OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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The Best Ideas Portfolio (see page 8): AAPL, MO, BRK-B, BKNG, CMG, CSCO, DG, FB, GM, GILD, GOOG, XLV, INTC, JNJ, PYPL, SDY, XLE,VRNT, V

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"While others have grown more confident in their skills during this bull market, we'll never confuse a bull market with brains, and we know that our biggest value add for our members will come when the going gets tough."

– Brian Nelson, CFA

10 Years Since the Fallout

September 15 marks 10 years since one of the worst days in financial history. The Dow stood at 11,421.99 this date in 2008. How far we have come…

By Brian Nelson, CFA

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Goal of the Best Ideas Newsletter

The goal of the Best Ideas Newsletter is to highlight ideas with strong capital appreciation potential and to update readers about new developments in the market. A simulated portfolio of capital appreciation ideas is presented on page 8 of each edition.

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"The American financial system was shaken to its core on Sunday. Lehman Brothers Holdings Inc. faced the prospect of liquidation, and Merrill Lynch & Co. agreed to be sold to Bank of America Corp. The U.S. government, which bailed out Fannie Mae and Freddie Mac a week ago and orchestrated the sale of Bear Stearns Cos. to J.P. Morgan Chase & Co. in March, played much tougher with Lehman. It refused to provide a financial backstop to potential buyers. Without such support, Barclays PLC and Bank of America, the two most interested buyers, walked away. On Sunday night, Bank of America struck a deal to buy Merrill Lynch for $29 a share, or about $44 billion. Lehman was working on a possible bankruptcy filing that would allow most of its subsidiaries to continue operating as the firm is wound down." – The Wall Street Journal, September 15, 2008

It was shocking.

During most of the Financial Crisis of late last decade, I was working at Morningstar. It was truly a unique time. I wasn't yet 30 years old then, but I feel like I aged a few decades during the tumultuous times of 2008-2009. At the time I was overseeing methodology and analyst training at Morningstar, and I thought I knew it all.

But I learned lessons during the Financial Crisis that I will never forget:

1. Banks are driven on pure confidence. Seemingly nothing more, nothing less.
2. Capital-market dependency can be a wrecking ball to equity prices (think MLPs).
3. Stock prices contain valuable information that can't be found in GAAP fundamentals.
4. Moral hazard is often not punished, and sometimes it is rewarded by non-market forces (e.g. the government).
5. When things go bad, they really go bad, and diversification and correlations often break down at the exact time that you need them most.

I learned a lot more than this, of course, but these are the top lessons that come to mind. It's easy to say that people overreacted to the events of 10 years ago, but the global financial system truly was looking down at the abyss. US gross domestic product was plummeting, unemployment was skyrocketing, and nobody was lending to anybody. Everybody was afraid that everybody else held toxic assets, and they couldn't even be confident that their own financials were sound. Many a book has been written about the causes and the aftermath of the Financial Crisis, but it truly was a mess.

In 2009-2010, I thought the stock market would never be the same, probably as much as I thought that we may never see another Republican President elected for at least a half dozen terms or more following the bad rap given to the Bush II administration. But it's incredible. Today, 10 years later, the Dow Jones Industrial Average stands at 26,154.67, up from 11,421.99 on September 15, 2008, and Donald Trump is President. People are indexing as if the stock market only goes up in the long run (and stock selection doesn't matter), and cryptocurrencies and cannabis stocks are all the rage. I remember the depths of the Financial Crisis like yesterday, but the markets sure seem like they don't.

I must say that I'm very thankful. For one, I'm thankful to all of our members. We've been prudent and cautious for the 7+ years of our existence (perhaps overly so), but we think we've done a great job when it comes to stock selection and highlighting the market's risks in this newsletter. An analyst's job is not to pump stocks or defeat another's thesis, but rather to paint the picture of an idea as balanced as possible. If everyone's bullish, it's time to break out the risks. If everyone's bearish, it's time to break out the opportunities. In valuation as in life, balance is what matters the most, and that's what we seek to bring in all aspects of Valuentum.

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I can't believe what I'm seeing nowadays. Respected money managers on CNBC telling listeners, whose financial profiles and risk tolerances they know nothing about, to call their brokers on the phone and start buying a particular stock. Renowned short sellers yelling "fraud" even though there may or may not be. CEOs tweeting about going private and then rescinding the offer, causing whiplash in the market. Advisors recommending index funds to scale their businesses, and yet, not even a mention of this potential conflict of interest or warning from regulators. I've been in this business a long time, but I must say, as a professional, the times are certainly changing – and maybe not for the better. It's worrisome.

But that may be neither here nor there. At Valuentum, we're going to keep working hard, and we're going to keep doing the best intrinsic value and dividend growth analysis we possibly can. While others have grown more confident in their skills during this bull market, we'll never confuse a bull market with brains, and we know that our biggest value add for our members will come when the going gets tough. Thank you for your membership, and I hope that you enjoy this September edition of the Best Ideas Newsletter.

Verint Raises Guidance

Shares of simulated Best Ideas Newsletter portfolio idea Verint surged after hours September 5 following a strong fiscal second quarter report.

By Kris Rosemann

Simulated Best Ideas Newsletter portfolio idea Verint (VRNT) turned in an impressive second quarter report September 9, and shares leapt in after-hours trading after management raised its full year top- and bottom-line guidance. The company's focus on actionable intelligence in customer engagement and cyber intelligence, which includes high-growth areas such as analytics, artificial intelligence, and automation technologies, is being met by strong demand as evidenced by its 11% year-over-year revenue growth reported in the quarter.

Non-GAAP revenue in its 'Customer Engagement' segment (~66% of total revenue) advanced 10.6% from the year-ago period, and its 'Cyber Intelligence' segment turned in ~11.4% year-over-year revenue growth in the period. Non-GAAP operating income in the quarter came in at $63.4 million compared to $45.6 million in the year-ago period, and its non-GAAP operating margin expanded more than four percentage points to 20.6%. Non-GAAP diluted net income per share in the quarter grew to $0.76 from $0.61 in the comparable period of the prior fiscal year.

Though Verint continues to report a material difference in its GAAP and non-GAAP income figures, we remain confident in its financial performance thanks to its robust free cash flow generation. In the six months ended July 31, 2018, it reported free cash flow of just over $83 million, up from $82 million in the year-ago period despite a ~26% increase in purchases of property and equipment and capitalized software development costs (cash flow from operations grew nearly 6%). The company's balance sheet remains relatively healthy given its cash-flow generating capacity with a net debt position of ~$377 million as of the end of its fiscal second quarter, which is down from ~$417 million at the beginning of the fiscal year.

Verint's material guidance increases that accompanied its fiscal second quarter report helped drive shares significantly higher in after-hours trading September 5. Total revenue guidance for the full fiscal year was raised to $1.24 billion from $1.23 billion, and it now expects it 'Customer Engagement' and 'Cyber Intelligence' segments to grow revenue by 7% and ~10%, respectively, compared to prior expectations for mid-single-digit and 10% revenue growth. Diluted earnings per share guidance was raised to $3.15 from $3.09 previously, which represents ~12% year-over-year growth.

We plan to continue highlighting Verint as an idea in our simulated Best Ideas Newsletter portfolio, and we're sticking with our fair value estimate of $54 per share for the time being. The company's recent guidance increase may put the upper bound of our fair value range in play for shares if it continues to deliver on its recent momentum, especially as it relates to margin expansion. Shares were initially highlighted in the simulated Best Ideas Newsletter portfolio at $38.95 in April 2017.

Dollar General Keeps Growing; Guidance Raised

Image shown: Dollar General's share price performance since early 2017. It was first highlighted in the simulated Best Ideas Newsletter portfolio in April 2017.

Simulated Best Ideas Newsletter portfolio idea Dollar General turned in a solid fiscal second quarter report and subsequently raised its top-line guidance. Shares have advanced nearly 60% since we first highlighted the company, and its business continues to be a model of consistency.

By Kris Rosemann

Simulated Best Ideas Newsletter portfolio idea Dollar General (DG) continues to drive its top line higher, and its consistently positive same-store sales growth over the past nearly three decades has been nothing short of impressive. Its fiscal 2018 second quarter report, results released August 30, only reaffirmed such a notion. Strength in consumables, seasonal, and apparel categories helped drive same-store sales growth of 3.7% from the year-ago period, which was partially offset by weakness in the home category. Both average transaction amount and customer traffic were higher in the period, and strong same-store sales growth helped drive net sales to 10.6% growth on a year-over-year basis.

Dollar General's gross margin faced slight pressure (contracted by seven basis points) in its fiscal second quarter as a result of a higher mix of consumables sales, higher markdowns, and increased transportation costs, which were partially offset by improved inventory management and higher initial markups, but SG&A spending as a percentage of revenue fell to 22.2% in the quarter from 22.3% in the year-ago period. A significantly lower tax bill also helped the company realize materially improved bottom-line results as net income came in at $407 million in the quarter compared to $295 million in the prior-year period and diluted earnings per share leapt 40.7% from the comparable quarter of fiscal 2017 to $1.52.

The company's bottom-line growth translated nicely onto its cash flow statement as cash flow from operations through the first 26 weeks of the fiscal year came in nearly 40% higher than the comparable period of fiscal 2017, and free cash flow jumped roughly 64% on a year-over-year basis to $776 million despite capital spending growing more than 18%. Cash dividends paid in the first half of fiscal 2018

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came in at ~$155 million, suggesting ample coverage of dividends with free cash flow, even after considering the $350 million in repurchases of common stock in the period. Though not a core part of our rationale for highlighting shares of Dollar General in the simulated newsletter portfolio, we view its dividend as healthy given its free cash flow coverage, despite its net debt position of ~$2.5 billion as of the end of the second quarter of fiscal 2018. Shares yield ~1.1% as of this writing.

Dollar General raised its fiscal 2018 guidance following its strong second quarter, and it now expects net sales to grow 9%-9.3% (was 9%). It also raised its same-store sales growth expectations to the mid-to-high two percent range (was mid-two percent range), but its operating margin is still expected to be roughly flat with that of fiscal 2017. The company also reiterated its diluted earnings per share guidance in a range of $5.95-$6.15, and it still plans to open ~900 new stores, remodel ~1,000 stores, and relocate 100 stores in fiscal 2018.

Shares of Dollar General are currently trading in the upper half of our fair value range, and we expect to continue highlighting the company in our simulated Best Ideas Newsletter portfolio. The company's track record of consistency cannot be ignored, and we're comfortable letting this idea continue to showcase its strength in the face of the proliferation of e-commerce, which has yet to make its way to the dollar store discount space.

Ford Facing Bumpy Road

The second-largest US automaker is facing a number of challenges in its business, and Moody's recently cut its credit rating to one notch above junk status. Let's take a look at the factors at play behind the downgrade.

By Kris Rosemann

There are a number of moving parts at Ford (F) these days, and the uncertainty surrounding the uphill climb it is facing has resulted in speculation over a potential dividend cut and a credit downgrade from Moody's. The company's plan to cease nearly all production of cars for the US market caught many investors by surprise, and it continues to struggle in multiple international markets. The most recent headline it made was the release of its August sales numbers in China, which fell 36% on a year-over-year basis in the month and are down 27% in the year-to-date period. Management has noted that plans for market-specific vehicles are well on their way, something that will be necessary for the company to regain recent market share losses.

Ford is also facing lower levels of profitability in the ever-important North American market, where its EBIT margin fell 210 basis points from the year-ago period in the second quarter of 2018, to 7.4%, due in part to higher input costs. It also conceded some market share in the region in the second quarter (now just under 14% as of the first half of 2108) as a result of lower sales to rental companies and other fleet. The company is targeting a 10% EBIT margin via cost improvements and a focus on trucks and SUVs, but its first half 2018 mark of 7.6% suggests there is considerable work to be done.

Other international markets are giving Ford headaches as well, including its South American operations, which turned in a $784 million pre-tax loss in 2017 and EBIT of negative $327 million in the first half of 2018. Europe presents its own unique set of challenges as a result of "Brexit" looming over the space, which may only add to recent losses in the region as a result of Ford's presence in the UK. One factor in our preference of simulated newsletter portfolio idea General Motors (GM) over Ford has been GM's recent sale of its European operations.

In addition to the aforementioned developments, Moody's cites multiple weakened credit metrics as drivers in its credit rating downgrade of Ford to Baa3 from Baa2. According to Moody's, the company's debt-to-EBITDA has risen to 3.3x as of the end of the second quarter of 2018 from 2.6x at the end of 2016, while its EBITA-to-interest has fallen to 1.8x from 4.5x and its EBITA margin has contracted to 2.0% from

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4.2%. Its outlook remains negative as a result of the above challenges.

We recently began calculating an adjusted Dividend Cushion ratio for Ford in an attempt to be less punitive on its financial services operations, and that adjusted measure currently sits at 1.4. However, given the number of challenges facing the business and the uncertainty that lies ahead, the company's unadjusted Dividend Cushion ratio of -1.26 should also be noted by investors (a dividend cut can't be ruled out), and its elevated yield of ~6.5% is largely a function of its depressed stock price than any sort of fundamental strength. Moody's notes that it may be forced to revisit the rating for another potential downgrade should Ford not make clear progress in its Fitness initiatives by early to mid-2019.

We're keeping a close eye on the developments at Ford, and we continue to prefer shares of rival GM, which we believe is well-positioned to lead the US auto market into the next generation of vehicles with its GM Cruise program. Shares present an interesting valuation opportunity, in our opinion, and the company's adjusted and unadjusted Dividend Cushion ratio are both considerably higher than that of Ford at 3.5 and 1.58, respectively. Shares of GM yield ~4.5% as of this writing.

In The News

Let's take a look at some of the top stories across the markets in recent weeks.

By The Valuentum Team

Let's get one thing straight: we have a tremendous amount of respect for Elon Musk.

He is a tremendously successful person and entrepreneur, but some of the things he has done during the past few months have been puzzling. We think we might be able to understand some of the pressures involved in running a business and trying to satisfy a growing list of customers (and skeptics), but what makes Elon Musk different is that he is a CEO of a publicly-traded company, and that means he has to be extremely careful in how he communicates publicly to all of his stakeholders.

From tweeting that he was considering taking Tesla (TSLA) private at $420 per share and that he had funding secured to a variety of other unusual spats on Twitter (TWTR), things have taken a turn to the absurd. We like Elon's vision and perseverance, but from securities-related lawsuits to ongoing operational hurdles and cash burn, it is really difficult to be a shareholder of Tesla these days. Has this new car company with a grand idea finally met its match? We value shares at ~$280 each at the time of this writing, and that's about where they are trading at the moment. What a story Tesla has been in 2018. Though not immune to widely-publicized tariff troubles, General Motors (GM) remains our favorite idea in the automotive space.

The market is truly challenging our conviction in Facebook (FB). As with many market participants, we were blindsided by a second-quarter report that essentially revealed the company taking conscious efforts to slow growth and increase spending, impacting the magnitude of expected profit performance in coming years. Though we thought Facebook's shares were undervalued going into the quarter, and even after factoring in reduced expectations after the quarter, the stock just flat-out is not acting "right" these past few weeks. The market is well-aware of Facebook's massive net cash balance sheet position, considerable network effect (one of the best competitive advantages), and its solid free cash flow generation, but the selling doesn't want to let up for some reason.

Facebook's COO Sheryl Sandberg and Twitter's CEO Jack Dorsey testified at a Senate panel September 5, and investors continue to be on edge about whether regulatory and legal action might heat up against social media (SOCL) entities, but still, the sell-offs across the social media arena, including Snapchat (SNAP), have been considerable. We continue to like Facebook for myriad reasons, but if Facebook and

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Twitter believe that they will be able to spend to "police" their websites, effectively "controlling speech," we don't think it can be done, nor should it be done. We think the best move for investors is to wait and see how things pan out in the coming quarters, but we just can't help but feel we might be wrong on the Facebook idea given its pricing action of late.

High-yielding used-video game retailer GameStop (GME) has had a volatile few weeks, and Seeking Alpha has reported that the company has gone formal with the sales process. Many are calling for a deal to be completed in the $22-$23 range, and that's about where we value shares. The company posted mixed second-qarter results September 6, but it did reaffirm its fiscal 2019 bottom-line guidance in the range of $3.00-$3.35, the midpoint of which came in above consensus expectations. Though GameStop's business model is under serious attack give the digitization of the gaming landscape, the company is worth something to private equity in runoff mode as it remains a solid free-cash-flow generator. We're not sure management will keep paying a near-10% dividend yield (only because it doesn't have to) but shares not only have potential buyout support but also a rather sizable dividend to prop them up. We think the end game is a binary one for GameStop -- either the company sells itself to a bidder at an above-market price, or its equity struggles lower as industry forces overcome its business model.

The British pound hit five-week highs against the dollar on the morning of September 11 as EU chief negotiator Michel Barnier said it was "realistic" to think the United Kingdom and European Union will reach a Brexit (EWU) deal within two months. The UK is scheduled to leave the EU on March 29, 2019, and Barnier's comments have helped ease some concerns that the UK would leave the bloc without a formal trading agreement. President Trump's silence regarding tariffs on the region has also fostered some cautious optimism, but a change of course from the US cannot be ruled out.

Nevertheless, multinational corporations are preparing for worst case scenarios. For example, Mondelez International (MDLZ) is reportedly stocking up on important ingredients in the event a hard Brexit takes place and products do not flow freely in and out of the UK. Unilever (UN, UL) has announced its intention to simplify its corporate structure, though no direct indication was made regarding its connection to Brexit. The company will move from two UK and Dutch legal entities into one holding company incorporated in the Netherlands. One share of New Unilever NV will be issued for each existing ordinary share of Unilever NV and Unilever PLC, and shares of New Unilever NV will be listed in London, Amsterdam, and New York, the latter via American depository shares.

Despite relative levels of optimism surrounding Brexit, global trade worries continue to weigh on equity markets around the world. US-China (FXI) relations show no sign of thawing as President Trump warned he would be ready to place tariffs on nearly all Chinese imports to the US, and China reportedly will ask the World Trade Organization for permission to impose sanctions on the US for its non-compliance with a ruling regarding US dumping duties across several industries that combine for an annual export value of ~$8.4 billion.

Such potential for increasingly restrictive global trade policies is helping keep a lid on emerging market expectations, alongside a strong US dollar and potentially higher interest rates in the US. Emerging market observers have grown more cautious on the potential for pain in countries such as Turkey (TUR) and Argentina (ARGT) to become more commonplace, and oil prices (OIL, USO) finding support from pending US sanctions on Iran could spell increasing trouble for emerging economies if the price of the black liquid rises rapidly should Iranian supply taken out of the market prove to be too significant.

The US is working to reduce imports of Iranian oil among its allies without pushing oil prices much higher, but it must get other OPEC nations and Russia (RSX) to maintain high levels of production. Meanwhile, China has curtailed orders of US crude since trade tensions began escalating, which has helped cause the WTI-Brent Crude discount to widen to ~$10 per barrel despite South Korean and Japanese imports of US crude hitting record highs in September as the Middle East market tightens.

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Valuentum's Best Ideas Portfolio

By Valuentum Analysts

**NEW* Valuentum released a study on its Best Ideas Newsletter portfolio! Please download the paper at the following link:*

https://www.valuentum.com/downloads/20180530/download

Note: Alphabet's "weighting" now reflects a consolidation of Class A and Class C shares held previously in the simulated newsletter portfolio.

Valuentum's BEST IDEAS -- as of September 15, 2018

Portfolio Holdings	Symbol	Div Yield %	Fair Value	Economic Castle	VBI Rating	P/FV	Last Close	% of Portfolio
Berkshire Hathaway	BRK-B	0.00%	$211.00	NA	5	1.03	216.37	5.5%-10%
Facebook	FB	0.00%	$233.00	Very Attractive	6	0.70	162.32	5.5%-10%
Alphabet - Class C	GOOG	0.00%	$1523.00	Very Attractive	3	0.77	1172.53	5.5%-10%
Visa	V	0.58%	$130.00	Attractive	6	1.14	147.84	5.5%-10%
Apple Corp.	AAPL	1.31%	$236.00	Highest Rated	6	0.95	223.84	4%-5.5%
SPDR S&P Dividend ETF	SDY	2.31%	NA	NA	UR	NMF	99.67	4%-5.5%
Energy Select SPDR	XLE	3.10%	NA	NA	UR	NMF	74.25	4%-5.5%
Health Care ETF	XLV	1.35%	NA	NA	UR	NMF	93.50	4%-5.5%
Cisco	CSCO	2.79%	$54.00	Very Attractive	6	0.88	47.40	2.5%-4%
Intel	INTC	2.54%	$56.00	Attractive	4	0.81	45.54	2.5%-4%
Johnson & Johnson	JNJ	2.63%	$133.00	Attractive	6	1.05	139.49	2.5%-4%
Altria Group	MO	5.26%	$67.00	Very Attractive	6	0.93	62.07	2.5%-4%
Booking Holdings	BKNG	0.00%	$2104.00	Highest Rated	6	0.91	1916.27	1.5%-2.5%
Chipotle	CMG	0.00%	$459.00	Very Attractive	5	1.07	491.56	1.5%-2.5%
Dollar General	DG	1.04%	$103.00	Attractive	6	1.06	108.91	1.5%-2.5%
Gilead Sciences	GILD	3.06%	$96.00	Very Attractive	6	0.76	73.38	1.5%-2.5%
General Motors	GM	4.31%	$61.00	Attractive	7	0.57	34.63	1.5%-2.5%
PayPal	PYPL	0.00%	$108.00	Attractive	6	0.84	90.78	1.5%-2.5%
Verint Systems	VRNT	0.00%	$54.00	Very Attractive	7	0.89	48.05	1.5%-2.5%
Cash consideration	-	-	-	-	-	-	-	5%-30%

UR = Under Review
This portfolio is not a real money portfolio. Data as of September 15, 2018.
We have consolidated our simulated position in Alphabet to the highest weighting to reflect our confidence in the idea.

Goal: The simulated Best Ideas Newsletter portfolio seeks to find stocks that have both good value and good momentum characteristics and typically includes in the simulated portfolio each idea from a Valuentum Buying Index rating of a 9 or 10 (consider buying) to a rating of a 1 or 2 (consider selling). Just like a value manager may not include every single undervalued company in the market in his/her portfolio, not all highly-rated companies on the Valuentum Buying Index are included in the portfolio.

We may tactically add to or trim existing positions in the portfolio on the basis of sector or broader market considerations, but we seek to capture a stock's entire pricing cycle (from being underpriced with strong momentum to being overpriced with poor momentum). The Best Ideas Newsletter portfolio puts the Valuentum Buying Index into practice.

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!

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

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

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Despite the ongoing trade concerns, Boeing (BA) is confident in its long-term outlook in China as it recently raised its 20-year aircraft demand forecast for the country to 7,690 from 7,240, which represents a monetary value of more than $1.2 trillion. The company expects single-aisle planes to account for 75% of new deliveries, but the 1,620 increase in widebody aircraft represents a tripling of the country's current fleet. Large aircraft have been left off of China's retaliatory tariff list thus far in the trade dispute, but should the situation continue to escalate, the country may very well turn to rival Airbus (EADSY), which delivered 176 aircraft to China in 2017 compared to 202 from Boeing.

Nevertheless, businesses across the country are reportedly curbing or postponing capital spending as a result of uncertainty related to trade tensions. Such a sentiment is an easy one to understand as business owners and investors have been whipsawed by a dynamic news stream, and yet another example came September 12 as the market was helped by a report of a new round of trade talks proposed by the US. According to a Fed survey, the US economy is showing tight labor market conditions and is expanding at a moderate pace, but rising input costs related to trade disruptions are forcing some businesses, manufacturers in particular, to reconsider their investment strategies despite generally being optimistic about the near term.

According to the Philadelphia Fed in the aforementioned Fed survey, which offers only anecdotal evidence and should not be taken as gospel, "nearly two-thirds of the firms that offered general comments noted that price hikes and/or supply disruptions had already occurred or were anticipated because of tariffs." Input costs are rising faster than selling prices according to the survey, and overall price gains in goods and services are showing some signs of deceleration. Another piece of anecdotal evidence on the impact of tariffs came from 3M (MMM) CFO Nick Gangestad's comments at a recent conference as he noted that raw materials prices could trim $0.10 per share from the company's earnings this year.

Grocery-store chain Kroger (KR) is also facing rising costs, though not in the same vein as 3M, as margin pressure and disappointing guidance drove shares down significantly during the trading session September 13. Its gross margin contracted 36 basis points as a result of price investments, higher transportation costs, and growth in its specialty pharmacy business, and its operating, general, and administrative spending advanced by the same amount due to higher expense for incentive plans. The company still expects identical sales growth, excluding fuel, to be 2%-2.5% in fiscal 2018, and adjusted earnings per share guidance was reiterated in a range of $2.00-$2.15. Shares are currently changing hands just above our fair value estimate of $27.

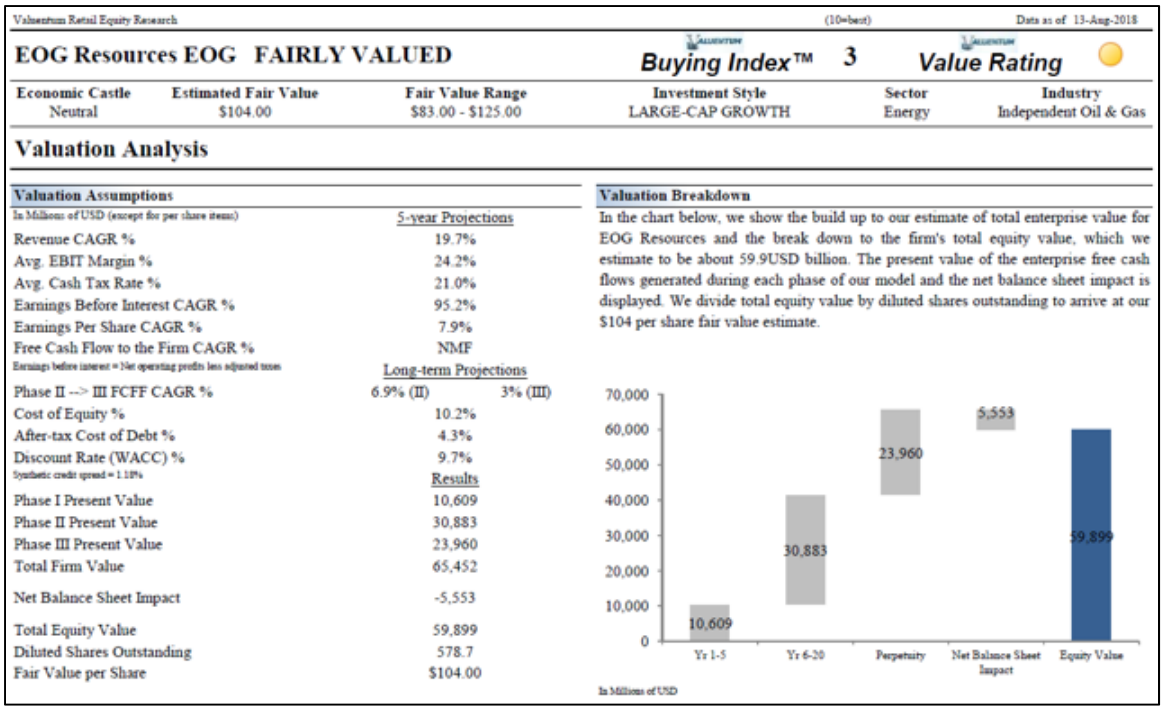
Simulated newsletter portfolio idea Altria (MO) and its big tobacco peers rallied during the September 12 trading session as the FDA threatened to pull e-cigarettes from shelves if manufacturers don't alter their practices to help curb teenager use of their products. The FDA also issued warnings to retailers of e-cigs, but many of the names that rallied have begun to correct as investor digest the implications of the announcement, which targeted more than 1,300 retailers and five major manufacturers.

The five manufacturers targeted were Juul, British American Tobacco's (BTI) Vuse, Altria's MarkTen, Imperial Brands' (IMBBY) Blu, and Japan Tobacco's (JAPAY) Logic brands, and the FDA will require them to submit teen use prevention plans within 60 days. Altria's big move on the initial news was largely due to speculation that privately-held Juul may be most at risk from the FDA's actions as it holds approximately 72% share in the e-cig market and traditional big tobacco companies have yet to find an effective way to compete with it.

Such a notion is supported by the FDA's obsession with the impact flavored e-cigs are having on youth consumption as Juul offers a range of nicotine-packed flavors. While these developments are still unfolding, the increased penalization on flavored e-cigs bodes well for US cigarette consumption and Altria's Marlboro brand by extension as it holds 43.2% market share as of the end of the second quarter. Our fair value estimate for Altria sits at $67 per share.

EOG Resources "Firing On All Cylinders"

By Brian Nelson, CFA



Valuentum Retail Equity Research (10=best) Data as of 13-Aug-2018

EOG Resources EOG FAIRLY VALUED Buying Index™ 3 Value Rating

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Neutral	$104.00	$83.00 - $125.00	LARGE-CAP GROWTH	Energy	Independent Oil & Gas

Valuation Analysis

Valuation Assumptions

In Millions of USD (except for per share items)	5-year Projections	
Revenue CAGR %	19.7%	
Avg. EBIT Margin %	24.2%	
Avg. Cash Tax Rate %	21.0%	
Earnings Before Interest CAGR %	95.2%	
Earnings Per Share CAGR %	7.9%	
Free Cash Flow to the Firm CAGR %	NMF	
Earnings before interest = Net operating profits less adjusted taxes	Long-term Projections	
Phase II --> III FCFF CAGR %	6.9% (II)	3% (III)
Cost of Equity %	10.2%	
After-tax Cost of Debt %	4.3%	
Discount Rate (WACC) %	9.7%	
Synthetic credit spread = 1.18%	Results	
Phase I Present Value	10,609	
Phase II Present Value	30,883	
Phase III Present Value	23,960	
Total Firm Value	65,452	
Net Balance Sheet Impact	-5,553	
Total Equity Value	59,899	
Diluted Shares Outstanding	578.7	
Fair Value per Share	$104.00	

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for EOG Resources and the break down to the firm's total equity value, which we estimate to be about 59.9USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $104 per share fair value estimate.

Image Source: Valuentum. In the above image, we show how we derive our $104 fair value estimate for EOG Resources.

For those that know us, you know that we like to look at stocks as though they are pieces of a business. As with the investing greats Benjamin Graham and Warren Buffett, we think each share of stock has something called intrinsic value. What we do each and every day is to strive to calculate what we think is an appropriate estimate of a company's intrinsic value because we want to have a reasonable basis to derive what an investor might be willing to pay for shares. We've had a lot success with intrinsic-value investing during the past several years, and we think it is helpful for readers to know that our primary efforts in equity analysis are dedicated to getting our estimates of a company's fair value range as "correct" as possible. Here's the basic construct of the enterprise discounted cash flow model that we use to value roughly 1,000 companies on a systematic basis.

When it comes to EOG Resources (EOG), we're looking at the company's business fundamentals, but most importantly, how those business fundamentals translate into future free cash flows and an estimate of intrinsic value. We spend almost all of our time thinking through the company's fundamentals and how they impact the upside and downside cases of intrinsic value estimation. Since future free cash flows can only be estimated (and the future is not yet written), we assign each company a fair value estimate range, which helps inform the reader when the odds may best be in their favor to consider an investment opportunity.

At the moment, we value EOG Resources at about $104 per share, so with shares declining to $115 from over $130 recently, we're not at all surprised by the recent move downward. We'd only grow truly surprised by the pricing action if EOG Resources fell outside our fair value estimate range, meaning that we could still rationalize a valuation as high as $125 per share (the high end of the fair value estimate range), implying upside to shares under more optimistic assumptions. We showcase our fair value estimate range in the image below, and we'd think shares would be quite the bargain under $83 each. The market might agree.

*EOG Resources...*continued on next page

EOG Resources...from previous page

The discounted enterprise cash flow model is generally defined as follows:

Figure 2. The Discounted Enterprise Free Cash Flow (Free Cash Flow to the Firm) Model

$$\text{Fair Value} = \left[\sum_{t=0}^{\infty} \frac{A(t)}{(1+d)^t} - B(0) - C(0) + D(0) \right]$$

where A (t) is an Enterprise Free Cash Flow (1) at year t,

B (0) is a Total Debt at time 0,

C (0) is a Preferred Stock at time 0,

D (0) is a Total Cash at time 0,

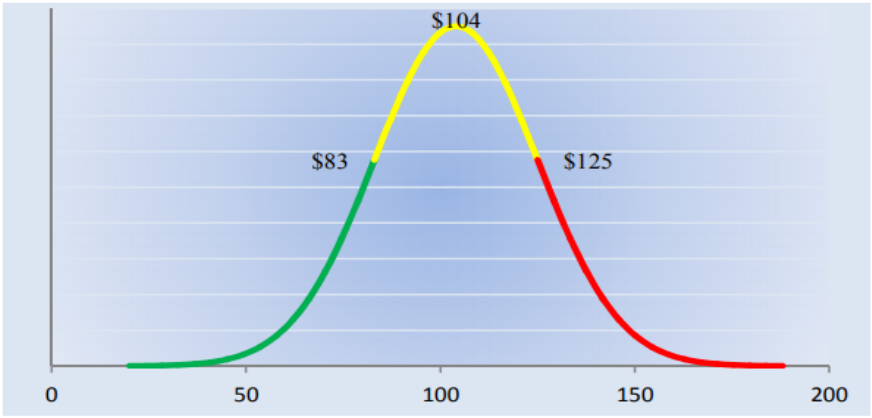
d is Weighted Average Cost of Capital (WACC).

Notes: This figure defines the basic structure of the enterprise free cash flow model in deriving enterprise value, which is then divided by shares outstanding, to arrive at a fair value estimate per share. The company's share price is then compared to a fair value estimate to determine a price-to-fair value (P/FV) ratio. A price-to-fair value ratio, which includes enterprise valuation, differs from other valuation multiples, including enterprise value-to-EBITDA (EV/EBITDA), or EBITDA to total enterprise value (EBITDA/TEV), which do not directly compare a company's share price with estimates of its intrinsic value, and therefore are not "true" measures of price versus value. The price-to-fair value ratio, augmented by a margin of safety, is the first component of the Valuentum Buying Index.

Image Source: How Well Do Enterprise-Cash-Flow-Derived Fair Value Estimates Predict Future Stock Prices? - And Thoughts on Behavioral Valuation (pdf)

Margin of Safety Analysis

Range of Potential Outcomes



Our discounted cash flow process values each firm on the basis of the present value of all future free cash flows. Although we estimate the firm's fair value at about $104 per share, every company has a range of probable fair values that's created by the uncertainty of key valuation drivers (like future revenue or earnings, for example). After all, if the future were known with certainty, we wouldn't see much volatility in the markets as stocks would trade precisely at their known fair values. Our ValueRisk™ rating sets the margin of safety or the fair value range we assign to each stock. In the graph above, we show this probable range of fair values for EOG Resources. We think the firm is attractive below $83 per share (the green line), but quite expensive above $125 per share (the red line). The prices that fall along the yellow line, which includes our fair value estimate, represent a reasonable valuation for the firm, in our opinion.

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EOG Resources At A Glance

• EOG operates primarily in the US, Canada, Trinidad, UK, China, and Argentina. The firm is the largest crude oil producer in the South Texas Eagle Ford Shale and North Dakota Bakken, which should drive significant reserve and production growth. EOG has a prudent focus on return on capital employed and expects the metric to return to 10%+ in 2018.

• Collapsing crude oil prices put EOG on the defensive. The company was able to reduce its all-in reserve replacement costs per BOE by 43% from 2013 to 2017 (to $8.71 from $15.23) and is expecting further reductions in 2018 thanks in part to its focus on premium drilling.

• EOG boasts the highest production per employee in its peer group, giving it a labor efficiency advantage. A shift to focus on premium drilling (to 90%+ of total wells expected in 2018) is expected to drive capital efficiency, and management expects 2018 US crude oil production growth to be 17%-19% over 2017. Free cash flow of $1.5+ billion is expected in the year assuming $60 oil prices.

• EOG expects to generate positive free cash flow at $50/bbl oil prices in 2018, which should put it in a position to strengthen its balance sheet and potentially grow the dividend in the year. Management anticipates a ~5% reduction in completed well costs and a ~7% reduction in cash operating expenses.

• EOG's total debt outstanding was roughly $6.4 billion at the end of 2017 for a debt-to-total capitalization ratio of ~25%. On a net debt basis, the company's leverage is slightly better at ~$5.6 billion. The firm is in better shape than some of its peers, but its net debt load shouldn't be ignored.

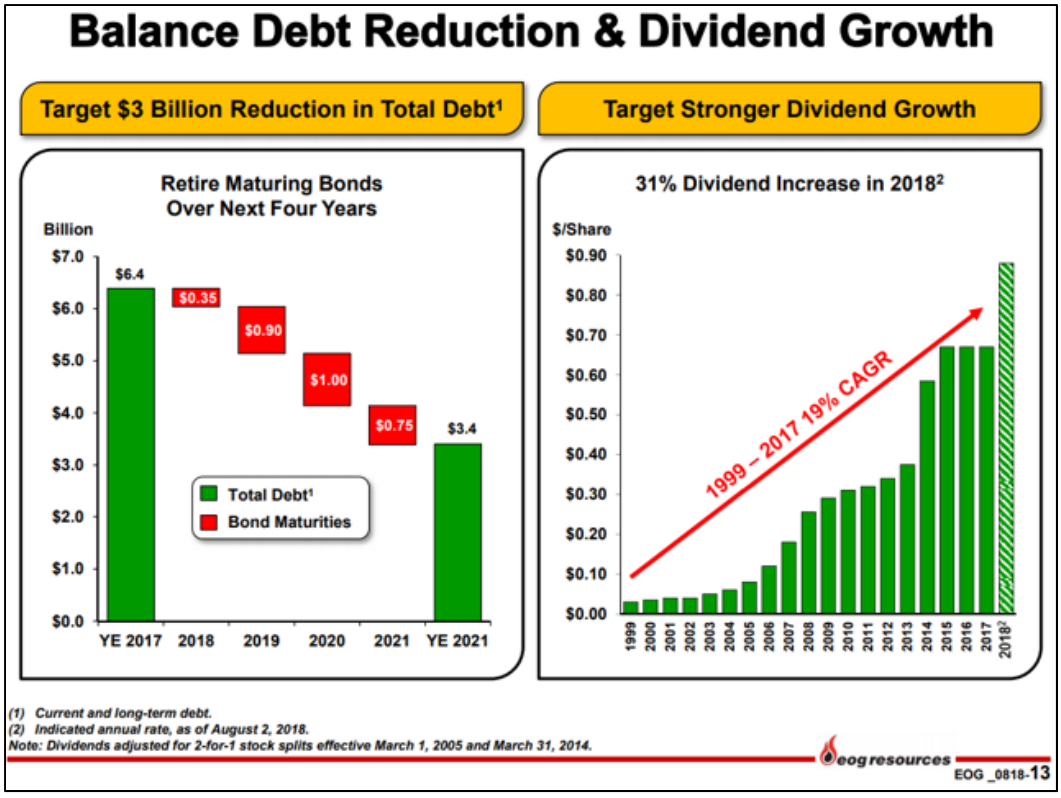

Image Source: EOG Resources

• Volatile crude oil prices ground EOG Resources' dividend growth plans to a halt, but this has changed more recently (see image above). Its yield isn't a head turner, however, at ~0.8%. Here's more of what we say about the company's dividend health in our Dividend Report:

EOG Resources...continued on next page

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Key Strengths

EOG Resources' operations are highly cyclical. The company is working to prop up free cash flow through capex reductions in light of the decline in operating cash flow due to suppressed energy prices. EOG's total anticipated capital expenditures for 2018 is $5.4- 5.8 billion, still lower than 2014 levels of $8.6 billion but significantly higher than 2016 levels of ~$2.6 billion. The company is on track to continue reducing cash operating costs per BOE (targeting a ~7% reduction in 2018), while targeting a return to meaningful production growth. EOG boasts one of the stronger dividends among its peers, which is not saying much, especially when considering the size of its yield. We like its position as an industry leader in return on capital employed.

Potential Weaknesses

The most critical risk to the EOG's dividend potential is the possibility of another material leg down in crude oil prices. Management is working to combat this by reducing well costs and improving well productivity, which it has been effective at in recent quarters. Net cash from operations has been volatile of late, but material capital spending cuts have helped in this area. EOG's total debt outstanding, ~$6.4 billion as of the end of 2017 equating to a debt-to-total capitalization ratio of ~25%, weighs on its Dividend Cushion ratio. Although we're modeling slower growth in the payout, the firm's yield and uncertain operating environment leave a good deal to be desired.

• The latest read at EOG is quite good. The company upped its dividend to $0.22 per share on a quarterly basis, revealing a near-19% increase from the prior dividend. Its second-quarter report also showed a nice beat on both the top and bottom lines. We're optimistic about its Powder River Basin Mowry and Niobrara Shale Plays. How could we not be excited about CEO Bill Thomas saying that "The EOG machine is firing on all cylinders." Isn't that cool?

Conclusion

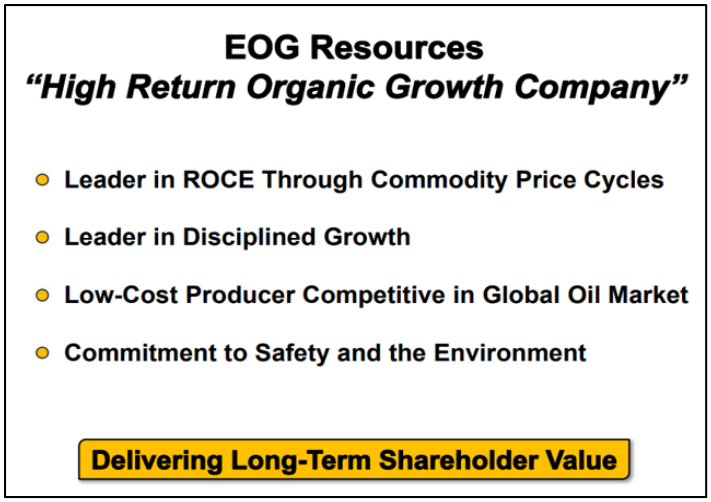

Image Source: EOG Resources

There's a lot to like about EOG Resources, and we are pleased to see its dividend growth back on track. The company is a self-proclaimed leader in return on capital employed, and it's hard to argue with its low-cost position. We also like that management is focused on deleveraging and is looking to shed $3 billion in total debt over the next four years. Though we think EOG Resources is at the high end of the risk scale given its exposure to the volatile energy resource environment and that its operations are stacked with leverage, we don't think the market is pricing shares too aggressively. EOG Resources is one of our favorite independent energy plays, but again, it is not without significant operational and financial risk. For dividend-oriented investors, its yield isn't that enticing...yet.

Nevro: Volatility Amps Up

Underscoring the volatile nature of small-cap healthcare companies, shareholders at Nevro are going through a rough period of volatility as it attempts to carve out a larger share for its proprietary pain relief products.

By Alexander J. Poulos

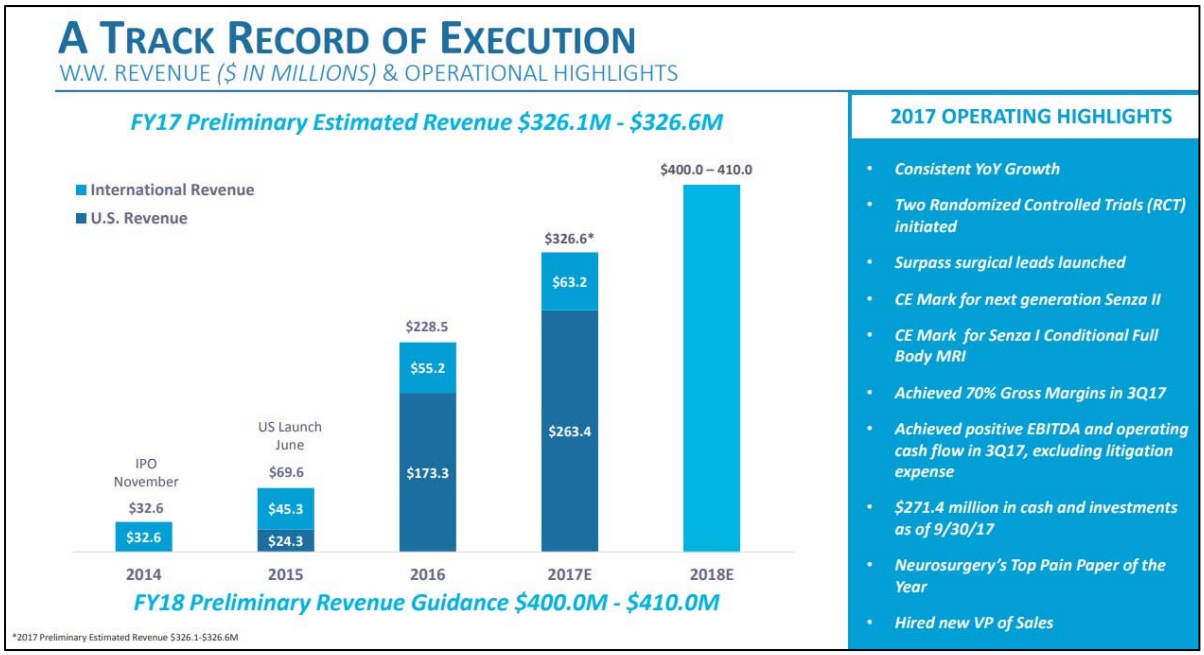

Image Source: Nevro Investor Relations

Key Takeaways

The small-cap medical device market remains a volatile area of the market.

Volatility pertaining to the patent estate of Nevro's Key SCS products has led to a wild ride for shareholders.

We have identified some key personnel issues that make us uneasy towards the future path of the company.

We feel the path forward remains challenging as we wait for a new sales leader to emerge.

Introduction- Who is Nevro?

Nevro (NVRO) is far from a household name. The company is an innovative small-cap healthcare device producer with a focus on bringing relief to its patients suffering from chronic pain via the utilization of drug-free therapies. Nevro produces a complete line of neuromodulation devices--implantable devices that are designed to block the pain impulses from the lower extremities with its key product focusing on spinal cord stimulation (SCS). The thesis is if the patient cannot feel the innervation of the nerves, or to a lesser extent than before, the device is providing "relief," thus lessening the need for chronic medications, which is more often than not opioids. Opioid abuse has risen to an epidemic level in the US, with a critical need arising to find alternative methods to treat those with chronic pain. We feel the neuromodulator market is part of the solution; thus, our continued profiling of Nevro.

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Sales

In our view, the main metric to evaluate young, upstart companies such as Nevro is their ability to ramp sales as the upstart nature of the enterprise will often preclude profitability. The thesis remains: as sales ramp higher, the company in time should realize economies of scale, which should allow profits to increase, thus enhancing overall profitability. The sales ramp post the November 2014 IPO remains positive, as recorded sales in 2015 ($69.6 million) accelerated to its current full year 2017 ($326.7 million), a very impressive rate thanks in large part to the overall neuromodulator market growing at a double-digit clip.

Upon a cursory glance at the revenue growth metric, the growth thesis remains intact as the sales ramp remains impressive. However, not all is right at Nevro as underlying growing pains have begun to emerge. Nevro has cycled through two VP of sales, a critical position for the company as a steady hand to guide sales growth is imperative for future growth. We continue to be perplexed by the sudden termination of James Alecxih, the recently-installed Vice President of Worldwide Sales. Alecxih's tenure at Nevro was a remarkably brief 8-months adding doubt to the stability of the management team as a bit of a revolving door at VP of sales has emerged.

The surprise July 13th 8-K post rattled the nerves of shareholders as Nevro sold off over 12% on the news. Nevro's revenue recognition remains lumpy with exaggerated post earning moves as the company's inability to hit sales targets continues to weigh on investor sentiment. We find it particularly perplexing that the VP of sales position remains a proverbial revolving door with Alecxih serving as the second VP of sales in roughly a one-year time span with the announcement of previous VP Michael Enxsing is no longer with the company as of July 5, 2017, 8-K filing. The uncertainty over who will replace Alecxih along with which direction the sales team focus will take post the announcement of a new hire continues to weigh in investor enthusiasm.

Patent Litigation

Nevro remains locked in a heated litigation battle with far superior capitalized medical device behemoth Boston Scientific (BSX) over the patent estate covering Nevro's paresthesia free spinal cord stimulator (SCS) suite of products. The litigation battle is a high-stakes affair for Nevro as an invalidation of the patent estate would, in our view, irreparably harm the company as the better-capitalized players can devote far more resources coupled with leveraging long-standing physician relationships to muscle Nevro out of the marketplace. The share price of Nevro plunged over 30% in early trading on July 25 based off a report the Court had invalidated a portion of Nevro's IP estate setting of a selling cascade with Nevro at one point quoted below $36 per share a level last seen in the companies infancy in 2015.

Nevro issued a press release later in the day on July 25th detailing the Court's decision to uphold a portion of the IP estate, which the management team at Nevro, believes will preclude Boston Scientific from entering the marketplace with a similar spinal cord stimulator device that operates between the 1.5 kHz and 100 kHz spectrum in the United States. Management's confidence in its patent estate was validated a few days later via a press release in which Boston Scientific conceded to the Court it has no intention to release an SCS system in the US, thus removing a potential competitor from the market.

Path Forward

In our view, Nevro remains at the crossroads as the company dodged an existential death blow to its patent estate. However, the Court win should not be viewed as an "all clear" signal as additional well-heeled competitors such as Abbott Labs (ABT) St Jude division offer competitive products. We suspect the sales traction difficulty revolves in large part to the smaller size of Nevro which inherently brings up trust issue with the physicians who decide which product suite they will train and utilize in operations. Nevro has its work cut out for it to establish a brand name, which may help assuage concerns physicians may have concerning durability, support, quality, and reputation that may be preventing greater uptake of the product.

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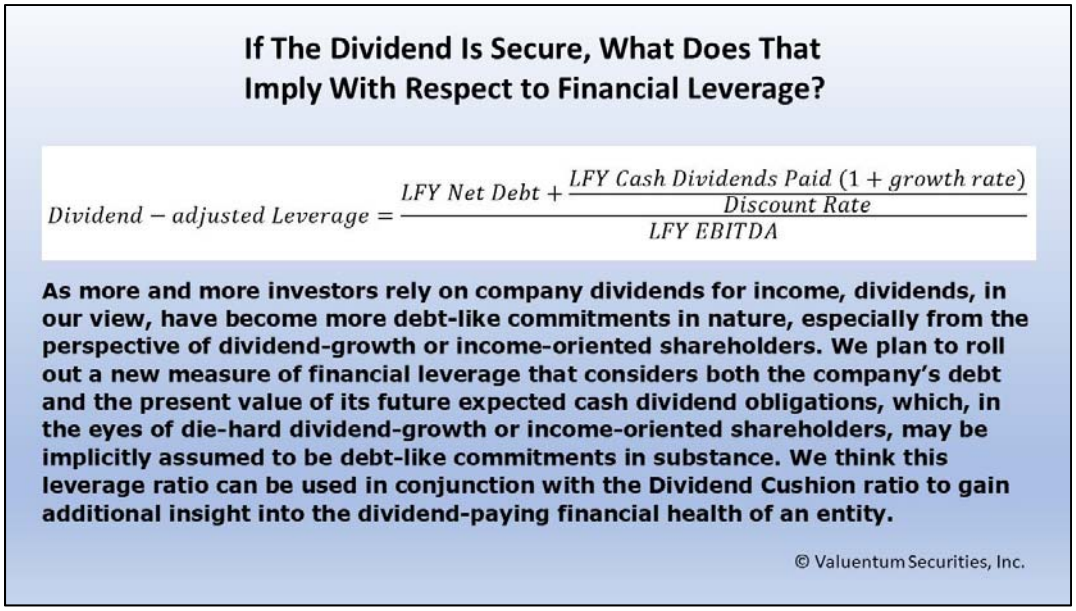
Our Take

Our enthusiasm for Nevro has waned considerably in light of the revolving door in the critical sales leadership position. We find the lack of cohesion between upper management and the VP of sales as particularly troubling as we get the distinct feeling the company is adrift currently as it seeks a new sales leader to help drive sales and arrest the disturbing pattern of having to consistently lower sales guidance.

In light of recent developments, most notably the Boston Scientific litigation quasi-victory, we believe the optimal outcome for current shareholders is a takeout of the company as Nevro would be easily integrated into a much larger sales organization in a similar manner as arch-rival St Jude was acquired by Abbot Labs. The most logical candidate remains Boston Scientific, though there are no assurances an acquisition will materialize at this time or ever. We rate Nevro as high-risk speculative stock with warts beginning to appear pertaining to the original thesis. We have no plans to add the company to the simulated Best Ideas Newsletter portfolio.

A New Measure of Leverage for Dividend-Growth and Income-Oriented Shareholders, One That Is Dividend-Adjusted

By Brian Nelson, CFA



Note: There is often great confusion with respect to published measures of financial leverage, and our intent with the creation of this leverage ratio is not to add to the confusion, but to help dividend growth and income-oriented investors think about what is implied in terms of leverage by their expectations that a company's dividend is secure (and is anticipated to grow), as in the case of the dividend essentially being viewed as a cash commitment to shareholders/unitholders, which may often be the case for many dividend growth and income-oriented investors. Typically, most reporting uses the credit-rating agencies' leverage metrics or measures of leverage that are provided by the company. Depending on the stakeholder, however, the application of various measures of leverage may be helpful in painting a better picture of the risk to the dividend. Said plainly, this tool is to help the equity investor evaluate the financial risks of more-speculative dividend payers and raise awareness of what their views regarding the dividend imply with respect to leverage.

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Financial leverage is a very subjective consideration and can be measured in a variety of different ways depending on its relevance to a particular stakeholder, whether it be an equity holder or debt holder. Some measures of leverage include assets-to-equity as in the third product of the DuPont equation, for example, or total debt-to-EBITDA, or net debt-to-EBTIDA, or total debt-to-equity, among many others. Most leverage metrics, however, tend to focus more on assessing credit quality, as in evaluating the ability of a company to repay its debtholders, or in measuring and ranking the probability of default.

The credit rating agencies, for example, employ a wide variety of adjusted financial metrics that have myriad "subjective judgments" embedded within them. Moody's, for example, uses debt-to-equity and debt-to-book-capitalization, as well as a unique measure called retained cash flow to net debt (RCF/net debt). The definitions for many credit metrics can be relatively complex, in some cases. For example, according to Moody's, RCF/net debt decomposes into the following: (FFO-preferred dividends-common dividends-minority dividends) / (short-term debt + long-term debt, gross – cash and cash equivalents).

The ratio RCF/net debt is a rare credit metric, in our view, that may be applicable to that of the dividend growth or income investor. Where a bond holder may implicitly assume that dividends can be cut/reduced in order to shore up cash flow to service debt repayment, from the perspective of the equity investor (one that is counting on that dividend for income), the view is quite different. In the eyes of many die-hard dividend growth or income investors, for example, the dividend payment is often viewed, in great substance, as the equivalent of a debt-like cash commitment. RCF/net debt provides some context in how much cash flow is left over after paying dividends or distributions to service the debt, but it may not be a pure measure of dividend-adjusted leverage, as in the traditional sense (where EBITDA may be in the denominator, for example, as in net debt-to-adjusted EBITDA).

In any case, what we like about the RCF/net debt ratio is that it does not assume that dividends are not going to be paid, as in the case of other traditional credit metrics that effectively ignore the dividend or distribution as an important cash outflow (and an implicit reduction to credit quality). The RCF/net debt ratio assumes that the dividend is a debt-like cash commitment reducing funds from operations, something we believe is very relevant to the dividend growth or income-oriented shareholder that is depending heavily on that dividend or distribution payment. What RCF/net debt also considers is that the same money distributed to shareholders or unitholders is not also used twice as same money that can be used to service the debt (double counting). In our view, it should be generally assumed that such capital can only be used once; if it's paid out as a dividend/distribution, it generally should not be assumed that it is also capital that can be used for debt repayment.

The idea of a new measure of leverage for dividend growth and income-oriented shareholders/unitholders that considers dividend/distribution obligations originated in the 2015 analysis of Kinder Morgan (KMI) when we explained how a dividend-growth or income-oriented investor that, if they are truly counting on the dividend/distribution to be paid in the future for their income stream, they should evaluate the company's financial leverage in the context of both its net debt and the present value of those dividends/distributions to shareholders/unitholders. Once the capital corresponding to dividend payments is released to shareholders/unitholders, that same capital shouldn't also be considered as a means to repay debt as well. Here's what we said in that 2015 piece:

> One of the dual and perhaps lesser-known benefits of the dividend discount model is that it seconds as a calculation of the present value of future cash dividend obligations. For example, the higher the "perceived" equity value that is supported by the dividend discount model, the more the present value of cash obligations the company has to shareholders, and by extension, the lower implicit credit quality of the organization, assuming a company continues to pay and increase its dividend…

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> In any case, what matters most is not the absolute level of the debt on Kinder Morgan's books, which is striking by itself, but whether Kinder Morgan can service all of its debt-like, cash obligations with its own organically-generated EBITDA, which pays no mind to capital spending in any form. Kinder Morgan currently has $42.8 billion in debt, net of cash, on the balance sheet, and implicitly, on the basis of the price targets of some brokerage houses that employ a dividend discount model, it has another ~$100 billion in "mandatory" obligations to shareholders in the form of dividends (though if you ask a shareholder, the dividend payment is as contractual as it gets).
>
> We think that, as the credit rating agencies evaluate the firm's die-hard commitment to shareholders and its unwavering backing of an explosive future dividend growth plan, the implied leverage of cash, debt-like commitments at Kinder Morgan should approach $140 billion. The company's reported Debt-to-EBITDA is 5.8 times, already a consideration for junk-rated credit status, but its implied Debt-to-EBITDA is closer to 19 times ($140 billion/$7.35 billion) after factoring in all cash, debt-like commitments…

What we're proposing is that the concept of financial leverage should be viewed differently as it relates to the perspective of either the debt holder or the dividend-growth and income-oriented equity holder. In the case of Kinder Morgan in 2015, for example, many holders of its stock were die-hard dividend growth investors, and they were counting on the company's dividend no matter what. This assumption should be an important part of leverage analysis of that of the dividend growth and income investor. Looking at financial leverage from the perspective of that of a bold holder, or as one that assumes the company will cut its dividend to repay debt, may not be an accurate representation of actual cash, debt-like obligations in the eyes of dividend-growth or income-oriented shareholders, which are counting on the dividend to be paid through thick and thin.

Where RCF/net debt effectively reduces the numerator by dividends paid as a way to explain just how much cash is left over to service the debt, an implied measure of leverage that views dividends as cash, debt-like commitments may be of equal usefulness. We believe it makes little sense from the perspective of a dividend-growth or income-oriented shareholder to evaluate a company's financial leverage as if one is never going to get paid a dividend or distribution! Financial leverage from the perspective of the dividend-growth or income-oriented shareholder should consider all net debt and the present value of all future expected dividend obligations. Much like rent can be capitalized to arrive at a present value of debt equivalent (as if a retailer were to finance a building instead of paying rent), dividends can be capitalized in much of the same way through either the construct of a dividend-discount model or through a growing perpetuity function with a reasonable discount rate.

The dividend-adjusted measure of leverage, or financial leverage as we think it should be viewed in the eyes of the dividend-growth and income-oriented investor, is as follows:

$$Dividend-adjusted\ Leverage = \frac{LFY\ Net\ Debt + \frac{LFY\ Cash\ Dividends\ Paid\ (1 + growth\ rate)}{Discount\ Rate}}{LFY\ EBITDA}$$

Valuentum will start to roll out this new dividend-adjusted leverage ratio in the fourth-quarter Data Screener, due for release October 1, 2018. We think this ratio used in conjunction with the Dividend Cushion ratio will provide even more insight into the dividend-paying financial health of the entity.

Register to Join This Online Financial Statement Analysis Webinar: September 26

By Valuentum Analysts

Valuentum's President of Investment Research Brian Nelson will be hosting an online webinar (workshop) that will walk through the in's and out's of financial statement analysis.

You do not have to have any previous analyst experience to attend. We'll cover ground from the beginner to the advanced, and everything in between.

The online webinar will be held Wednesday, September 26. **Recordings will be made available to those that register in advance**.

What You'll Learn:

- How to assess the operating strength and earnings power of a company (income statement)
- How to assess the financial health and leverage of a company (balance sheet)
- How to assess the cash flow generating capacity and capital intensity of a company (cash flow statement)
- **How the Valuentum team predicts dividend cuts and assesses long-term dividend safety**
- **How financial statement analysis fits into valuation (a walk through of the discounted cash flow modeling process)!**
- How to assess earnings quality and common financial warning signs
- Open Q&A with Brian
- And more!!!

Date Offered:

Wednesday, September 26: 1:00pm-3:00pmCT

Once you have registered, dial-in instructions and presentation materials will be made available in the coming days.

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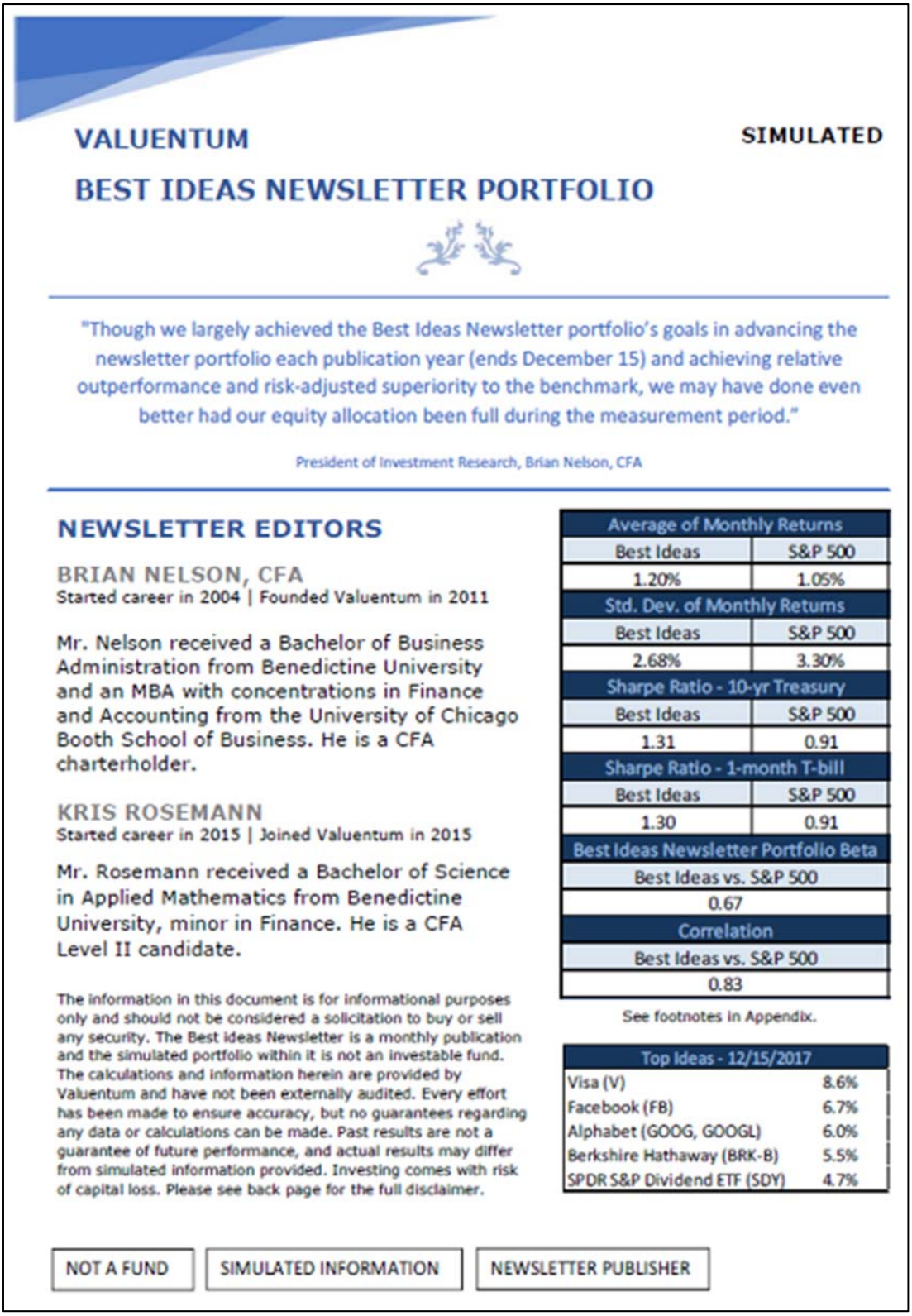
By Valuentum Analysts



VALUENTUM

SIMULATED

BEST IDEAS NEWSLETTER PORTFOLIO

"Though we largely achieved the Best Ideas Newsletter portfolio's goals in advancing the newsletter portfolio each publication year (ends December 15) and achieving relative outperformance and risk-adjusted superiority to the benchmark, we may have done even better had our equity allocation been full during the measurement period."

President of Investment Research, Brian Nelson, CFA

NEWSLETTER EDITORS

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Started career in 2004 | Founded Valuentum in 2011

Mr. Nelson received a Bachelor of Business Administration from Benedictine University and an MBA with concentrations in Finance and Accounting from the University of Chicago Booth School of Business. He is a CFA charterholder.

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Mr. Rosemann received a Bachelor of Science in Applied Mathematics from Benedictine University, minor in Finance. He is a CFA Level II candidate.

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Average of Monthly Returns	
Best Ideas	S&P 500
1.20%	1.05%
Std. Dev. of Monthly Returns	
Best Ideas	S&P 500
2.68%	3.30%
Sharpe Ratio - 10-yr Treasury	
Best Ideas	S&P 500
1.31	0.91
Sharpe Ratio - 1-month T-bill	
Best Ideas	S&P 500
1.30	0.91
Best Ideas Newsletter Portfolio Beta	
Best Ideas vs. S&P 500	
0.67	
Correlation	
Best Ideas vs. S&P 500	
0.83	

See footnotes in Appendix.

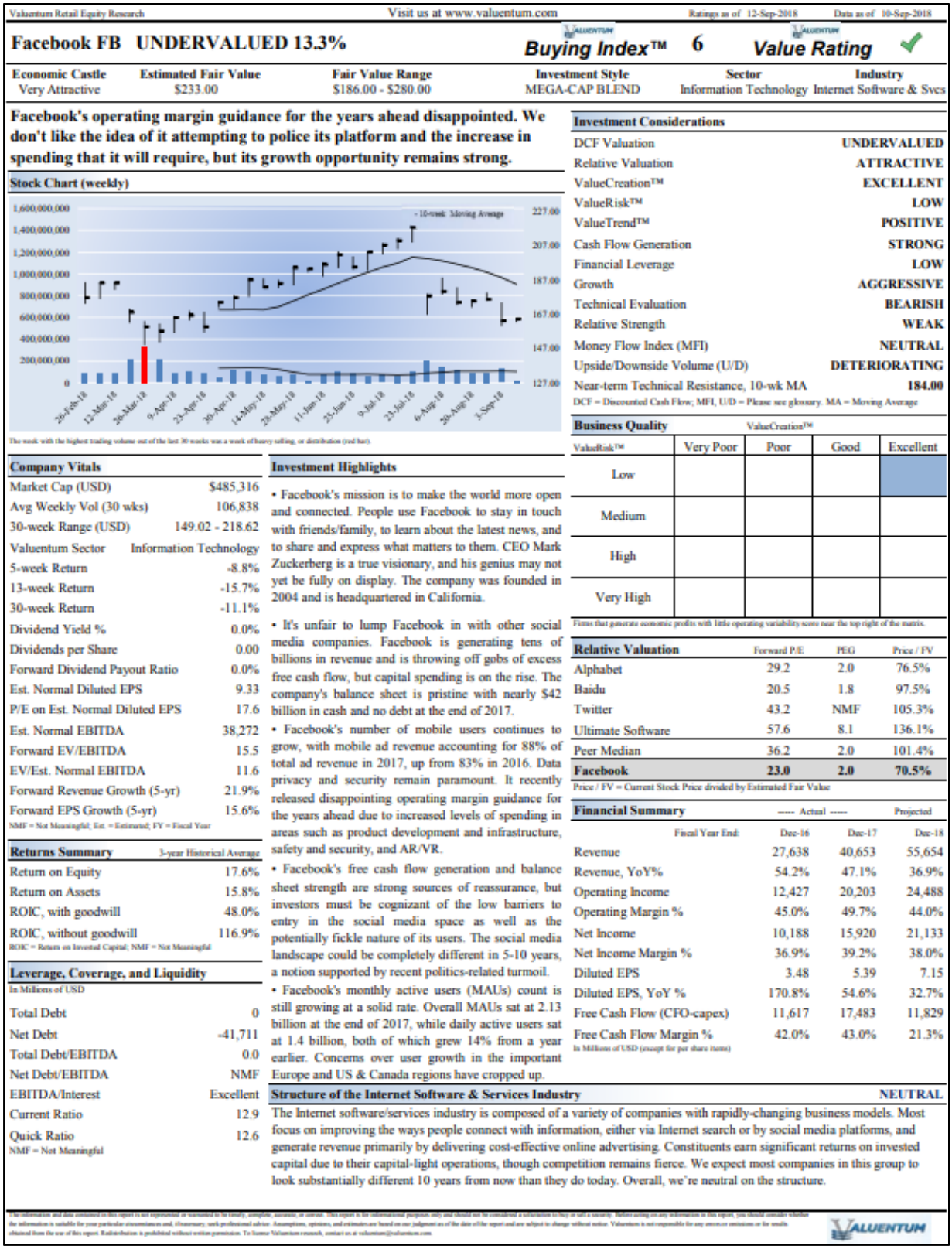
Top Ideas - 12/15/2017	
Visa (V)	8.6%
Facebook (FB)	6.7%
Alphabet (GOOG, GOOGL)	6.0%
Berkshire Hathaway (BRK-B)	5.5%
SPDR S&P Dividend ETF (SDY)	4.7%

NOT A FUND | SIMULATED INFORMATION | NEWSLETTER PUBLISHER

Facebook (FB) – Page 1 of 16

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

By Valuentum Analysts



Valuentum Retail Equity Research — Visit us at www.valuentum.com — Ratings as of 12-Sep-2018 — Data as of 10-Sep-2018

Facebook FB UNDERVALUED 13.3% — Buying Index™ 6 — Value Rating ✓

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Very Attractive	$233.00	$186.00 - $280.00	MEGA-CAP BLEND	Information Technology	Internet Software & Svcs

Facebook's operating margin guidance for the years ahead disappointed. We don't like the idea of it attempting to police its platform and the increase in spending that it will require, but its growth opportunity remains strong.

Stock Chart (weekly)

The week with the highest trading volume out of the last 30 weeks was a week of heavy selling, or distribution (red bar).

Company Vitals

Market Cap (USD)	$485,316
Avg Weekly Vol (30 wks)	106,838
30-week Range (USD)	149.02 - 218.62
Valuentum Sector	Information Technology
5-week Return	-8.8%
13-week Return	-15.7%
30-week Return	-11.1%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	9.33
P/E on Est. Normal Diluted EPS	17.6
Est. Normal EBITDA	38,272
Forward EV/EBITDA	15.5
EV/Est. Normal EBITDA	11.6
Forward Revenue Growth (5-yr)	21.9%
Forward EPS Growth (5-yr)	15.6%

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

Returns Summary — 3-year Historical Average

Return on Equity	17.6%
Return on Assets	15.8%
ROIC, with goodwill	48.0%
ROIC, without goodwill	116.9%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	0
Net Debt	-41,711
Total Debt/EBITDA	0.0
Net Debt/EBITDA	NMF
EBITDA/Interest	Excellent
Current Ratio	12.9
Quick Ratio	12.6

NMF = Not Meaningful

Investment Highlights

- Facebook's mission is to make the world more open and connected. People use Facebook to stay in touch with friends/family, to learn about the latest news, and to share and express what matters to them. CEO Mark Zuckerberg is a true visionary, and his genius may not yet be fully on display. The company was founded in 2004 and is headquartered in California.
- It's unfair to lump Facebook in with other social media companies. Facebook is generating tens of billions in revenue and is throwing off gobs of excess free cash flow, but capital spending is on the rise. The company's balance sheet is pristine with nearly $42 billion in cash and no debt at the end of 2017.
- Facebook's number of mobile users continues to grow, with mobile ad revenue accounting for 88% of total ad revenue in 2017, up from 83% in 2016. Data privacy and security remain paramount. It recently released disappointing operating margin guidance for the years ahead due to increased levels of spending in areas such as product development and infrastructure, safety and security, and AR/VR.
- Facebook's free cash flow generation and balance sheet strength are strong sources of reassurance, but investors must be cognizant of the low barriers to entry in the social media space as well as the potentially fickle nature of its users. The social media landscape could be completely different in 5-10 years, a notion supported by recent politics-related turmoil.
- Facebook's monthly active users (MAUs) count is still growing at a solid rate. Overall MAUs sat at 2.13 billion at the end of 2017, while daily active users sat at 1.4 billion, both of which grew 14% from a year earlier. Concerns over user growth in the important Europe and US & Canada regions have cropped up.

Investment Considerations

DCF Valuation	UNDERVALUED
Relative Valuation	ATTRACTIVE
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	POSITIVE
Cash Flow Generation	STRONG
Financial Leverage	LOW
Growth	AGGRESSIVE
Technical Evaluation	BEARISH
Relative Strength	WEAK
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	DETERIORATING
Near-term Technical Resistance, 10-wk MA	184.00

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

Business Quality — ValueCreation™

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

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

Relative Valuation

	Forward P/E	PEG	Price / FV
Alphabet	29.2	2.0	76.5%
Baidu	20.5	1.8	97.5%
Twitter	43.2	NMF	105.3%
Ultimate Software	57.6	8.1	136.1%
Peer Median	36.2	2.0	101.4%
Facebook	**23.0**	**2.0**	**70.5%**

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

Financial Summary

	---- Actual ----		Projected
Fiscal Year End:	Dec-16	Dec-17	Dec-18
Revenue	27,638	40,653	55,654
Revenue, YoY%	54.2%	47.1%	36.9%
Operating Income	12,427	20,203	24,488
Operating Margin %	45.0%	49.7%	44.0%
Net Income	10,188	15,920	21,133
Net Income Margin %	36.9%	39.2%	38.0%
Diluted EPS	3.48	5.39	7.15
Diluted EPS, YoY %	170.8%	54.6%	32.7%
Free Cash Flow (CFO-capex)	11,617	17,483	11,829
Free Cash Flow Margin %	42.0%	43.0%	21.3%

In Millions of USD (except for per share items)

Structure of the Internet Software & Services Industry — NEUTRAL

The Internet software/services industry is composed of a variety of companies with rapidly-changing business models. Most focus on improving the ways people connect with information, either via Internet search or by social media platforms, and generate revenue primarily by delivering cost-effective online advertising. Constituents earn significant returns on invested capital due to their capital-light operations, though competition remains fierce. We expect most companies in this group to look substantially different 10 years from now than they do today. Overall, we're neutral on the structure.

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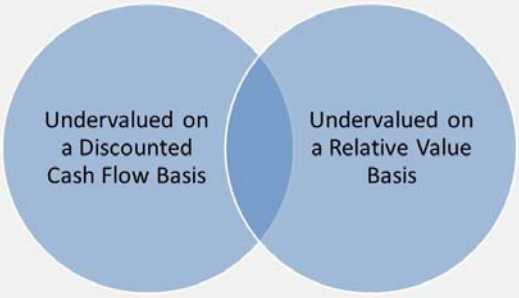
VALUENTUM

The Watch List

By Valuentum Analysts

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



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

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

[Screen expanded to include stocks with NEUTRAL and UNATTRACTIVE relative value ratings.]

You'll notice there are not many ideas in this market that pass this stringent "value" test. We continue to emphasize that some of our best ideas are included in our simulated newsletter portfolios.

Company Name	Symbol	DCF Valuation	Relative Valuation	Price / Fair Value	Fair Value Estimate
General Motors	GM	UNDERVALUED	NEUTRAL	0.72	$61.00
Discover Financial	DFS	UNDERVALUED	UNATTRACTIVE	0.76	$102.00
Verint	VRNT	UNDERVALUED	NEUTRAL	0.78	$54.00
General Electric	GE	UNDERVALUED	NEUTRAL	0.71	$18.00
Cardinal Health	CAH	UNDERVALUED	NEUTRAL	0.69	$71.00
AIG	AIG	UNDERVALUED	ATTRACTIVE	0.78	$69.00
Alphabet	GOOG	UNDERVALUED	NEUTRAL	0.76	$1523.00
Facebook	FB	UNDERVALUED	ATTRACTIVE	0.70	$233.00
Sohu.com	SOHU	UNDERVALUED	UNATTRACTIVE	0.63	$32.00
Finisar	FNSR	UNDERVALUED	UNATTRACTIVE	0.75	$22.00

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

*Ideas...*continued on next page

***Ideas...*from previous page**

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

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

Due to the frothy stock market environment, which is making driving up prices, there are no stocks that register a 9 or 10 on the Valuentum Buying Index rating system at this time. **Please consult the Best Ideas Newsletter portfolio on page 8 for our best ideas.**

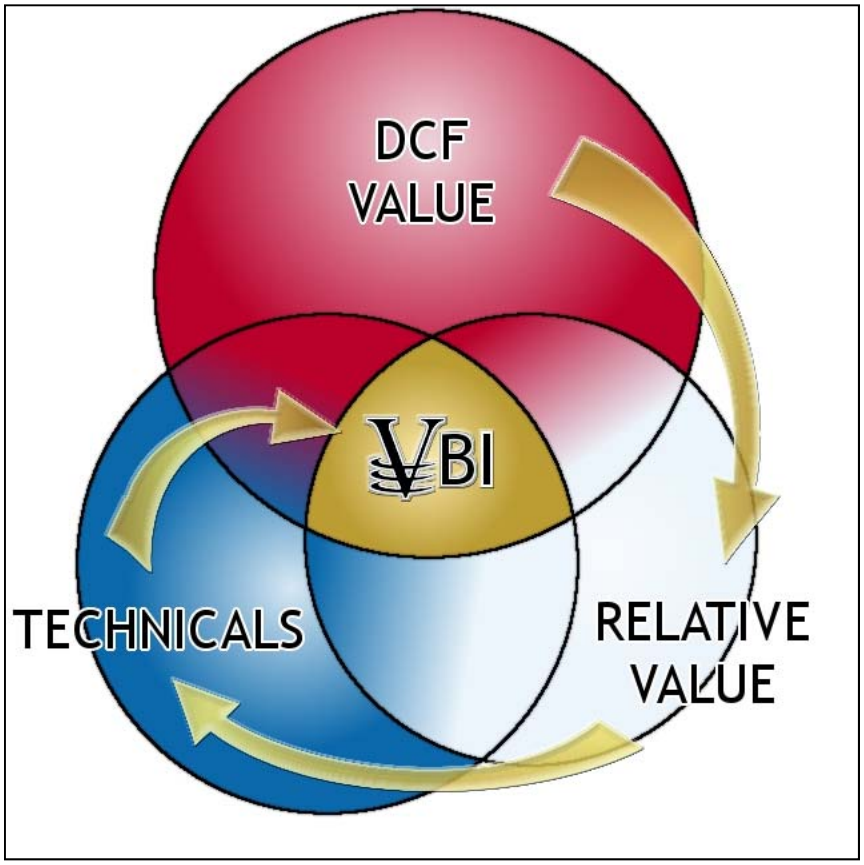
Company Name	Symbol	Sector	VBI
Ecolab	ECL	Materials	1
Chart Industries Inc	GTLS	Materials	1
Fiserv	FISV	Information Technology	1
Arch Capital	ACGL	Financials	1
Estee Lauder	EL	Consumer Discretionary	1
H&E Equipment	HEES	Industrials	1
Graco	GGG	Industrials	1
IDEX	IEX	Industrials	1
McGrath	MGRC	Industrials	1

Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

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

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



Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

The center of the Venn diagram above, the Valuentum Buying Index (VBI) combines rigorous financial and valuation analysis with an evaluation of a firm's technicals and momentum indicators to derive a rating between 1 and 10 for each company (10=best). Because the process factors in a technical and momentum assessment after evaluating a firm's investment merits via a rigorous DCF and relative-value process, the VBI attempts to identify entry and exit points on what we consider to be the most undervalued stocks.

We think research firms that just focus on valuation may expose readers to a stock on its way down (a falling knife), while those that just use technical and momentum indicators may expose portfolios to significantly overpriced stocks at their peaks. It is our view that only when both sides of the investment spectrum are combined can investors find undervalued stocks at potentially timely prices for consideration.

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

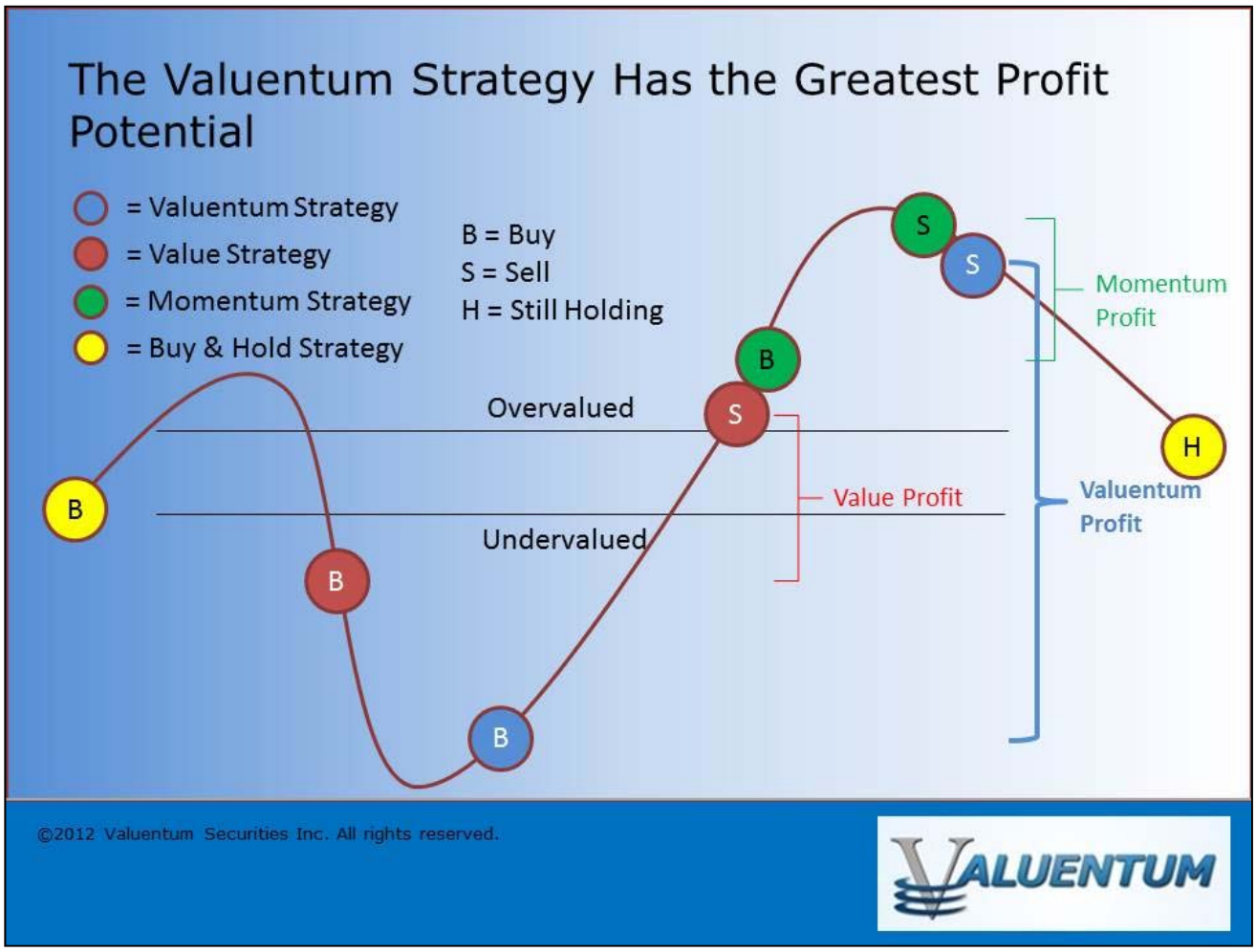


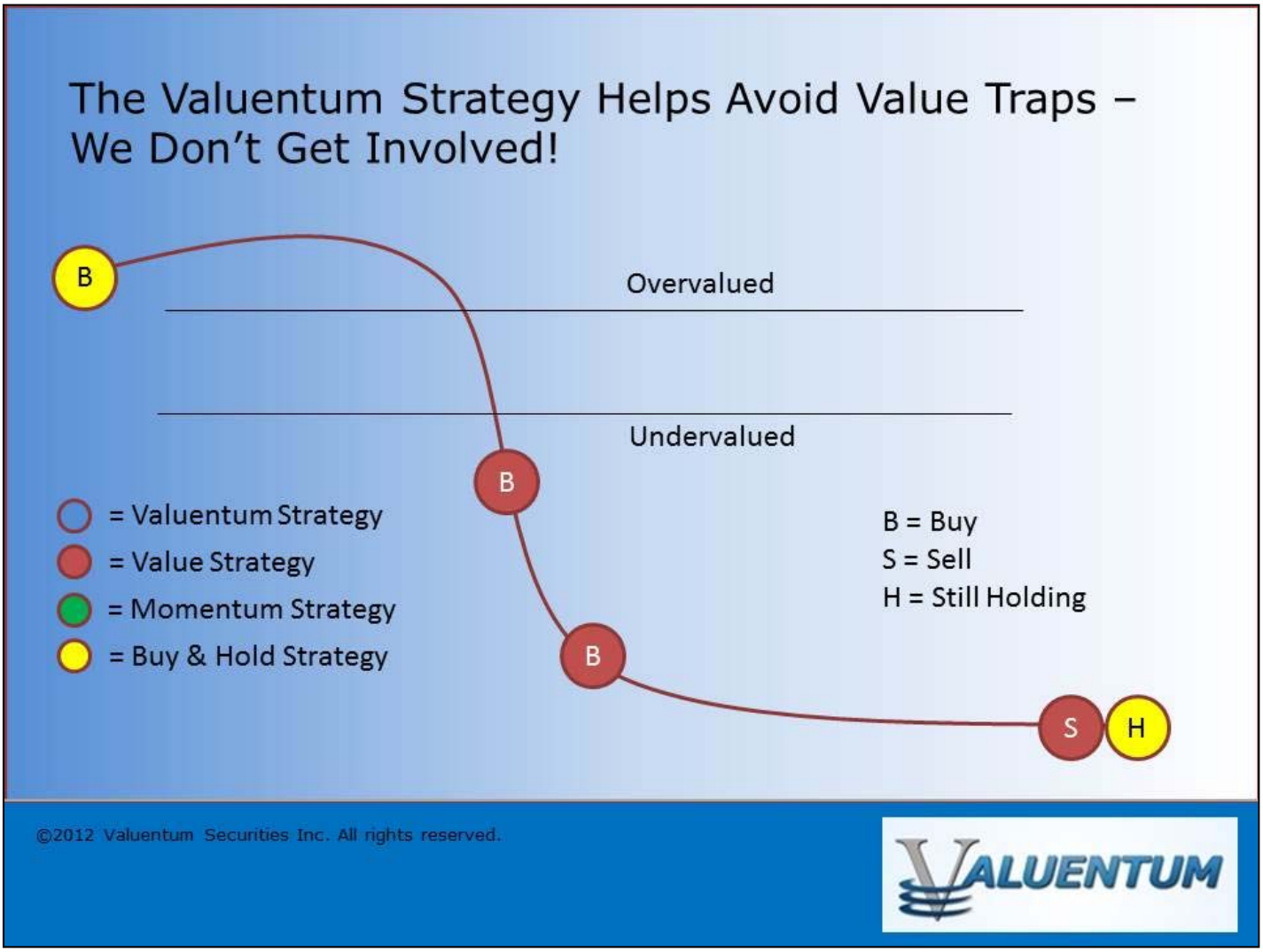
Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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



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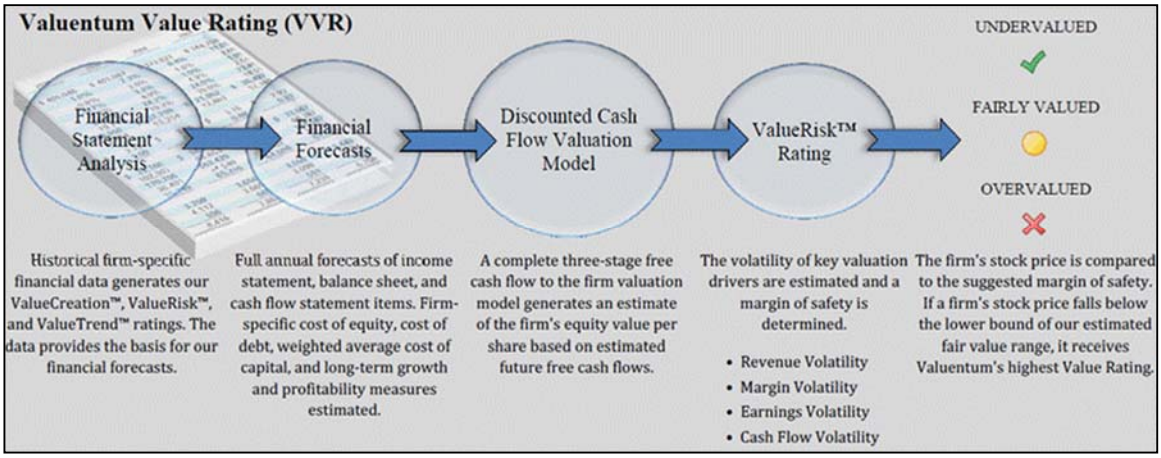
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

Let's walk through the three investment pillars of our stock-selection methodology.

I. The Valuentum Buying Index Applies A Rigorous Discounted Cash Flow Valuation Process

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



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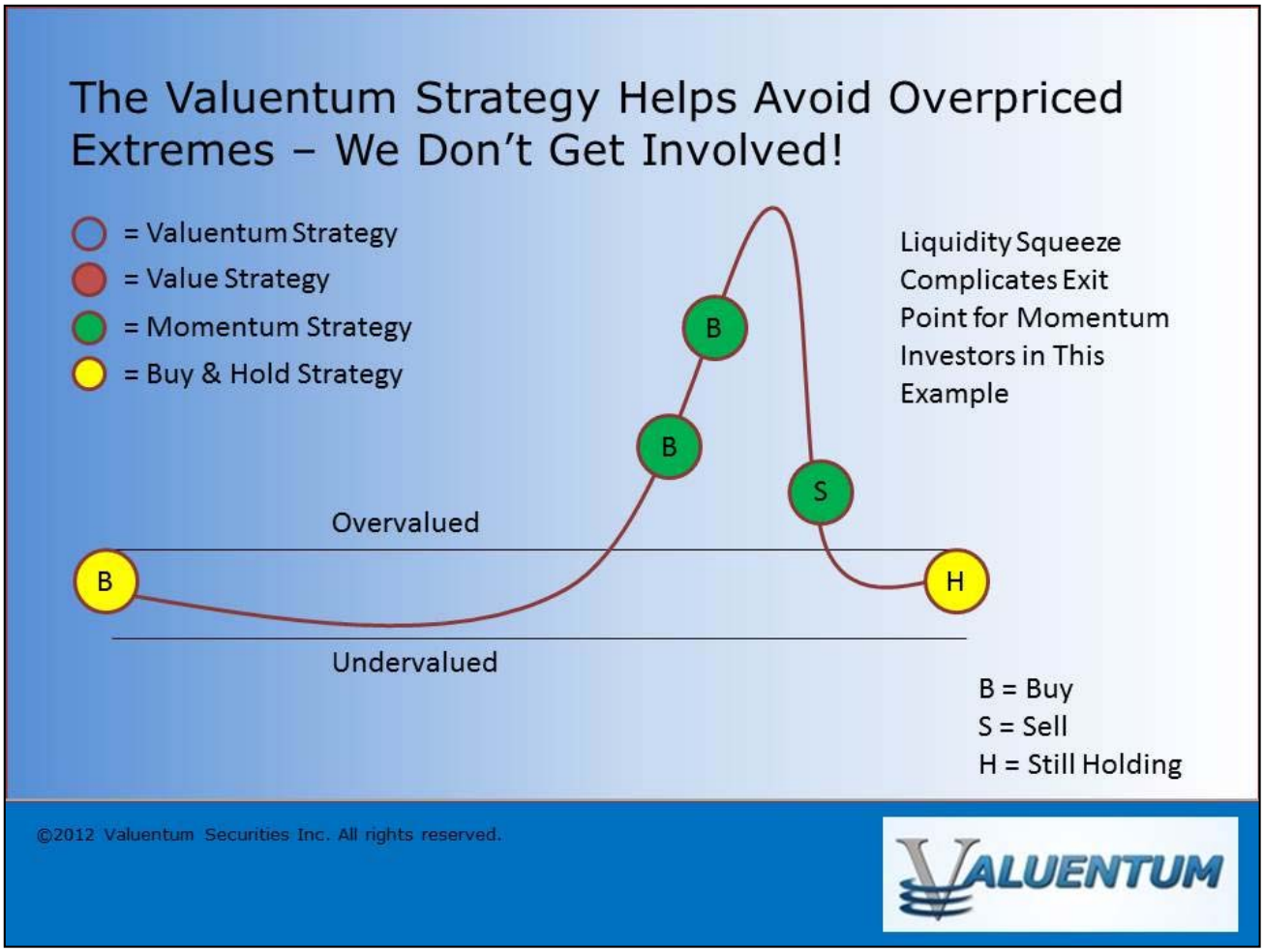
After evaluating historical trends, we then make full annual forecasts for each item on a company's income statement and balance sheet to arrive at a firm's future free cash flows. We derive a company-specific cost of equity (using a fundamental beta based on the expected uncertainty of key valuation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

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

We think a focus on discounted cash-flow (DCF) valuation helps to prevent investors from exposing their portfolios to significantly overpriced stocks at their peaks. The image below reveals how pure momentum investors may expose their portfolios to pricing extremes and dramatic falls (green circles: Buy --> Sell). The Valuentum Buying Index attempts to steer clear from these situations.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page



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II. The Valuentum Buying Index Incorporates A Forward-Looking Relative Value Assessment

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

III. The Valuentum Buying Index Seeks to Avoid Value Traps, Falling Knives and Opportunity Cost

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

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

valuation criteria).

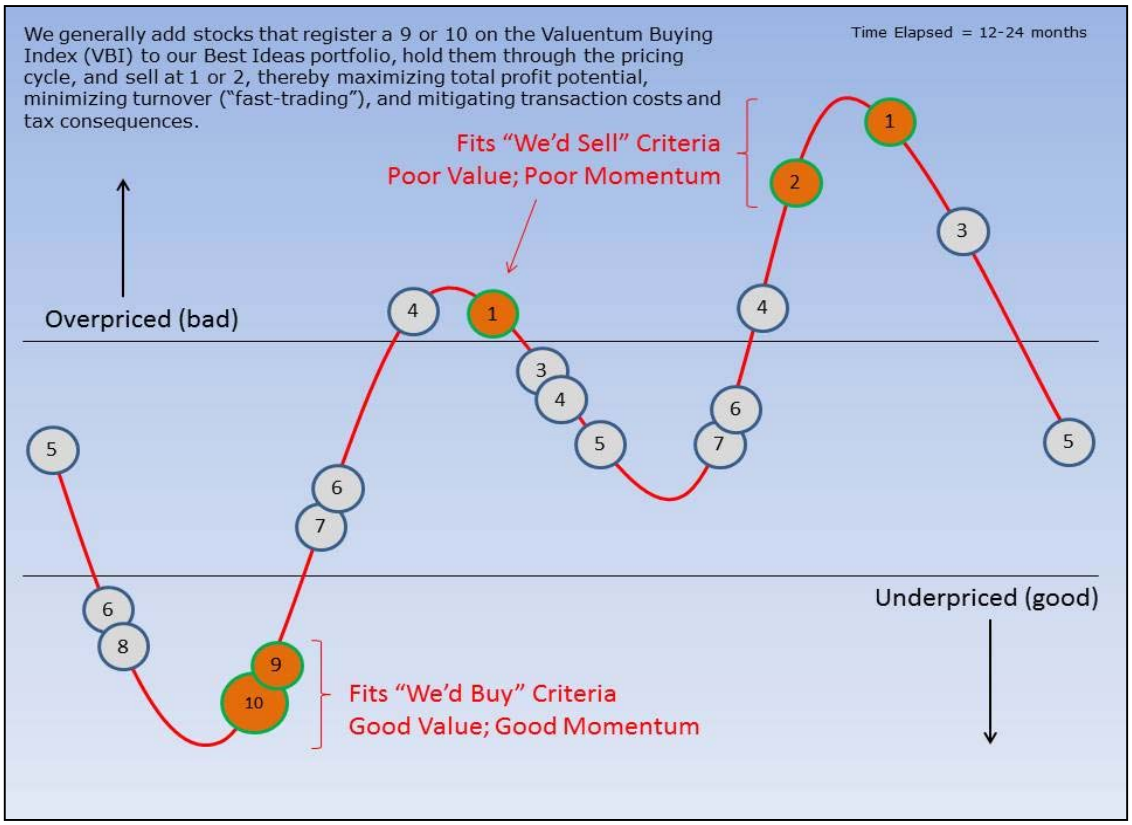
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with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

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

Putting It All Together - the Valuentum Buying Index

Though the time frame varies depending on each idea, on a theoretically basis, we would expect our best ideas to "work out" over a 12-24 month time horizon (on average) -- the duration of any individual idea can vary considerably, however. We tend to include firms in the Best Ideas Newsletter portfolio when they register a 9 or 10 on our Valuentum Buying Index (VBI) and tend to remove firms from the Best Ideas Newsletter portfolio when they register a 1 or 2 on the Valuentum Buying Index.

In theory, the Valuentum Buying Index attempts to maximize profits on every idea within the Best Ideas Newsletter portfolio, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. A value strategy (10 --> 5), for example, may truncate potential profits, while a momentum strategy (4 --> 1), for example, may ignore profits generated via value assessments. The Valuentum Buying Index seeks to capture the entire profit potential, as shown below.



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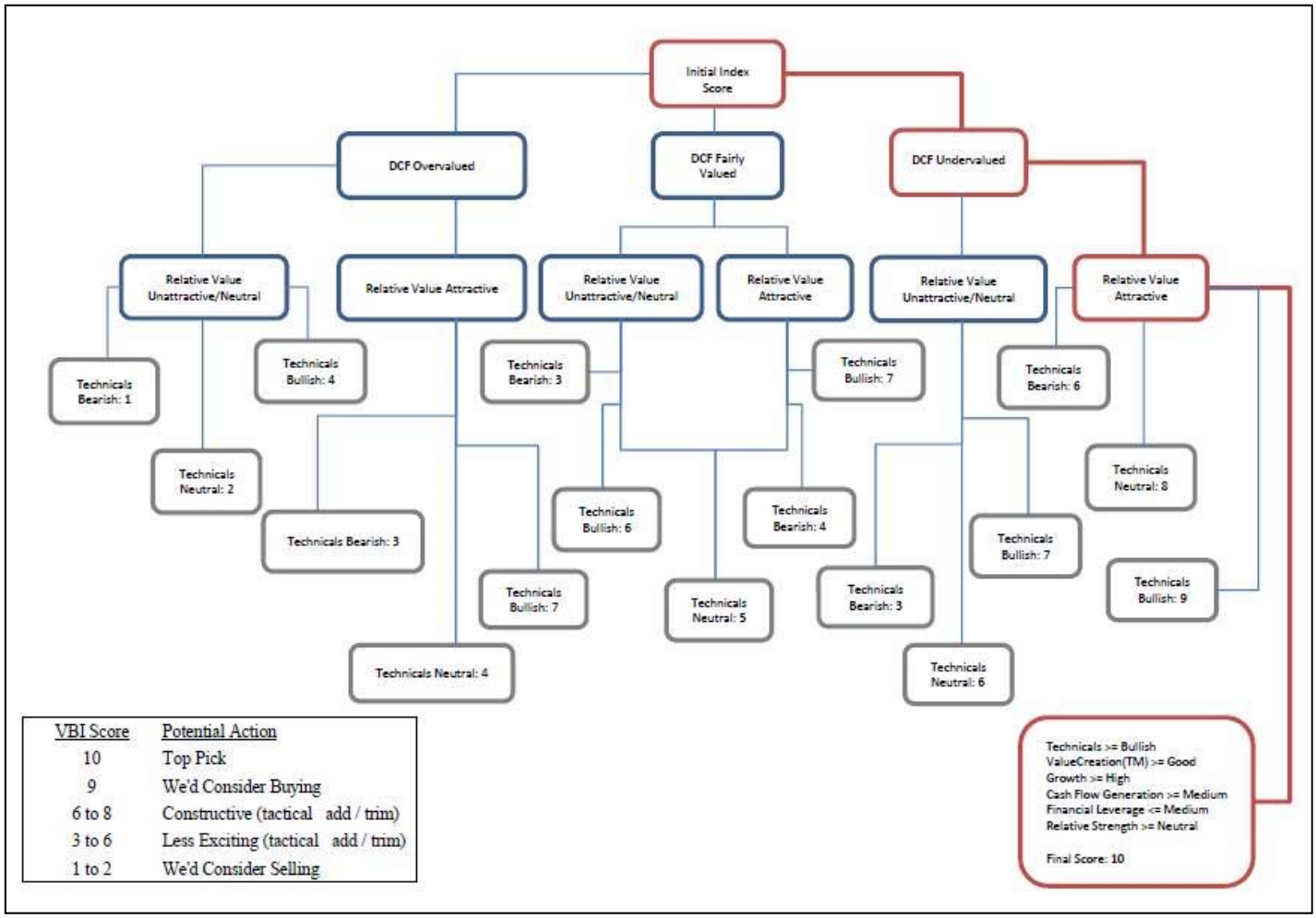
Our Methodology – The Valuentum Buying Index continued on next page

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

Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on the Valuentum Buying Index (a "Top Pick"). Please click here to view an enlarged pdf version.

First, the company would need to be 'UNDERVALUED' on a DCF basis and 'ATTRACTIVE' on a relative value basis. The stock would also have to be exhibiting 'BULLISH' technicals. The firm would need a ValueCreation rating of 'GOOD' or 'EXCELLENT', exhibit 'HIGH' or 'AGGRESSIVE' growth prospects, and generate at least a 'MEDIUM' or 'NEUTRAL' assessment for cash flow generation, financial leverage, and relative price strength.

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



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

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

About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

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

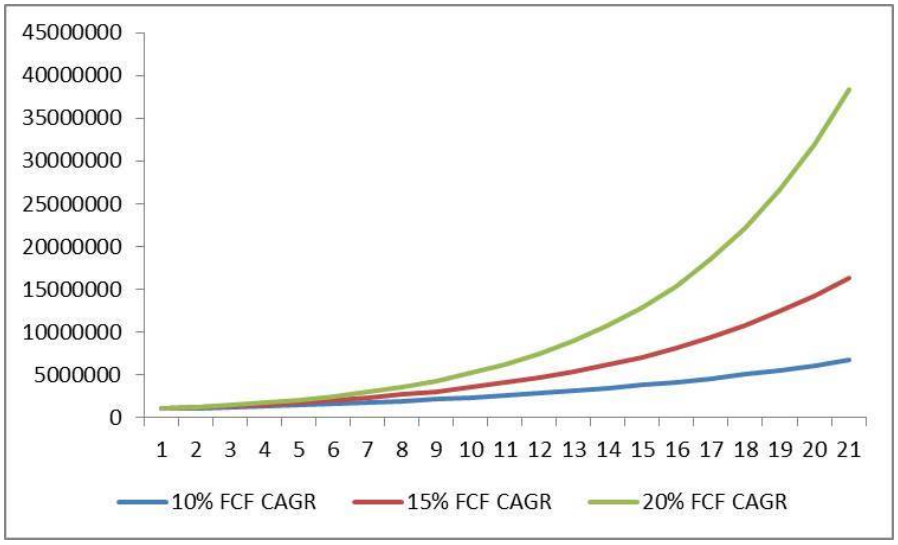
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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



About the Fair Value Range continued on next page

About the Fair Value Range continued from previous page

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

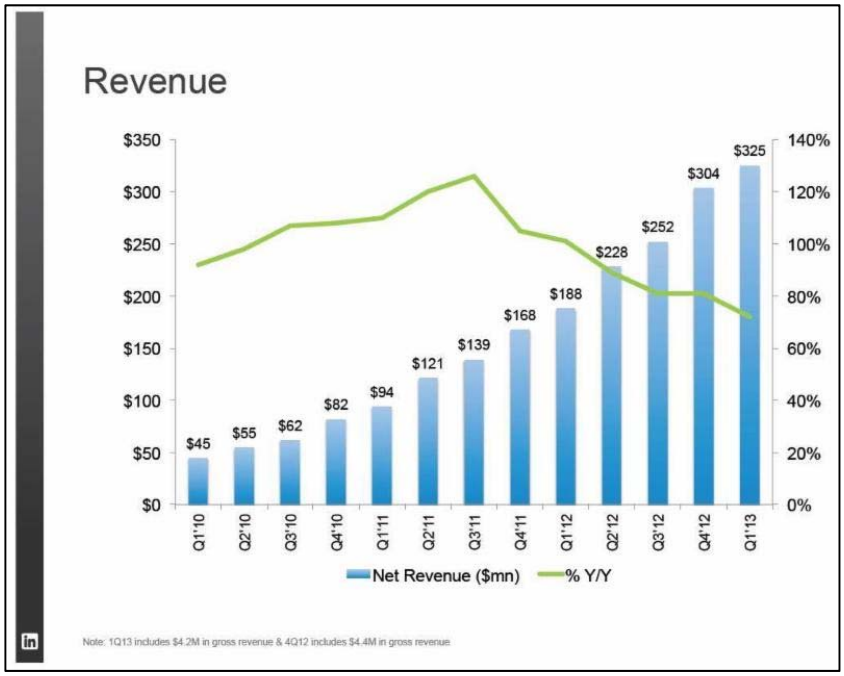


Image Source: LinkedIn

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

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

Shares collapsed in a huge way.

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About the Fair Value Range **continued from previous page**

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

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

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

By Valuentum Analysts

We often receive questions about how we use the Valuentum Buying Index (VBI) rating system, one of the key metrics we use to source ideas, but we think it is equally important to mention up front that it is only one of the many facets of our website and services. For example, if you haven't checked out the Dividend Cushion ratios on the stocks in your portfolio or the dividend growth product (from individual reports to the newsletter and beyond), surely you are not maximizing your membership! Don't forget about the Economic Castle rating and the Nelson Exclusive publication, too.

No matter your strategy or process though (it is not for us to say what is best for you), the Valuentum Buying Index rating system is still a helpful tool to have at your disposal, even if you are not using it. Admittedly, the VBI, as we call it, is not as easy to evaluate as 1, 2, 3, or even buying 9s and 10s and selling 1s and 2s until their VBI changes upon the next update. Generally speaking, we measure the process over longer-term time periods--from the time a company registers a rating to a defined time in the future--not an interim update basis. Please read more our case study, where Valuentum Buying Index ratings, as of September 2013, were recorded and the performance of stocks were measured from that time through September 2014.

The Valuentum Buying Index Has Checks and Balances

With prudence and care, the Valuentum Buying Index process and its components are carried out. Our analyst team spends most of its time thinking about the intrinsic value of companies within the context of a discounted cash-flow model and evaluating the risk profile of a company's revenue model. We have checks and balances, too. First, we use a fair value range in our valuation approach as we embrace the very important concept that value is a range and not a point estimate. A relative value overlay as the second pillar helps to add conviction in the discounted cash-flow process, while a technical and momentum overlay seeks to provide confirmation in all of the valuation work. There's a lot happening behind the scenes even before a VBI rating is published, but it will always be just one factor to consider.

Within any process, of course, we value the human, qualitative overlay, which captures a wealth of experience and common sense. We strive to surface our best ideas for members, and flying blind is never a good strategy, in our opinion. In probably one of the most obvious cases, for example, an experienced investor knows when a price-to-earnings (P/E) ratio isn't informative (as in the case of negative or negligible earnings), but a quantitative rating system that uses a P/E ratio may not know any better. That's why the VBI has checks and balances and focuses on the discounted cash-flow process first and foremost, but the human, qualitative overlay is still extremely important, especially when considering various business models and unique "un-modelable" risks. In our opinion, a golf club is only as good as the player that uses it, and in a similar light, a financial model or a rating system is only as good as the user that applies it.

That said, for the sake of transparency, we measure the performance* of the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter. The portfolios, in part, represent data points measuring the outcome of the work we do on the website, rolled into an assessment: our best ideas for each respective strategy. The ideas in the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter have been evaluated by our analyst team for consideration in the newsletter portfolios. The thoughts behind the weighting of each idea and the portfolio management process revealed in full transparency on a month to month basis may be worth the cost of a membership alone, even if you're not using the portfolios!

Here's why this is important. In a market environment where more than 90% of large-cap funds have trailed the S&P 500 in the 5-year period ending August 31, 2016, the Best Ideas Newsletter portfolio* has exceeded its benchmark return over a similar time period. What's more, we showcased this performance in full transparency, and we wrote every single day, and some days weren't all that great. When patience

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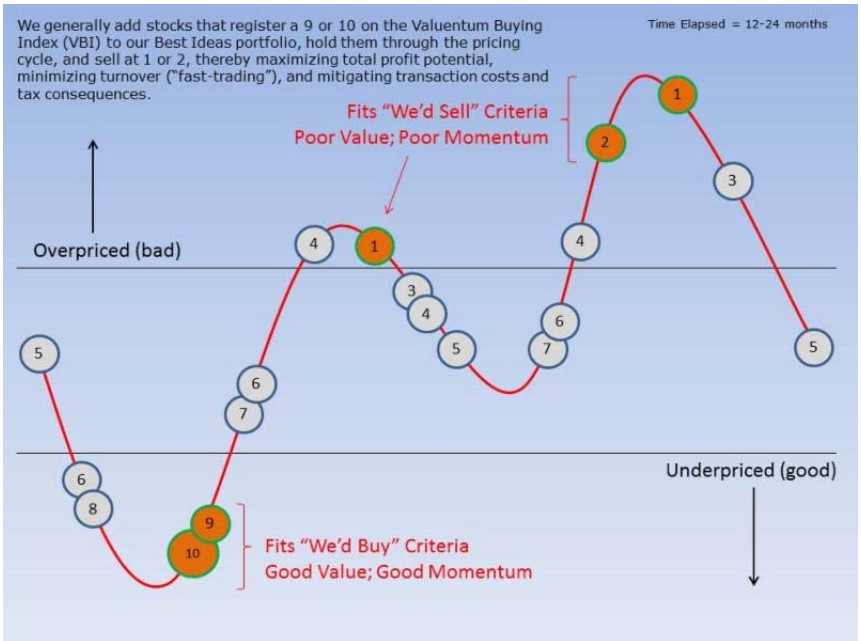
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

** Actual results may differ from simulated information being presented. The Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio are not real money portfolios. Results are hypothetical and do not represent actual trading.*

The Valuentum Buying Index Is One of Many Important Factors to Consider

That said, let's talk about how the VBI helps to inform which ideas we include in the Best Ideas Newsletter portfolio. This is where some clarification is probably important. For one, the word choice is critical, "inform," because the VBI is generally just one factor that goes into whether we add a company to the Best Ideas Newsletter portfolio, even if the VBI is one of the most important factors. Second, the timing element or duration concept is a key consideration. We've noticed via our statistical backtesting that a momentum factor can be much more pronounced (powerful) over longer periods of time. This was one of the interesting findings of our academic white paper study (2012). We try to consider this dynamic with the update cycle of our reports (and the time horizon for ideas to work out). That's why our reports are updated regularly (generally on a quarterly basis) or after material events and not daily or weekly. Perhaps most practically though, we don't think portfolio churn is the way to generate outperformance. Momentum may be high turnover, but Valuentum is low turnover.

Though the time frame varies depending on each idea that we consider for the Best Ideas Newsletter portfolio, we would expect our best ideas to generally work out over a 12-24 month time horizon (on average). Not all ideas will be successful, however. Our "holding period" is targeted to be much, much longer for some ideas in the Dividend Growth Newsletter portfolio, as income and dividend growth are other key factors (in addition to the Valuentum Buying Index and capital appreciation potential). The time horizon or duration concept is where the Valuentum Buying Index rating system becomes more complicated than a simple 1, 2, 3. For example, we tend to "add" stocks to the Best Ideas Newsletter portfolio when they register a 9 or 10 on the Valuentum Buying Index (VBI), "hold" them for some time depending on a number of variables (the VBI, market conditions, sector weightings within the portfolio itself), and then we tend to "remove" stocks from our Best Ideas Newsletter portfolio when they register a 1 or 2 on the VBI. You'll notice that we have a qualitative overlay for the Best Ideas Newsletter portfolio (and one for the Dividend Growth Newsletter portfolio, too, based on dividend-related considerations).



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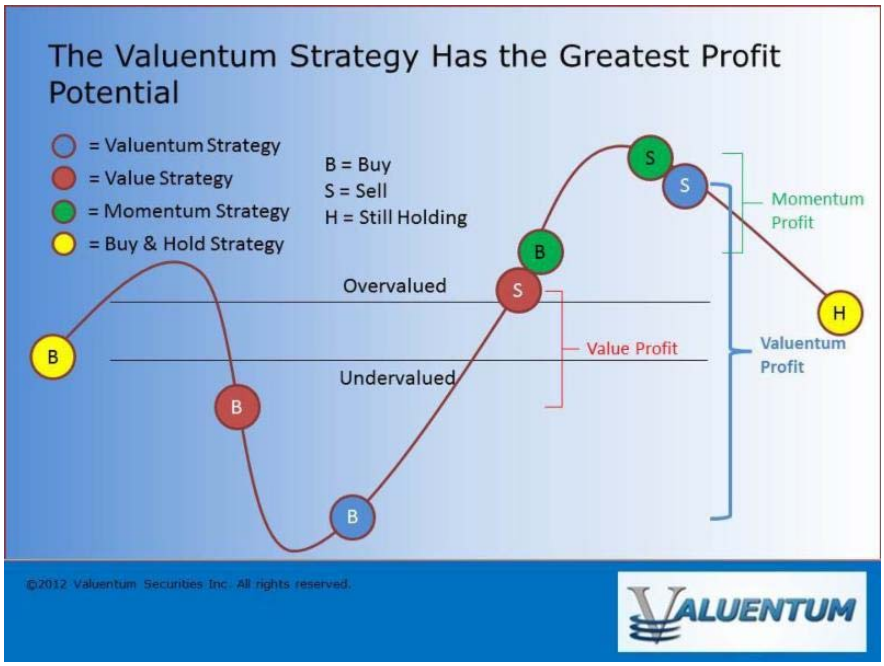
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and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



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Not All Highly-Rated Stocks Are Added to the Newsletter Portfolios

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

But why not add every highly-rated stock on the Valuentum Buying Index to the Best Ideas Newsletter portfolio? Think of it as if you were to imagine a value investor not adding and holding every undervalued stock to his/her portfolio. He or she wants the very best ones, in his or her opinion -- obviously, that means having to leave some good ideas behind. And then, of course, there are always tactical and sector weighting considerations in any portfolio construction, yet another reason why the human touch remains a vital aspect of the Valuentum process. At the core of how we use the VBI in the Best Ideas Newsletter portfolio, however, is a qualitative portfolio management overlay. The VBI rating helps to inform the

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process, but the Valuentum team makes the allocation decisions of the newsletter portfolio on the basis of a number of other firm-specific and portfolio criteria. Sometimes, under certain market conditions, we may even have to relax the VBI criteria entirely in order to do what we think is required to achieve newsletter portfolio goals.

Some Examples of the Valuentum Buying Index In Action

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

There have been more straightforward opportunities in the Best Ideas Newsletter portfolio, too, especially in the case of EDAC Tech, which tripled since it was added to the newsletter portfolio (never registering below a 9 along the way), and then of course, Apple (APPL), Visa (V) and Altria (MO), but it is usually through the nuances of the process that one truly comes to understand it (as in the eBay example). Not to be overlooked either, the Valuentum Buying Index rating also informs us when we may consider "removing" a position from the newsletter portfolios. Kinder Morgan (KMI), for example, registered a 1 on the Valuentum Buying Index just prior to its notorious fall and dividend cut. The VBI ratings on each stock's most recent 16-page report, downloadable directly from the website at www.valuentum.com, reflect our current opinion on the company.

In all, the Valuentum Buying Index rating system, as with all methodologies, helps to inform the investment decision process, but in constructing the newsletter portfolio, a qualitative overlay is not only necessary, in my view, but helps to optimize performance. If the returns of the Best Ideas Newsletter portfolio during the past 5+ years are any measure of the VBI rating system, it is performing fantastically well. Of course, please always contact your financial advisor to determine if any idea or strategy may be right for you.

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About Our Name

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

-- Warren Buffett, Berkshire Hathaway annual report, 1992

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

Valuentum Best Ideas Newsletter: Volume 8, Issue 9

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

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Valuentum uses its own proprietary stock investment style and industry classification systems. Peer companies are selected based on the opinions of the Valuentum analyst team. Research reports and data are updated periodically, though Valuentum assumes no obligation to update its reports, opinions, or data following publication in any form or format. Performance assessment of Valuentum metrics, including the Valuentum Buying Index, is ongoing, and we intend to update investors periodically, though Valuentum assumes no obligation to do so. Not all information is available on all companies. There may be a lag before reports and data are updated for stock splits and stock dividends.

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