter of 2018, GM Financial's total debt load was ~$83.5 billion, and Ford Credit's total debt was north of $141.9 billion.

Conclusion

All things considered, Ford may very well be back on the up and up, but we continue to prefer shares of GM, and material upside may exist to our fair value estimate should it deliver on its potential to be a leader in the revolution of automaking and personal transportation. We currently value shares of GM at $45, and we like its dividend profile as its Dividend Cushion ratio sits at 2.8 to go along with a yield of roughly 4%. Shares of Ford are trading in the lower half of our fair value range, the midpoint of which is $15 per share, and its Dividend Cushion ratio is a healthy 2.1. Shares of Ford yield ~5.4% as of this writing.

The Transformation of Novartis Continues

Leadership change can often bring a great deal of uncertainty especially when a new leader is replacing a successful CEO. In the case of Novartis, we are witnessing a focused effort to streamline the business: a deliberate attempt to shift focus from a sprawling healthcare enterprise towards a more pure-play pharma/biotech powerhouse with an innovative, cutting-edge product portfolio.

By Alexander J. Poulos

Key Takeaways

We liked that Novartis divested its stake in its healthcare joint-venture with GlaxoSmithKline, and we were very pleased with the large sale price of $13 billion. The cash proceeds will offer increased financial flexibility at Novartis.

We're not completely against the company's near-$9 billion deal for AveXis, though this, too, had a high price tag. AveXis has a promising gene replacement therapy for spinal muscular atrophy (SMA) and further augments Novartis' commitment to Neuroscience.

We remain pleased with Novartis' performance during the first quarter of 2018, with mid-single-digit sales growth and solid core operating income expansion, even after adjusting for currency fluctuations. Quarterly net income and core earnings-per-share growth came in at 12% and 6%, respectively, adjusting for currency, and free cash flow advanced to $1.9 billion in the period (up 15% on a year-over-year basis in USD).

Cosentyx ($580 million in sales during the first quarter) remains the molecule that has been driving the nice top-line expansion at Novartis, as sales of the molecule increased ~35% over the comparable period in 2017.

At its current run-rate of $200 million per quarter and with payer resistance falling by the wayside as evidenced by an uptick in new prescriptions written for the product, we believe Entresto is well on its way to achieving blockbuster status (sales over $1 billion per year).

Novartis may spin-off its optic division Alcon, as evidenced by the distinct lack of near-term molecules for the treatment of various optic disease states.

Though Novartis' portfolio continues to shift around given the JV sale, the acquisition of AveXis, and the potential spin off of Alcon, the company's Dividend Cushion ratio still stands at a healthy 1.5. We continue to monitor the viability of Novartis' clinical pipeline for clues regarding the long-term sustainability of the dividend, however, but the payout looks solid for the foreseeable future.

Leadership Change and Divestiture of Novartis' JV Consumer Healthcare Stake

Vasant Narasimhan ascended into the CEO role at Novartis (NVS), effective February 1, 2018. We view Narasimhan as a change agent with a unique runway to dramatically alter Novartis into a more-nimble global operator through a series of moves to streamline the company. We have not been disappointed thus far in 2018, as Narasimhan has moved quickly and decisively to recast the business.

In our recent report titled "GlaxoSmithKline: Not All Dividends Are Created Equal," we discussed our concerns about the strategic direction at pharma rival GlaxoSmithKline (GSK). We anticipated a purchase on the part of Glaxo of Novartis JV stake in the business, and we are pleasantly surprised at the speed of which the deal was announced. Novartis will divest its stake for a staggering $13 billion with the deal widely expected to close in the second quarter of 2018. We found the following quote for Narasimhan particularly enlightening:

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> *Vas Narasimhan, CEO of Novartis, said: "While our consumer healthcare joint venture with GSK is progressing well, the time is right for Novartis to divest a non-core asset at an attractive price. This will strengthen our ability to allocate capital to grow our core businesses, drive shareholder returns, and execute value-creating bolt-on acquisitions as we continue to build the leading medicines company, powered by digital and data.*
>
> Quote Source: Novartis March 27, 2018 press release

Purchase of AveXis

Not to be outdone, Narasimhan followed up the bold move of selling the reliable, yet slow-growing consumer healthcare division with a masterstroke of a deal, assuming the product gains approval. Novartis reignited the feeding frenzy in junior biotechs with the audacious takeout of AveXis to gain control of its promising gene replacement therapy for spinal muscular atrophy (SMA). The price tag for AveXis came to a staggering $8.7 billion in cash with the treatment widely-expected to enter the US market in 2019. Novartis issued guidance of peak sales in the multi-billion-dollar range with an expectation the product will become accretive to earnings in 2020.

Spinal Muscular Atrophy is a genetic disorder caused by a defect in the SMN1 gene. We remain optimistic the treatment will gain widespread adoption as the potential for a lifetime fix for a deadly disease that kills off most infants before they reach the age of 2. We view the AveXis purchase as an excellent use of cash as it will further augment Novartis' commitment to Neuroscience, as it pairs the treatment with top-selling Gilenya to form a potent franchise. We tend to have a more favorable stance to M&A targets that add to an existing franchise as the need to build out a sales staff is lessened. In the case of Novartis, the staff is firmly in place with significant long-term relationships with the specialists practicing in the field.

First Quarter 2018 Results

We remain pleased with Novartis' performance during the first quarter of 2018, with mid-single-digit sales growth and solid core operating income expansion, even after adjusting for currency fluctuations. Quarterly net income and core earnings-per-share growth came in at 12% and 6%, respectively, adjusting for currency, and free cash flow advanced to $1.9 billion in the period (up 15% on a year-over-year basis in USD). Novartis has begun to improve from the decline emanating from the loss of patent protection of its key oncology franchise Gleevec in 2017. Let's examine the various components of the "Innovative Medicines" group to gain a feel for how the various franchises are performing.

Immunology

Cosentyx ($580 million in sales during the first quarter) remains the molecule that has been driving the nice top-line expansion at Novartis as sales of the molecule increased ~35% over the comparable period in 2017. The sales expansion was viewed as a disappointment, however, as payers begin to push back over the exorbitant prices of such treatments. Cosentyx sales suffered from a destocking trend in specialty pharma coupled with a more-aggressive rebate, which management hopes will be offset by an increase in volume. Thus far, we are inclined to accept management's assertion the destocking trend affected sales as overall share grew. However, if the trend does not reverse in the second quarter, we will view this as a negative not only for Cosentyx but the overall health of all the Immunology products.

Cardiovascular

We are pleased with the steady yet slow growth of Entresto ($200 million in sales during the first quarter), a novel new class of treatment for heart failure. Novartis continues to face an uphill battle in gaining widespread acceptance of the product. Entresto is mired in a widespread educational campaign to expand the overall market beset with numerous generic alternatives. At its current run-rate of $200 million per quarter and with payer resistance falling by the wayside as evidenced by an uptick in new prescriptions written for the product, we believe Entresto is well on its way to achieving blockbuster status (sales over $1 billion per year).

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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 simulated Dividend Growth Newsletter portfolio (see page 5).

Though the dividend growth portfolio may be fully invested at times, we may swap in stocks on this list or stocks on the 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 simulated Dividend Growth Newsletter portfolio.

Don't forget to visit the website at www.valuentum.com.

Company Name	Symbol	Est Div Yield	VBI	Div Growth	Div Safety	Div Cushion
Buckeye Partners	BPL	8.9%	7	GOOD	GOOD	1.3
Spectra Energy Partners	SEP	6.7%	7	EXCELLENT	GOOD	1.7
General Motors	GM	3.5%	7	GOOD	EXCELLENT	2.8
Exxon Mobil	XOM	3.5%	7	EXCELLENT	GOOD	1.4
Interpublic	IPG	3.4%	7	GOOD	GOOD	2.0
Western Union	WU	3.3%	7	EXCELLENT	GOOD	2.3
Archer-Daniels-Midland	ADM	3.2%	7	EXCELLENT	GOOD	1.9
Gilead Sciences	GILD	2.9%	7	EXCELLENT	GOOD	2.2
Sonoco	SON	2.9%	7	EXCELLENT	GOOD	1.1
Hanesbrands Inc	HBI	2.7%	7	GOOD	GOOD	1.0
Cheesecake Factory	CAKE	2.4%	7	EXCELLENT	GOOD	2.7
Intel	INTC	2.3%	7	EXCELLENT	GOOD	2.4
Analog Devices	ADI	2.1%	7	EXCELLENT	GOOD	1.5
Caterpillar	CAT	2.0%	7	GOOD	GOOD	2.3
Robert Half	RHI	1.7%	7	EXCELLENT	EXCELLENT	3.4
Celenese	CE	1.7%	7	EXCELLENT	GOOD	2.5
NewMarket	NEU	1.7%	7	EXCELLENT	GOOD	1.6
General Dynamics	GD	1.6%	7	EXCELLENT	EXCELLENT	2.9
PPG Industries	PPG	1.5%	7	EXCELLENT	EXCELLENT	3.0
Papa John's	PZZA	1.5%	7	EXCELLENT	GOOD	2.0
Equifax	EFX	1.3%	7	EXCELLENT	GOOD	2.3
Tyson Foods	TSN	1.1%	7	EXCELLENT	GOOD	2.1
Factset Research	FDS	1.1%	7	EXCELLENT	EXCELLENT	3.2
Morningstar	MORN	1.0%	7	EXCELLENT	EXCELLENT	4.2
Franklin Electric	FELE	0.9%	7	EXCELLENT	EXCELLENT	3.7
Littelfuse	LFUS	0.7%	7	EXCELLENT	EXCELLENT	4.0
Ametek	AME	0.5%	7	GOOD	EXCELLENT	5.9

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
GameStop	GME	12.0%	1.6	Attractive	19.82
Automatic Data Processing	ADP	2.1%	7.0	Very Attractive	14.89
Cooper Tire & Rubber	CTB	1.4%	9.5	Neutral	13.31
Chico's FAS	CHS	3.3%	3.8	Attractive	12.82
Abercrombie & Fitch	ANF	4.0%	2.7	Unattractive	10.81
Chicago Rivet	CVR	2.7%	3.9	Neutral	10.62
Finish Line	FINL	3.2%	3.3	Unattractive	10.38
Ford	F	5.0%	2.1	Neutral	10.25
General Motors	GM	3.5%	2.8	Attractive	9.96
QUALCOMM	QCOM	4.0%	2.4	Very Attractive	9.56
AVX Corp	AVX	2.7%	3.4	Attractive	9.05
Guess	GES	4.2%	2.1	Attractive	8.56
American Eagle	AEO	2.7%	3.1	Attractive	8.45
Foot Locker	FL	2.6%	3.2	Attractive	8.36
Gentex	GNTX	1.8%	4.4	Attractive	8.05
Apple	AAPL	1.4%	5.6	Highest Rated	8.03
Graham Holdings Co	GHC	0.9%	9.0	Attractive	8.03
CA Tech	CA	3.0%	2.6	Very Attractive	7.83
Resources Connection	RECN	3.0%	2.6	Attractive	7.81
Western Union	WU	3.3%	2.3	Neutral	7.72
Newmont Mining	NEM	1.4%	5.2	Neutral	7.52
Oracle	ORCL	1.6%	4.5	Very Attractive	7.42
Cisco	CSCO	3.1%	2.4	Very Attractive	7.37
Big 5	BGFV	10.9%	0.7	Neutral	7.36
Amgen	AMGN	3.1%	2.4	Very Attractive	7.34
Cardinal Health	CAH	2.6%	2.8	Very Attractive	7.29
Pfizer	PFE	3.8%	1.9	Attractive	7.25
Lear Corp	LEA	1.4%	5.0	Attractive	7.22
Fluor	FLR	1.5%	4.7	Attractive	7.18
Ralph Lauren	RL	1.8%	3.9	Attractive	7.12
Hewlett-Packard	HPQ	2.4%	2.9	Very Attractive	7.09
Rio Tinto	RIO	4.0%	1.8	Neutral	7.07
Williams-Sonoma	WSM	3.3%	2.2	Attractive	7.04
Paychex	PAYX	3.0%	2.3	Highest Rated	7.00
Best Buy	BBY	2.5%	2.8	Very Attractive	6.98
Gap	GPS	2.6%	2.6	Attractive	6.96
NTT Docomo	DCM	3.5%	2.0	Attractive	6.92
Honda	HMC	2.3%	3.0	Neutral	6.89
Methode Electronics	MEI	1.1%	6.2	Attractive	6.81
Interpublic	IPG	3.4%	2.0	Very Attractive	6.78
Garmin	GRMN	3.5%	1.9	Attractive	6.78
H&R Block	HRB	3.5%	1.9	Very Attractive	6.65
Xerox	XRX	3.1%	2.1	Very Attractive	6.59
Xilinx	XLNX	2.0%	3.2	Highest Rated	6.57
Ethan Allen	ETH	3.0%	2.2	Unattractive	6.57
Cedar Fair	FUN	5.5%	1.2	Attractive	6.55
Acuity Brands	AYI	0.4%	18.3	Attractive	6.47
Jabil Circuit	JBL	1.2%	5.5	Attractive	6.47
Cummins	CMI	2.6%	2.5	Attractive	6.47
Cheesecake Factory	CAKE	2.4%	2.7	Attractive	6.47

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.

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
Ensco	ESV	Energy Svcs - Offshore Drilling	0.6%	VERY POOR	-49.4
Range Resources	RRC	Independent Oil & Gas	0.6%	VERY POOR	-35.2
Superior	SUP	Auto Parts Suppliers	2.5%	VERY POOR	-11.9
R.R. Donnelley	RRD	Commercial Services	5.9%	VERY POOR	-7.1
Ryder System	R	Rental and Leasing	2.8%	VERY POOR	-5.2
H.B. Fuller	FUL	Chemicals - broad	1.1%	VERY POOR	-4.8
Intl Game Technology	IGT	Leisure	3.1%	VERY POOR	-3.6
Casey's General	CASY	Food Retailers	0.9%	VERY POOR	-3.5
Devon Energy	DVN	Independent Oil & Gas	1.0%	VERY POOR	-3.5
Newell Brands	NWL	Household Durables	3.3%	VERY POOR	-2.9
Rent-A-Center	RCII	Rental and Leasing	3.5%	VERY POOR	-2.9
Centurylink	CTL	Telecom Services - diversified	11.4%	VERY POOR	-2.7
Dine Brands Global	DIN	Restaurants - Fast Cas & Full Svc	3.9%	VERY POOR	-2.6
Yamana Gold	AUY	Metals & Mining - gold	0.7%	VERY POOR	-2.6
Orchids Paper	TIS	Paper Products	10.1%	VERY POOR	-2.3
Noble Energy	NBL	Independent Oil & Gas	1.4%	VERY POOR	-2.3
Viacom	VIA	Media - CATV	2.1%	VERY POOR	-2.1
Teekay	TGP	Shipping	2.9%	VERY POOR	-1.9
Olin Corp	OLN	Chemicals - mid/small	2.4%	VERY POOR	-1.7
Wendy's Co	WEN	Restaurants - Fast Food & Coffee	1.9%	VERY POOR	-1.7
Ashland	ASH	Chemicals - broad	1.2%	VERY POOR	-1.3
Kroger	KR	Food Retailers	2.1%	VERY POOR	-1.1
Molson Coors	TAP	Beverages - alcoholic	2.2%	VERY POOR	-1.1
Ball Corp	BLL	Containers & Packaging	1.0%	VERY POOR	-1.1
Regal	RGC	Media - entertainment	3.8%	VERY POOR	-1.1
Macerich	MAC	REIT - Retail	5.2%	VERY POOR	-1.0
CyrusOne	CONE	REIT - Retail	3.7%	POOR	-1.0

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

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

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Oncology

The oncology division continues to grow at a brisk clip despite the lack of a market-defining blockbuster product such as PD-1 star Keytruda or the lymphoma leader in Imbruvica. The growth of the oncology division can now be viewed as a key growth driver for Novartis with the near-term product pipeline recently bolstered by new entrants such as Kisqali, Rydapt, and the Car-T treatment Kymriah. We view the oncology division as the premier area for additional R&D spend—we are very pleased with the recent approvals which underscore the productivity of Novartis clinical team unlike what is traditional witnessed in other big pharma peers.

The Alcon Spin Off

We are watching with particular interest the turnaround underway at Alcon, the optical division of Novartis. Novartis has issued guidance indicating it is contemplating a spin-off of the division in the first half of 2019, thus ensuring ample time to effect a turnaround in the division. We were impressed with the 7% top-line growth during the first quarter of 2018, coupled with core margin expansion (20.2% versus 16.2% in the prior-year quarter). In our opinion, Novartis may very well spin-off Alcon, as evidenced by the distinct lack of near-term molecules for the treatment of various optic disease states.

On the basis of our review of Novartis' pipeline, the earliest new entry in the field of eye disease is UNR844 and ECF843, with a planned timeline for approval in 2021. We do not give much credence to the potential of the products, as we have yet to see detailed clinical data indicating the long-term potential of the molecules. A quick scan of the near-term pipeline underscores a strong trend: the focus remains on label expansion of current products along with a shift towards immunology and oncology as the key growth drivers.

Role of the Dividend

Though Novartis' portfolio continues to shift around given the JV sale, the acquisition of AveXis, and the potential spin off of Alcon, the company's Dividend Cushion ratio still stands at a healthy 1.5. We continue to monitor the viability of Novartis' clinical pipeline for clues regarding the long-term sustainability of the dividend, however, but the payout looks solid for the foreseeable future. As is the norm for most European-based companies, Novartis pays out its dividend in an annual fashion. The annual dividend of $2.94 per share was paid on April 25, 2018, an 8% increase over the prior year's payout. We remain comfortable with the financial outlook for Novartis in light of the productivity of its near-term portfolio coupled with the growth of its new product portfolio.

Concluding Thoughts

We remain impressed with the overall performance of Novartis in the recently-concluded quarter. We would like to highlight its growing trend towards more of a pure-play pharma company, with a burgeoning pipeline bolstered with an aggressive, yet intelligent tuck-in acquisition in areas of notable strength. We believe the sale of its consumer JV unit to Glaxo is the first step towards the transformation into a pure-play pharma entity. We will continue to monitor events at Novartis with timely updates posted when warranted. The company remains an idea in the simulated Dividend Growth Newsletter portfolio.

Johnson & Johnson Off to a Good Start in 2018

By Brian Nelson, CFA

On April 17, Johnson & Johnson (JNJ) issued a strong first-quarter 2018 report that showed sales increasing 12.6% thanks to a near-20% jump in international top-line performance. On an operational basis, excluding the net impact of acquisitions and divestitures, worldwide sales advanced 4.3% thanks again to an above-average international sales ramp. The company's bottom line fared well during the period, too. Adjusted net earnings and adjusted earnings per share for the first quarter came in at $5.6 billion and $2.06, respectively, both up double digits on a year-over-year percentage basis.

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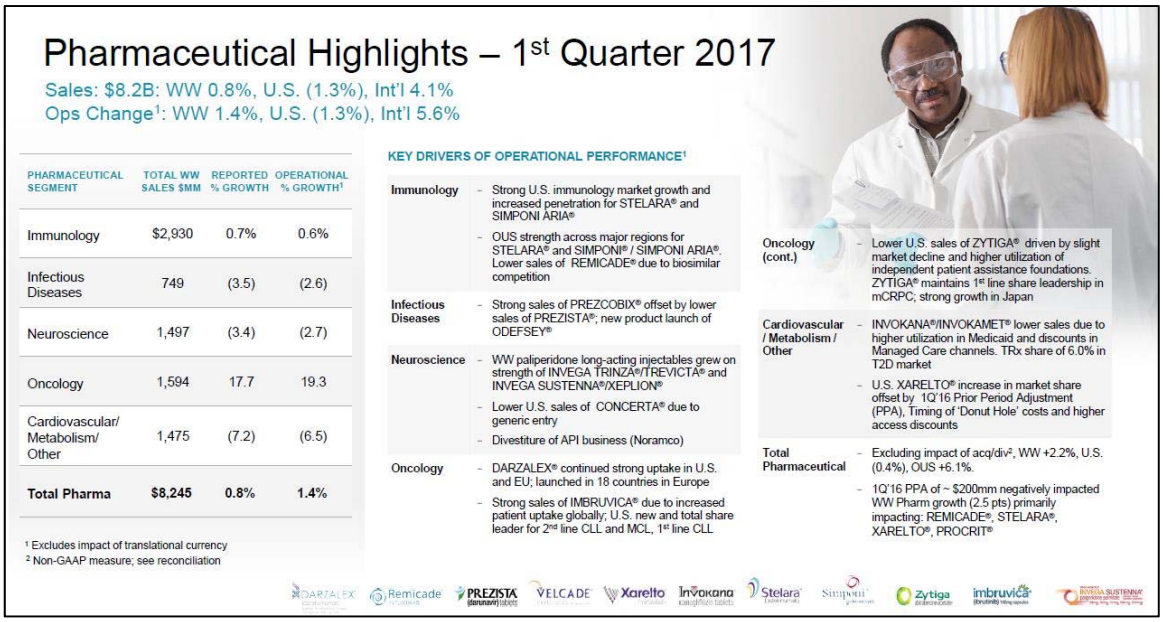

Image source: J&J

Looking ahead to 2018, management is expecting sales to be in the range of $81-$81.8 billion, reflecting strong operational growth to the tune of 4%-5%. Johnson & Johnson also reiterated its adjusted earnings guidance for full-year 2018 to the range of $8-$8.20 per share, reflecting operational growth of nearly 10% at the high end of the range. There was no news about the dividend, but J&J last increased its payout 5% in late April 2017, so we should be expecting something soon.

Though Johnson and Johnson's pharmaceutical portfolio has some risks, "Johnson & Johnson in Transition Mode," the division was the star performer during the first quarter of 2018, with worldwide sales on an operational basis advancing 7.5%. Sales of Simponi, Stelara, Imbruvica, and Zytiga advanced considerably during the period, and revenue from J&J's oncology portfolio leapt 37% on an operational basis during the quarter. We're expecting big things in oncology at J&J, "Key Oncology Assets Powering Johnson & Johnson Higher."

We think most of the headline risk at J&J is coming from consumer lawsuits regarding talc products, but any settlements in that area will be quite manageable, in our opinion, and won't disrupt the company's strong balance sheet. Strong top-line growth and earnings leverage during the first quarter speak to a strong start for 2018 at Johnson & Johnson, in our view, and expectations for ongoing cost cuts may only improve the bottom line. We continue to like Johnson & Johnson and expect good things ahead.

Market Not Overreacting to Hasbro's Miss

By Kris Rosemann

Simulated Dividend Growth Newsletter portfolio idea Hasbro's (HAS) first-quarter 2018 results, released April 23, weren't great as the liquidation of Toys "R" Us in the US and UK and retail inventory overhang in Europe weighed on its top line. The issues impacting its business are not reflective of the underlying health of the business, in our view, and the market has largely recognized this view, too, with its share price moving meaningfully positive intraday April 23 following a fairly considerable premarket dip. Management continues to expect 2018 to be a challenging year, however, as it works to put the short-term disruption of the Toys "R" Us situation behind it and accelerate plans to transform its business for the evolving retail environment. The company expects to drive growth in 2019 and beyond.

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*Market Not Overreacting...*from previous page

Revenue in Hasbro's 'US and Canada' segment fell 19% in the first quarter on a year-over-year basis, while net revenues in Europe dropped 28% from the year-ago period. A net loss of $112.5 million reported in the quarter includes after-tax expenses of $61 million related to the Toys "R" Us liquidation, ~$16 million in severance costs related to the acceleration of the company's commercial organization transformation, and a net charge of nearly $48 million related to US tax reform. Once again, these are not recurring issues, and we do not expect net losses to become a typical occurrence at Hasbro.

The company's attractive 'Entertainment and Licensing' segment, which we view as a key driver in the future trajectory of Hasbro's business, turned in revenue growth of 21% on a year-over–year basis in the first quarter and slightly higher growth in operating income as its operating margin expanded slightly to 21.7%. Company-wide operating margins typically run in the mid-teens and came in at 15.6% in full-year 2017, well below the 'Entertainment and Licensing' segment's margins.

Though the net loss at Hasbro impacted its operating cash flow generation, and ultimately free cash flow, in the first quarter, free cash flow of ~$290 million was sufficient in covering cash dividends paid as well as an uptick in share repurchases. The company is well on track to hit its goal (and may exceed its goal as it was about halfway there after one quarter) of $600-$700 million in operating cash flow in 2018. Its balance sheet remains a non-concern as its total debt of just over $1.7 billion slightly overshadows its $1.6 billion in cash and cash equivalents on the books.

All things considered, we were happy to see the market not overreact to Hasbro's weak quarter, which, in our view, was largely expected, and we continue to include the idea in the simulated Dividend Growth Newsletter portfolio. Free cash flow coverage of the dividend has been solid of late, and we expect management to continue raising the payout (it has hiked the dividend in 14 of the last 15 years, with the lone exception being 2009).

That said, we're keeping an eye on M&A rumors that have suggested Hasbro may be targeting a tie-up with rival Mattel (MAT). A buyout of Mattel may not be the worst case scenario for Hasbro shareholders, but if the company levers up in a meaningful way, capital allocation priorities may shift and income-oriented investors will need to carefully consider the implications. The company's Dividend Cushion ratio is currently a healthy 2.1, and shares yield ~3% as of this writing. Shares look fairly valued and are trading just shy of our fair value estimate of $87 per share.

General Electric Gets a Boost; Honeywell Hikes Guidance

General Electric continues to struggle, but its first quarter earnings report came in better than expected as demand across many of its business was positive. We still have no interest in shares. Meanwhile, Honeywell continues to power ahead as it raised its top- and bottom-line guidance for the full year 2018, reflecting a similarly positive demand profile.

By Kris Rosemann

General Electric Gets a Boost

Embattled industry giant General Electric (GE) continues to work to change its fortunes, and strong demand in a number of its businesses helped the company to beat lowered expectations in the first quarter of 2018, results released April 20. Shares received a nice boost on the news, too, but expectations have been quite beaten down. GE's Aviation, Healthcare, Renewables, and Transportation segments were all areas of strength in the quarter, but Power and Oil & Gas continue to be sources of weakness.

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Total revenue grew 7% on a year-over-year basis in the quarter, and adjusted earnings per share jumped to $0.16 from $0.14 in the year-ago period. Adjusted GE industrial operating margin expanded 60 basis points, and adjusted GE industrial free cash flow improved but still came in at roughly negative $1.7 billion. The company continues to work towards its goal of $20 billion in divestitures in 2018-2019 (it may sell its rail business to Wabtec), and it is still facing challenges from legacy businesses in its discontinued operations as it recorded a reserve of $1.5 billion related to a WMC FIRREA investigation over allegations that GE Capital violated subprime mortgage laws prior to the Financial Crisis. Nevertheless, a robust backlog of $341 billion as of the end of 2017 means it top line has a large degree of resiliency.

GE continues to optimize its cost structure, and it reduced industrial structural costs by $805 million in the first quarter, putting it on track to exceed its 2018 cost reduction goal of $2 billion. Management reaffirmed its guidance for 2018; adjusted earnings per share are expected to be in a range of $1.00-$1.07, and industrial free cash flow is expected to be $6-$7 billion. The company has some ground to make up for following negative free cash flow generation in the first quarter, and our Dividend Cushion ratio of 0.1 is reflective of how confident we are in GE's ability to meaningfully ramp its free cash flow generation back to robust levels. Our fair value estimate sits at $20 per share, and shares yield ~3.4% as of this writing.

Honeywell Hikes Guidance

Honeywell (HON) is off to a strong start in 2018 as its first quarter report, released April 20, revealed solid organic sales growth of 5% over the year-ago period. Strong demand in commercial aviation for original equipment, the US defense market, sales and order growth in Intelligrated (its warehouse automation business), and short cycle process automation were all drivers of the organic growth in the quarter. While GE continues to struggle to right the ship, Honeywell seems to be executing very effectively and is becoming a software-industrial leader as we march forward to "The Next Industrial Revolution" that is the Industrial Internet of Things.

The company was able to expand its segment margin 40 basis points in the first quarter thanks to its Commercial Excellence efforts and the Honeywell Operating System, which led to material productivity and volume leverage. Earnings per share excluding separation costs (it is preparing to spin-off its Transportation Systems and Homes business by the end of 2018) jumped 14% from the year-ago period to $1.95, and free cash flow excluding separation costs jumped 30% to ~$1 billion, nearly double cash dividend obligations of $556 million in the quarter. Honeywell's Dividend Cushion ratio checks in at 2.6 as of the most recent update, and shares yield ~2% as of this writing. Net debt was ~$8 billion at the end of the first quarter.

Management took the opportunity after its strong first quarter to raise guidance thanks to its healthy demand outlook and confidence in its execution. Organic revenue growth in 2018 is now expected to be 3%-5% (was 2%-4%), earnings per share guidance has been raised to a range of $7.85-$8.05 (was $7.75-$8.00), and the lower bound of free cash flow expectations was raised by $100 million to bring guidance to $5.3-$5.9 billion.

We have been impressed by Honeywell's ability to execute effectively, and its businesses have been helped along the way by a strong demand profile. The company is well-positioned to take advantage of GE's recent missteps, and the Industrial Internet of Things represents a meaningful opportunity for it to continue this trend, as evidenced by the positive trends in its warehouse automation business and progress in its transition to a software-industrial leader. Shares are trading in the upper half of our fair value range as of this writing and at nearly 19 times the midpoint of management's 2018 earnings guidance. Our updated fair value estimate for shares currently sits at $148.

Procter & Gamble Pressured By Pricing

By Kris Rosemann

Shares of former simulated Dividend Growth Newsletter portfolio idea Procter & Gamble (PG) hit their lowest mark since early 2016 in the trading session April 19 following its fiscal 2018 third-quarter report. We believe the company may have made its transition to a more-focused entity too rapidly as it continues to navigate multiple difficult operating environments around the globe. Its strategy to focus only on its highest-quality brands in its core markets was intended to reveal a stronger, more efficient company that held the strongest of its once-massive brand portfolio, which should translate the retention of pricing power via refined brand strength.

That wasn't the case in the most-recently reported period at Procter & Gamble, however. Organic sales at Procter & Gamble grew 1% in the third quarter of fiscal 2018 on a year-over-year basis as volume growth of 2% and favorable product mix of 1% (largely thanks to an increase in premium beauty product sales) were partially offset by a 2% decline in pricing. The pressure on pricing was primarily due to price reductions in its US shave care portfolio, and management was quick to note that its pricing trajectory should improve as it enters next fiscal year. We're not completely convinced, however, and we'll be monitoring pricing trends at Clorox (CLX), Kimberly-Clark (KMB), Church & Dwight (CHD), Colgate-Palmolive (CL), and Unilever (UN, UL), among others, for incremental information.

Though net sales advanced 4% in the quarter from the year-ago period thanks to favorable foreign currency-exchange fluctuations, the combination of weakened pricing, muted organic sales growth, and a contracting gross margin are not indicators of confidence in what is supposed to be a refined and strengthened brand portfolio. Currency-neutral core gross margin contracted 90 basis points in the fiscal third quarter as 230 basis points of productivity savings were more than offset by increases in commodity costs, unfavorable geographic and product mix (including an increase in transportation costs), unfavorable pricing, and innovation reinvestments.

Nevertheless, Procter & Gamble's free cash flow performance through three quarters in fiscal 2018 has been impressive as the measure advanced 15% from the comparable period of fiscal 2017. Such strength gave management the confidence to raise its annual dividend for the 62nd consecutive year, a track record matched by few others. The company's balance sheet health might give the most debt-averse investors a reason for pause, however as its cash balance of ~$15.5 billion as of the end of the third quarter of fiscal 2018 is easily overshadowed by its total debt load of ~$35.3 billion. However, its net debt load of ~$19.8 billion implies a net debt-to-annualized EBITDA ratio of just over 1.1x.

Management's decision to acquire the Consumer Health business of Merck KGaA, Darmstadt, Germany (MKKGY) for €3.4 billion, or ~$4.2 billion, shows its willingness to grow inorganically, even after the recent portfolio transformation. However, the deal comes with the announcement of Procter & Gamble's decision to terminate its consumer health JV with Teva Pharmaceuticals (TEVA) on July 1 of this year, a decision that came following a review of Teva and Procter & Gamble that revealed differing priorities and strategies.

Merck KGaA's portfolio of OTC remedies for muscle relief, joint and back pain, colds and headaches, among others, should complement the existing assets Procter & Gamble will retain following the break-up of its JV with Teva, and management expects the business to provide it with adequate scale it needs to operate a global OTC business without the help of a healthcare partner. Merck KGaA's key markets include Europe, Latin America, and Asia. The purchase price of €3.4 billion implies a trailing EBIT multiple of more than 34 times 2017 EBIT, a bit pricey, but roughly in-line with the average trailing EV/EBIT multiple for healthcare product firms of approximately 35 times, according to NYU Stern. Merck KGaA had been looking to divest the business for some time, and it appears as though Procter & Gamble has agreed to pay a fair value—perhaps a bit more than fair value.

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Regardless of the developments related to its Consumer Health business, Procter & Gamble has its work cut out for it moving forward. Price reductions have helped volume performance, but a core tenet of its portfolio transformation strategy was refocused brand power, which it has yet to be on display in a sustained and meaningful way since the shift. Gross margin pressures only add to our concerns, but the company remains a strong free cash flow generator with one of the strongest dividend track records available. Fiscal 2018 guidance points to expectations for solid performance but nothing to get excited about. Organic sales growth is expected to be 2%-3%, and core EPS growth guidance was raised to 6%-8% after the fiscal third quarter from previous guidance of 5%-8% growth.

Procter & Gamble will continue to be a consumer staples bellwether, but we are content with our decision to rid the simulated Dividend Growth Newsletter portfolio of shares in early April at $77.93 per share as it continues to work through multiple challenging operating environments and get a better grasp on its "new" business. Shares yield ~3.8% on a forward-looking basis as of this writing.

Kinder Morgan Back on Track But We're Watching Financial Statements Closely

Kinder Morgan says it is paying dividends out of internal free cash flow generation, which should remove capital-market dependency risk. Shares look attractive in the mid-teens, though we're not in any hurry to add them to either newsletter. We'll be watching its financial statements closely through the course of the year.

By Brian Nelson, CFA

After the market closed April 18, Kinder Morgan (KMI) reported decent first-quarter 2018 results that showed operating income of $949 million, slightly lower than the $977 million achieved in the year-ago period, but pre-tax income that advanced 2.2%. Net income increased to $542 million from $445 million, but the vast majority of the improvement came from a lower effective tax rate thanks to the new tax laws coming into play for the new year. Short- and long-term debt were $2.5 billion and $34.7 billion at the end of the quarter, while the company's cash balance remained minimal at just under $300 million, good for $37 billion in net debt, including 50% of KML preferred shares. Net debt to adjusted EBITDA was 5.1x at the end of the period.

The organic performance was as-expected, in our view, and the company's leverage is still a bit on the high end of what we would like, but Kinder Morgan has always been a debt-fueled "story." The lower tax bill helped Kinder Morgan raise its dividend 60%, to $0.20 per quarter ($0.80 annualized), and we like that its income performance is getting back on track following the "cut heard 'round the world." In 2015, Kinder Morgan once paid a quarterly dividend of $0.51 per share. Executive Chairman Richard Kinder is optimistic that even with the dividend hike, the company expects to internally fund its growth. We take this to mean that Kinder Morgan's free cash flow generation, as measured by cash flow from operations less all capital spending, will be greater than future expected cash dividends paid.

For 2018, Kinder Morgan is looking to achieve adjusted EBITDA of $7.5 billion, and the company is on pace to exceed that level on the basis of its reported adjusted EBITDA of $1.9 billion during the first quarter of 2018. The pipeline giant expects to spend as much as $2.3 billion in growth projects this year, and management reiterated that it will not require outside capital to do so. We'll be paying close attention to the balance sheet and cash flow statement through the course of the year. Total debt should not increase, and net new equity issuance should not show up in the financing section of the cash flow statement.

We think Kinder Morgan ripped the Band-Aid off at the beginning of 2016 to start its rebuilding campaign,

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and thus far, things are looking up. We think the company is better insulated from any disruptions in the capital markets because of its more conservative internal growth financing, and in the event that energy markets swoon, Kinder Morgan is better positioned than its midstream MLP brethren given that it is no longer capital-market dependent, though its huge debt load still presents leverage/refinancing risks. Our fair value estimate for shares stands at $20.

Philip Morris Shocks the Tobacco Space But Why?

By Brian Nelson, CFA

The market seems like it has gone "mad," with Philip Morris trading off nearly 20% following its first-quarter report April 19. The company beat on the bottom line, while revenue roughly came in-line for the period, and the cigarette maker raised its full-year diluted earnings per share forecast to be in a range of $5.25-$5.40, above consensus forecasts of $5.26 and representing ~35%-39% growth versus the $3.88 mark in 2017. The regulatory landscape in tobacco remains in influx, with the FDA looking to set maximum nicotine levels in cigarettes, new rules on menthol tobacco, and revised rules for e-cigs, but this sell-off in shares of Philip Morris may make little sense as the company conducts business outside the US.

Reports are suggesting that investors had been banking on Philip Morris' smokeless (vapor) tobacco system, iQOS, to offset declines in core traditional smoking, and while the first-quarter report may have disappointed some in that department, one quarter the long term does not make, especially with a company that raised its full-year earnings per share guidance mark above consensus. We think investors may be rushing to make a determination on the progress of iQOS, which heats rather than burns tobacco, and extrapolating shortfalls over the long haul, something that we think is premature. Given the stock price decline, we almost feel like we're looking at different numbers than the market on a completely different company. Heated tobacco unit shipment volume of 9.6 billion units was up 5.1 billion units versus the same period in 2017.

Philip Morris is targeting a whopping $9+ billion in operating cash flow during 2018 and capital expenditures of $1.7 billion, good enough for free cash flow expectations of $7.3 billion for the year. The tobacco company has a strong capital structure and garners A2/A credit ratings from S&P and Moody's, respectively. Furthermore, even in its slide deck, Philip Morris says "IQOS (is) performing exceptionally" with "strong sequential quarterly share growth across launch markets." Though we assign Philip Morris a Dividend Cushion ratio of 0.6, and we think its dividend metrics could be better, it's way too early to say its dividend is in jeopardy.

Simulated newsletter portfolio holding Altria (MO) faces unique risks with respect to US regulation, but we don't think a 5.1 billion-unit jump in heated tobacco during the first quarter of 2018 from Philip Morris is necessarily a bad thing, and the damage to the equity prices of industry constituents seems unsubstantiated. The market is overreacting to Philip Morris' first-quarter report, in our view, but our fair value estimate of Philip Morris stands at $84 per share, now about where shares are trading following the sell-off. We're not making any changes to our fair value estimates of tobacco companies at this time.

Demand Bouncing Off Multi-Year Bottom at Caterpillar

By Kris Rosemann

It may seem like an eternity ago, but as recently as 2016, Caterpillar (CAT) was at the tail end of its only stretch of four years of consecutive annual sales declines in more than 90 years of business. The demand environment for the heavy machinery giant's products has improved drastically since then, and the company's shares initially jumped following its April 24 earnings report, which was full of positive developments surrounding demand and a significant profit guidance hike. The rally, however, was short-lived after management's commentary on first-quarter margin performance not being sustained throughout the full year 2018 hit the wires.

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Caterpillar reported 31% revenue growth on a year-over-year basis in the first quarter of 2018, driven by strength across its three major segments. Adjusted profit per share more than doubled from the year-ago period to $2.82, and operating profit exploded to $2.1 billion from $380 million in the comparable period of 2017. However, cash flow from operations was pressured in the quarter, due in part to a significant decrease in accrued wages, salaries, and employee benefits. Nevertheless, free cash flow came in positive in the quarter, but at $178 million, it compared unfavorably to cash dividends paid of $467 million.

Caterpillar's strong first-quarter results stemming from higher demand across all regions and most end markets led management to raise its 2018 profit outlook range to $9.75-$10.75 from previous guidance of $7.75-$8.75. Better-than-previously-expected sales volume is the key driver of the increased outlook, but any potential impact from geopolitical risks and increased trade disruptions have not been factored in the outlook, which have a real possibility to provide headwinds.

Improved price realization is expected to be partially offset over the course of the year by growing material costs largely due to higher commodity prices, which is also a key driver of demand for its own products, the latter of which did not have as meaningful of an impact on Caterpillar's performance in the first quarter of the year. As a result, the first quarter is expected to be the strongest period of 2018, and management acknowledging as much sent shares tumbling during the April 24 trading session.

In its 'Construction Industries' segment in 2018, the company expects growth across all regions to be led by construction activity in North America and infrastructure development in China. The EAME (Europe, Africa, and Middle East) region is expected to continue growing in 2018 alongside business confidence and stability in oil-producing countries, while the ongoing recovery in Latin America is expected to continue.

Caterpillar expects mining companies to increase capital spending in 2018 for both equipment replacement cycles and expansions as global economic conditions and favorable commodity prices allow for larger budgets. Global demand for commodities should also help drive a positive operating environment for heavy construction, quarry, and aggregate customers, and higher machine utilization levels from customers across its 'Resource Industries' segment is expected to push aftermarket parts growth.

The company's 'Energy & Transportation' segment continues to benefit from the improvements in the energy resource pricing markets, and positive demand for reciprocating engines in the North American oil & gas market is expected to lead segment growth in 2018. The midstream space continues to support Caterpillar's backlog of turbines, and an increase in rail traffic in North America has reduced the number of idle locomotives and railcars, which should translate into an increase in rail services revenue at Caterpillar. 2018 is also expected to mark the turnaround in its Power Generation sales after multiple challenging years.

Though it may not be an immediate concern, we're keeping an eye on Caterpillar's debt load, which includes more than $27.3 billion in Financial Products debt as of the end of the first quarter. A tightening credit cycle alone may not be cause for concern, but should rising borrowing rates be accompanied by a material disruption in Caterpillar's end markets, which we saw in record-length fashion as recently as the period 2013-2016, such a debt load could spell trouble for the firm. It is worth noting, however, that total debt related to its Machinery, Energy, and Transportation businesses (i.e. non-financial related) came in just under $8 billion at the end of the first quarter, which is only slightly higher than its cash balance of nearly $7.9 billion.

Caterpillar's near-term demand outlook is undoubtedly stronger, and its profit guidance hike for 2018 was encouraging, even if it may not repeat the margin performance turned in in the first quarter. Relatively weak free cash flow generation is not a significant cause for concern on the basis of one quarter, and we would expect it to more or less catch up to the relative strength of management's other performance expectations over the course of the year. We've raised our fair value estimate to $137 per share, and Caterpillar's Dividend Cushion ratio currently sits at 2.3 (adjusted for Financial Products debt) as shares yield just over 2% as of this writing.

Digital Realty Raises Core FFO Guidance

By Kris Rosemann

Digital Realty (DLR) continues to benefit from the secular trends driving data center demand. The Cisco Global Cloud Index estimates that the number of hyperscale data centers will almost double, hyperscale data centers will make up over half of all data center servers, and hyperscale data center traffic will quadruple by 2021. North American data center construction continues at a solid rate, but the new supply is being rapidly absorbed by the market. Management estimates that the North American data center space is roughly at equilibrium with a national vacancy rate of 10%.

In the first quarter of 2018, revenue at Digital Realty leapt 35% on a year-over-year basis, and core funds from operations per share advanced 7% from the year-ago period to $1.63. Rental rates on renewals in the first quarter were 3.9% higher than the comparable period of 2017 on a cash basis, and management noted growing local origination in key growth markets around the world as reason for optimism related to lease renewals and new bookings. The REIT held more than $9.1 billion in total debt at the end of the first quarter, good for a net debt-to-adjusted EBITDA ratio of 5.3x, and its fixed charge coverage was a healthy 4.3x.

In early March, Digital Realty approved a 9% dividend increase, and 2018 marks the thirteenth straight year in which it has raised the payout, each year since its IPO in 2004. The company does not expect to have to tap the outside capital markets for development capital in 2018, instead funding its $1 billion development budget for the year with cash flow from operations and proceeds from asset sales. Shares yield ~3.75% as of this writing.

Coca-Cola's Free Cash Flow Generation Could Be Better

Coca-Cola reported messy first-quarter 2018 results, making an assessment of its underlying free-cash-flow generation paramount. Coverage of cash dividends with free cash flow generation has become rather tight in recent years, and the company's net debt position isn't exactly encouraging. Very few companies have the competitive advantages and dividend growth track record of this tried-and-true beverage giant, however.

By Brian Nelson, CFA

On April 24, beverage giant Coca-Cola (KO) reported non-GAAP organic revenue growth of 5% in its first-quarter 2018 results. The headline number of a 16% decline in net revenue may be disturbing at first glance, but most of the decline came from refranchising/divesting its bottling operations. At the core, concentrate sales growth came in at 4% while price/mix growth came in at 1% during the period. It was good to see both volume and price moving in the right direction at Coca-Cola. A byproduct of refranchising/divesting its lower-margin bottling operations is higher levels of profitability, and that's precisely what we saw during the period, with non-GAAP operating margins expanding 600 basis points. Operating cash flow dipped 20% in the quarter reflecting the benign divestitures of its bottling operations, but free cash flow improved modestly, advancing 5% on a year-over-year basis thanks entirely to its more capital-light operations (reduced spending).

Coca-Cola's competitive advantages rest on two distinct considerations: its strong brand name and its sprawling distribution network. The company's One Brand Strategy, for example, helped drive 3% growth in brand Coca-Cola volume and an incredible double-digit pace of volume expansion in Coca-Cola Zero Sugar during the period. The company continues to innovate, too. Volume growth of Diet Coke, for example, is now increasing in North America again thanks to the company's launch of four new flavors that came with a sleek design and innovative marketing. When you talk about Coca-Cola's distribution network, the company's products are almost everywhere. The quarter, for example, saw strong performance in Turkey and South Africa and weakness in Nigeria and Western Europe. It achieved mid-single-digit growth in Brazil, Argentina, and Mexico, along with strong performance in China and India during the period. Volume in its 'tea and coffee' segment advanced 5% during the first quarter of 2018.

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Looking ahead, reported performance at Coca-Cola will continue to messy as it works through refranchising/divesting initiatives and as new tax laws are implemented. However, the company is guiding for ~4% growth in organic revenue on a non-GAAP basis, and 8%-9% expansion in comparable currency-neutral operating income. As its accounting statements digest a number of dynamics during 2018, we think close attention to the cash flow statement may be most informative. Operating cash flow is targeted at $8.5 billion, while capital expenditures are expected to come in at $1.9 billion. We'll be watching free cash flow performance very closely this year, and we'd view any shortfall as a disappointment. In recent years, Coca-Cola's free cash flow has fallen to $5.3 billion in 2017 from ~$8 billion in 2015, as the company's endeavors to become less capital-intensive haven't helped free-cash-flow generating capacity at all.

The company's target for free-cash-flow generation during 2018 is $6.6 billion, barely north of the $6.3 billion it paid out in dividends last year. Total debt at Coca-Cola stood at $34.5 billion while total cash stood at $15.4 billion, as of the end of 2017, revealing a considerable net debt position. Dividend growth investors should be taking a more cautious look at Coca-Cola's operations, in our view. The company's Dividend Cushion ratio stands at 1.1, as this tried-and-true beverage giant continues to walk a fine line. Despite our concerns about the tight coverage of cash dividends paid with free cash flow and Coca-Cola's large net debt position, very few companies come with greater competitive advantages and a better dividend growth track record. We like Coca-Cola a lot, but we'd like to see better free-cash-flow generation and reduced leverage on the balance sheet. Look for more credit downgrades in coming years, in our view. Shares yield ~3.5% at the time of this writing.

Dividend Growth Portfolio: Adding Two New Gems

By Brian Nelson, CFA

We decided to remove Boeing (BA) and Procter & Gamble (PG) from the Dividend Growth Newsletter portfolio recently. You can view the Dividend Growth Newsletter notification log here. We still like both companies a lot. Boeing has a fantastic position and an inherently hedged business portfolio, while Procter & Gamble still retains some of the best consumer brands, even after a rather aggressive brand simplification process. However, Boeing has run too far too fast, and we can't rule out P&G turning into another General Electric (GE) given its decision, too, to shrink its brand exposure.

We're replacing those two stalwarts with two key players off the bench. We've long been fans of Digital Realty Trust (DLR) and Oracle (ORCL), and we're finally giving these two dividend growth ideas the nod. Remember, you can access all of our information on these companies on their respective landing pages, from our estimate of their intrinsic value, our calculation of their Dividend Cushion ratios, and what we think of their business models. We're setting Oracle in the 2.5%-4% weighting bands and Digital Realty Trust in the 4%-5.5% weighting bands, replacing the weightings for Boeing and Procter & Gamble, respectively.

If you haven't checked out our quarterly Dividend100, it is an awesome publication to sort through dividend ideas in just one pdf. The second-quarter 2018 edition can be downloaded here (pdf). Make sure that you are on the financial adviser level membership plan to keep receiving this publication. You could be paying as much as $400-$600 a year just to hold an index fund ETF on a $100,000 account. That's about what it costs for the financial adviser level membership plan for a full year, and we're actually doing research!

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.

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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 Foods (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.

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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 2017) 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 the Valuentum Dividend Cushion…*on next page

About the 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 Dividend Cushion Ratio Helps Income Investors

$$\frac{\sum_{t=1}^{5}[A(t) - B(t)] + C(0) - D(0)}{\sum_{t=1}^{5} E(t)}$$

A = cash flow from operations (from the operating section of the cash flow statement),
B = capital expenditures or additions to property plant and equipment (from the investing section of the cash flow statement),
C = cash and cash equivalents (from the balance sheet),
D = long-term debt (from the balance sheet), and
E = cash dividends paid (from the financing section of the cash flow statement).

"All else equal, a firm with billions of net cash on the balance sheet is better positioned to keep paying a dividend than a firm with billions of net debt on the balance sheet. More cash on the books relative to debt reveals significantly more financial flexibility. The dividend payout ratio ignores this important concept, while the Dividend Cushion ratio embraces it." – Valuentum's Brian Nelson, CFA

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

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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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