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HIGH YIELD DIVIDEND NEWSLETTER

ASSESSING THE MIDSTREAM ENERGY SPACE

Shares of the Alerian MLP ETF (AMLP) have fallen considerably since mid-2015, but the US midstream energy space looks to have some attractive secular trends. Though there may be a solid fundamental backdrop, we still don't like the long-term outlook for the master limited partnership ownership structure, even as we include the AMLP in the simulated High Yield Dividend Newsletter portfolio.

Image shown: the Alerian MLP ETF share price performance since Spring 2015.

The US midstream energy space has struggled for the better part of four years, as measured by the share price performance of the Alerian MLP ETF (AMLP), and you're probably familiar with Valuentum's call on the space in mid-2015, which may go down in history as one of the most prescient calls we've seen.

Nevertheless, US midstream observers believe the space appears to be fundamentally well-positioned moving forward thanks to the robust growth of North American onshore E&P activity in recent years. Production growth has routinely surprised to the upside recently and continues to do so, and natural gas liquid, crude oil, and natural gas pipeline capacity are all very tight as of late 2018, suggesting there are opportunities for attractive expansion in the near term. The number of drilled but uncompleted wells, most notably in the prolific Permian Basin, continue to grow, which indicates tightness in completion services,

> "THIS OPTIMISTIC PICTURE OF LONG-TERM POTENTIAL IS NOT TO SAY THAT THE US ENERGY SPACE IS NOT WITHOUT ITS FAIR SHARE OF CHALLENGES. COMMODITY-BASED BUSINESSES ALWAYS HAVE A LARGE DEGREE OF PRICE-TAKING RISK RELATED TO THE INHERENTLY CYCLICAL NATURE OF COMMODITY PRICES AS DELICATE GLOBAL SUPPLY/DEMAND BALANCES DRIVE PRICE REALIZATIONS REGARDLESS OF HOW WELL ANY SINGLE OPERATOR MAY EXECUTE." – KRIS ROSEMANN

labor, trucking, and concerns regarding transportation of extracted energy resources.

Over the long term, the US E&P space appears to have staying power and material upside with respect to its volumetric potential. As E&P firms and oilfield service operators continue to become more efficient in extraction, the group only becomes increasingly more competitive on a global scale, and the US is fully expected to become a major exporter of crude oil in coming years. A similar trend is expected with respect to liquified petroleum gas (LPG), and export capacity additions will be necessary in most cases to meet rising global demand for US commodities.

As it relates to downstream demand, the US is oversupplied for all hydrocarbons, but the rising standard of living around the globe is driving demand for the likes of ethylene and propylene, which should only drive the need for export capacity higher. The US petrochemical industry is expected to continue holding an advantage over the rest of the globe with respect to feedstocks, and this will only further drive demand for exports of its price advantaged hydrocarbons and chemicals. Asia is the largest driver of this demand as the continent imports about half of its LPG, ~40% of which currently comes from the US. A meaningful portion of this is due to a rising middle class in China and India, which brings relatively inelastic and consumer-driven demand, and clean-air policies being adopted in both China and India bode well for chemical import demand as well.

This optimistic picture of long-term potential is not to say that the US energy space is not without its fair share of challenges. Commodity-based businesses always have a large degree of price-taking risk related to the inherently cyclical nature of commodity prices as delicate global supply/demand balances drive price realizations regardless of how well any single operator may execute. Concerns regarding the ability of the Permian Basin to continue delivering previously anticipated production growth and efficiency levels underscore the unpredictability of operations in the space as well. US hydraulic frac activity has disappointed to a degree of late, but this may indicate an opportunity for the once-beleaguered midstream space to catch up to the production growth experienced in the space.

Regardless of the health of the US energy space as a whole, an individual assessment is necessary for any idea found within. With that in mind, let's take a look at the fourth quarter reports of some of the ideas found within the simulated High Yield Dividend Newsletter portfolio.

Magellan Midstream Partners Targeting 5% Annual Distribution Growth in 2019

Magellan Midstream Partners (MMP) reported a solid finish to a year in which it delivered record distributable cash flow thanks to strong demand for its refined petroleum products and crude oil pipeline and terminal services, but units faced selling pressure following the January 31 release of its fourth quarter results after 2019 guidance came up short of market expectations and management announced a change in its near-term strategic growth investments. This master limited partnership operates a primarily fee-based business model and employs a conservative financial policy, both of which are core drives behind its inclusion in the simulated High Yield Dividend Newsletter portfolio.

In its fourth quarter, Magellan reported net income growth of 32% on a year-over-year basis thanks in large part to favorable mark-to-market adjustments for hedge positions in its commodity-related activities. This growth was partially offset by an impairment charge related to the MLP's ammonia pipeline system, and it has chosen to discontinue operations of the pipeline beginning in late 2019 due to low profitability and an expected drop off in ammonia production. Management points to this decision and the decision to not pursue a stand-alone project to build a new crude oil pipeline in the Delaware Basin as evidence of its disciplined approach to growth capital spending.

However, the market did not like the change in plans as it may indicate a downturn in distributable cash flow growth. Management's planned 5% annual dividend increase for 2019 also appears to have disappointed investor expectations as it came in at the low end of prior guidance of 5%-8% annual distribution growth in 2019 and 2020. We're not overreacting to what may very well be a prudent capital allocation decision, and though distribution growth guidance and industry-specific cash flow measures may have disappointed, Magellan did provide a route for which upside to its near-term

distributable cash could be had via advantageous price differentials.

Magellan uses "operating margin," a non-GAAP financial measure that reflects operating profit before general and administrative expense and depreciation, amortization and impairment expense, to measure the progress of its business segments. Its 'Refined Products' segment (~68% of total operating margin in the quarter) reported operating margin growth of more than 60% on a year-over-year basis due in large part to the aforementioned mark-to-market adjustments for commodity hedges. Average pipeline rate increases helped drive transportation and terminals revenue higher.

The MLP's 'Crude Oil' segment (~25% of operating margin in the quarter) experienced an ~8% year-over-year decline in operating margin due in part to an increase in volumes in the Houston distribution system, which carries lower rates, and its 'Marine Storage' segment (~6% of operating margin in the quarter) reported an ~18% increase in operating margin in the period as higher utilization was driven by more tanks being out of service for maintenance in the year-ago period. Management continues to expect 85%+ of its operating margin to be generated by fee-based transportation and terminals services, as commodity-related activities are projected to contribute less than 15% of its operating margin.

Distributable cash flow, the industry specific measure of cash flow available for distributions that ignores *growth* capital spending, took a slight step back in the fourth quarter of 2018 at Magellan due to costs associated with the future shut down of the ammonia pipeline and write-offs related to discontinued capital projects, but the measure hit record levels in the full year 2018. Distributable cash flow of more than $1.1 billion in 2018 was nearly 9% higher than 2017 levels, and it drove a distribution coverage ratio of 1.26x. Units yield ~6.4% as of this writing.

Magellan expects 2019 to bring another year of record distributable cash flow generation, with its target for the year set at $1.14 billion. It is also targeting a 5% increase in annual cash distributions (down from 8% in 2018), and the combination of these two targets is expected to result in a distribution coverage ratio of ~1.2x, which it expects to maintain for the foreseeable future. Net income per limited partner unit guidance comes in at ~$3.90 and excludes future mark-to-market adjustments on the MLP's commodity-related hedges, and this mark came in significantly below consensus expectations for $4.40.

However, there is upside potential for Magellan's distributable cash flow target. According to management, "Due to the volatility in the pricing differential between the Permian Basin and Houston that encourages spot shipments on the Longhorn and BridgeTex pipelines, current guidance assumes spot shipments occur on both pipelines during the first quarter of 2019 only. If spot shipments continued throughout the remainder of the year, the partnership's DCF could be up to $1.2 billion for 2019."

We continue to highlight Magellan Midstream Partners as an idea in the simulated High Yield Dividend Newsletter portfolio, **and we like its investment grade credit ratings (BBB+/Baa1) that rank near the highest among all MLPs.** Its payout remains dependent upon access to the capital markets, but its strong credit rating bodes well in case of future tightening credit conditions. Its disciplined track record is well-documented, and management has only had to issue $260 million worth of equity related to growth projects over the past decade, which has seen it deploy $5.4 billion in expansion capital. We like its simple organizational structure that consists of 100% limited partner ownership and helps keep its cost of capital among the lowest in the MLP space.

Our fair value estimate for units of Magellan currently sits at $68 each, and our adjusted Dividend Cushion ratio is currently 1.1, highlighting the capital market dependence of the payout.

Enterprise Products Partners Hits 20 Years of Consecutive Distribution Growth

2018 marked the 20th consecutive year in which Enterprise Products Partners (EPD) raised its annual distribution, and the fourth quarter of the year marked the 58th consecutive quarter of increases in the payout. The fourth quarter of the year, results released January 31, brought a 41% year-over-year increase in gross operating margin (defined the same as that of Magellan

Midstream Partners) thanks in large part to mark-to-market gains.

Enterprise's 'NGL Pipelines & Services' segment (~45% of total operating margin in the quarter) delivered an 11% increase in operating margin from the year-ago period thanks in part to higher natural gas processing margins and a favorable impact from hedging activities, and total fee-based processing volumes advanced 16% on a year-over-year basis. In the MLP's 'Crude Oil Pipeline & Services' segment (~30% of total operating margin in the quarter), operating margin more than doubled from the year-ago period to a quarterly record of $644 million thanks to mark-to-market gains related to cash settlement of underlying hedges and a narrowing of commodity price differentials. Total crude oil pipeline transportation volumes hit a record of 2 million barrels per day in the quarter.

The MLP's 'Natural Gas Pipelines & Services' segment (~12% of total operating margin in the quarter) turned in 47% year-over-year operating margin growth in the fourth quarter as total natural gas transportation volumes climbed 9%, and average sales margins moved higher thanks to price differentials between the Permian Basin and Texas Gulf Coast. Enterprise's 'Petrochemical & Refined Products Services' segment (~12% of total operating margin in the period) reported 48% growth in its operating margin from the year-ago period as a 13% increase in volumes was exacerbated by higher average sales margins.

Enterprise Product Partners delivered a record level of distributable cash flow in 2018, which leapt 33% from 2017 levels to $6 billion, and its distribution coverage ratio came in at 1.5x, after excluding proceeds from asset sales and monetization of interest rate derivatives. **While this is a solid ratio, we continue to highlight the capital-market dependency of MLPs to grow their respective payouts and asset bases.** Enterprise's traditional free cash flow for the full year 2018 came in at just under $1.6 billion, and our back of the envelope calculation estimates cash distributions paid to limited partners came in at more than $3.7 billion in the year.

The MLP expects capital spending to take a step back in 2019, which should help its traditional free cash flow generation, and total capital spending is anticipated to be in a range of $3.5-$3.9 billion, including $3.1-$3.5 billion of growth capital spending. It plans to self-fund the equity portion of capital spending in 2019 amid continued distribution growth. The distribution increase announced in its quarterly report raised the quarterly payout by more than 2%, and it brings Enterprise's forward distribution yield to ~6.3%. As of the end of 2018, total debt-to-adjusted EBITDA sat at ~3.7x.

Enterprise boasts solid investment grade credit ratings (BBB+/Baa1), and we like that it has a simplified structure with no general partner incentive distribution rights. Management states that it is working to transition from an MLP model to a traditional financial model in which it hopes to self-fund the equity portion of growth capital expenditures and use both distributions and buybacks to return capital to shareholders. It is targeting debt-to-normalized EBITDA to be ~3.5x over time. We'll be watching progress related to this transition closely, but we would like to see significant improvement in its free cash flow generation relative to cash outlays prior to anointing it a successful traditional financial model.

Units of Enterprise Product Partners are currently trading just below our fair value estimate of $30 per unit, and its adjusted Dividend Cushion ratio is 2 at last check. We expect to continue highlighting the MLP in the simulated High Yield Dividend Newsletter portfolio for the foreseeable future.

Tallgrass Energy Agrees to $3.3 billion Deal

Blackstone Infrastructure Partners (BX) has agreed to acquire 100% of the membership interest of Tallgrass Energy's (TGE) general partner, as well a ~44% economic interest in Tallgrass. Blackstone brings with it scale and investment expertise from a multitude of angles in the energy industry, and its access to long-term capital should make it a solid partner with which to target accretive growth opportunities. The deal comes after the combination of Tallgrass Energy GP and Tallgrass Energy Partners in 2018 and is expected to close in the first quarter of 2019.

Tallgrass reported net income, adjusted EBITDA, and cash available for distributions of ~$125 million, ~$241 million, and ~$199 million, respectively, in the fourth quarter of 2018, and management tabs its dividend

coverage ratio at 1.36x based on cash available for dividends per share of $0.71 and a declared dividend of $0.52 per share. As with distributable cash flow in the case of MLPs, we warn against the reliance of this coverage measure as cash available for dividends ignores growth capital spending and is calculated as adjusted EBITDA less cash interest costs and maintenance capital spending. The $0.52 quarterly dividend declared for the fourth quarter of 2018 represents a 2% increase from the third quarter of the year.

In 2019, Tallgrass Energy expects adjusted EBITDA to be $965-$1,035 million, and cash available for dividends guidance comes in a range of $760-$835 million, which is expected to result in dividend coverage of at least 1.25x for the year. Management expects to deliver annual dividend growth of 6%-8% in 2019. Shares of Tallgrass Energy yield ~8.7% as of this writing.

Kinder Morgan Reiterates Dividend Growth Intention

2018 was a transformative year for Kinder Morgan (KMI).

The once-troubled pipeline operator has come a long way in terms of capital allocation since its massive dividend cut in late 2015, but management continues to expect significant growth in the payout in the years ahead. The company's growth in 2018 (fourth quarter results released January 16) was largely driven by robust US natural gas demand, which rose to 90 billion cubic feet per day, an 11% increase over 2017. The company rode this wave of strong demand to fourth quarter net income available to common stockholders of $483 million (up from a loss of more than $1 billion in the year-ago period) and a 6% year-over-year increase in distributable cash flow per share, which came in at $0.56 in the quarter.

Higher utilization rates for a large portion of Kinder Morgan's system came without the need to deploy capital, and the resulting bottom-line growth should help its growth capital allocation plans moving forward. Management expects 2019 to be another strong year for natural gas, which should help it maintain its target leverage ratios. The company was the recipient of a credit rating upgrade from both Moody's and S&P (BBB/Baa2), and it reduced its adjusted net debt-to-adjusted EBITDA (1) ratio to 4.5x at the end of 2018 from 5.1x a year earlier. The reduction in leverage is largely due to its share of asset sales from the Trans Mountain project, which helped push its cash position to nearly $3.3 billion at the end of 2018 from $264 million at the end of 2017.

While we await the release of the 10-K to get a look at Kinder Morgan's full, audited financial statements, most notably its cash flow statement, which was absent from the earnings release, management states that it was able to "fund all growth capital through operating cash flows with no need to access capital markets for that purpose." Management's 2019 outlook suggests a similar dividend coverage profile as that of 2018 as it expects "internally generated cash flow to fully fund its 2019 dividend payment as well as the vast majority of its 2019 discretionary spending, without the need to access equity markets."

Shareholders should expect a portion of its capital outlays in the year to be funded with debt, but the company anticipates ending the year with a net debt-to-adjusted EBITDA ratio of ~4.5x. Kinder Morgan expects distributable cash flow to grow to $2.20 per common share in 2019, up from $2.12 in 2018, and it continues to project an increase in its quarterly dividend to $0.25 per share in the year, up from $0.20 declared for the fourth quarter of 2018. Management also reiterated its expectations for its annual dividend to hit $1.25 in 2020.

All things considered, we aren't looking to add exposure to Kinder Morgan in either simulated newsletter portfolio for the time being; we have been 'fully invested' in each simulated portfolio since December 26. The company has made nice progress in deleveraging, but its debt load of ~$37 billion is still enough to raise some eyebrows and weighs on its Dividend Cushion ratio, which currently sits at parity (1) on an adjusted basis. We value shares, which yield ~4.5% as of this writing, at $23 each, suggesting a bit of upside may be in store if 2019 brings more of the same in terms of strong demand for natural gas and management executes effectively.

Valuentum's call on Kinder Morgan and the collapse of the MLP space in 2015 was as high-profile a call you will find. Valuentum's President of Investment Research

Brian Nelson details the story of that call in the preface of his book Value Trap. You can order the paperback on Amazon: https://www.amazon.com/Value-Trap-Theory-Universal-Valuation/dp/0998038490

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1) Adjusted net debt includes adjustments related to: 50% of KML preferred shares, which is included in noncontrolling interests, of $215 million as of both December 31, 2018 and 2017. Also, the cash component as of December 31, 2018 has been (i) reduced by $890 million, representing the portion of cash KML distributed to KML restricted voting shareholders on January 3, 2019 as a return of capital; and (ii) increased by $91 million, representing the unrecognized gain as of December 31, 2018 on net investment hedges which hedge our exposure to foreign currency risk associated with a substantial portion of our share of the proceeds from the sale of TMPL, TMEP and related assets.

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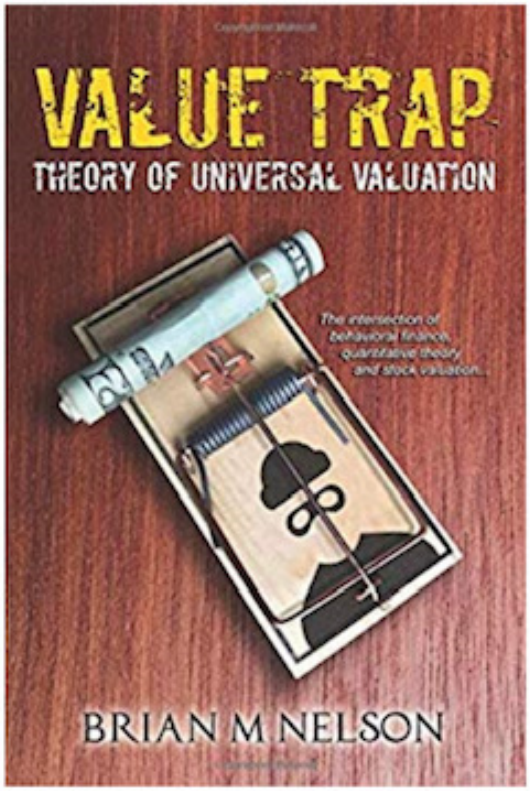

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4.4%-Yielding Schlumberger Slashes Spending as Operating Cash Flow Growth Remains Elusive

Image Shown: Schlumberger's share price performance since 2015.

By Callum Turcan and Kris Rosemann

We added Schlumberger to the simulated High Yield Dividend Newsletter portfolio on January 18, and members were notified of that move via email.

Shares of leading energy equipment and services provider Schlumberger (SLB) received a nice boost following its fourth-quarter 2018 earnings report, released January 18, thanks to expectations for a positive supply/demand balance to drive a gradual recovery in oil prices in 2019. Uncertainty in its North American onshore outlook continues to raise concerns, but management is anticipating solid single-digit growth in international markets in 2019.

In the fourth quarter of 2018, which was marked by a material decline in oil prices due to increased US shale production and the impact of geopolitical issues on supply/demand balance, revenue fell 4% on a year-over-year basis due in large part to lower activity and pricing in its North American onshore operations. North America revenue fell 12% on a quarter-over-quarter basis. The company's pretax operating margin contracted 230 basis points from the year-ago period to 11.8% in the fourth quarter due in part to reduced pricing and activity in its North America onshore operations, seasonal activity decline in Russia, and increased spending on international drilling resources. Pretax operating income fell 16% from the fourth quarter of 2017 to $967 million.

Schlumberger's free cash flow generation improved nicely in the full year 2018 as it jumped to nearly $2.5 billion from ~$1.4 billion in 2017 thanks to cash flow from operations more than doubling. (Investors should note that the calculation of free cash flow includes Schlumberger Production Management investments and multiclient seismic data capitalized.) However, cash dividends paid in the year came in at nearly $2.8 billion, marking the third consecutive year in which it failed to cover dividends paid with internally-generated cash flow. With high yield comes high risk.

The company finished 2018 with net debt of just under $13.3 billion compared to $13.1 billion a year earlier. This debt load, though not yet cause for material concern, and uncertainty related to North American onshore customer spending levels weigh on Schlumberger's Dividend Cushion ratio, which currently sits at 1.1. Free cash flow should benefit from the company's expectations for capital spending to decline in 2019, though it did not provide guidance for Schlumberger Production Management investments and multiclient seismic data capitalized. We like the flexibility baked in to 2019's budget, and shares yield ~4.5% as of this writing.

Reviewing 2018

In 2018, Schlumberger generated $32.8 billion in revenue and $2.1 billion in net income on a GAAP basis. Compared to 2017 levels, its revenue jumped by 8% while its GAAP net income generation turned positive from a large negative figure. On an adjusted basis, its net income rose by 8% to $2.3 billion last year. As Schlumberger's pre-tax operating income climbed just 7%, its pre-tax operating margin dropped 12 basis points to 10.8%. Stronger North American performance was the key growth driver of 2018, as Schlumberger's revenue from this region jumped by 26% on a year-over-year basis to $12 billion. International revenue of $20.4 billion in 2018 was flat with 2017 levels.

Schlumberger generated $5.8 billion in net operating cash flow last year, up marginally from 2017 levels. A $0.7 billion tax refund from the US government artificially inflated Schlumberger's net operating cash flow in 2017, but it should be noted that the company's working capital build and other charges in 2017 consumed $0.8 billion more cash than in 2018.

Management expects Sclumberger's SPM investment contributions to fall to $0.6 billion in 2019 according to commentary from its fourth quarter conference call. Combined with a $1.6 billion capital expenditure budget at the midpoint of guidance, Schlumberger is expected to spend $1 billion less this year versus 2018 levels in capex and SPM investments. **One of the most likely reasons Schlumberger's stock performed well after its earnings report is due to management clearly communicating free cash flow was going to be Schlumberger's number one goal going forward.** Operating cash flow growth, if it can be achieved, combined with disciplined spending levels is how the firm is going to achieve that goal. That being said, operating cash flow growth is far from certain given the inherent volatility associated with the energy space, and ongoing problems at one of its most important divisions.

Problem Area

One area Schlumberger has struggled with recently is likely one most wouldn't expect, and that is well completion services, specifically in North America. This falls under its 'Production' division. Schlumberger's OneStim segment offers a full suite of completion services to North American upstream firms, ranging from pressure pump offerings (which are used to hydraulically fracture unconventional wells) to sand sales (sand is the main proppant used during the fracking process) to well intervention services (to clean out the well after completing the fracking process but before commencing production).

By being able to cater to the oilfield service needs of unconventional upstream producers in the US, a nation whose oil & gas production continues to post record highs, one would imagine this would be a major boon for the company. However, that hasn't consistently been the case. This is from Schlumberger's fourth quarter earnings press release:

"Production revenue of $2.9 billion, of which 53% came from the international markets, declined 10% sequentially. OneStim revenue in North America land dropped 25% as we decided to warm-stack a number of our fleets during the latter part of the quarter, and as we focused on securing dedicated contracts for the first half of 2019 early in the fourth-quarter tendering cycle. Well Services revenue also declined internationally from lower hydraulic fracturing activity in Argentina."

Schlumberger's 'Production' division posted a pre-tax operating margin of 6.8% during the fourth quarter of last year, highlight the very negative impact pricing pressures and lower revenue generation can have on its financial performance. That was a precipitous drop from 9.9% and 10.3% during the third quarter of 2018 and the fourth quarter of 2017, respectively.

Both on a sequential and year-over-year basis, Schlumberger's 'Production' revenue was down during the fourth quarter while its operating income was lower by over a third when compared to either period. Weaker operating margins and less revenue generation is a worrying sign as lower global oil prices are likely to put downward pressure on unconventional development activities in America and around the world as we move forward into 2019.

When looking at Schlumberger's full-year performance, its OneStim unit posted 41% revenue growth in 2018 over 2017 levels, which was a key reason why its North American revenue grew by 26% last year. However, as global oil prices moved materially lower during the final quarter of 2018 and have only modestly recovered this year, it is important to keep in mind Schlumberger's 'Production' division is facing material headwinds that already have made their presence known in its financial results.

South American Fracking Woes

Schlumberger is running into the same problems other oilfield service providers are contending with in Argentina. Namely, that development activity at the Vaca Muerta shale play hasn't lived up to lofty expectations. While the emergence of hydraulic fracturing has led to a boom in North American energy output, that has yet to play out in the South American country. A small part of that could be due to ongoing economic and political troubles, but that doesn't tell the whole story.

Outside of North America, the Vaca Muerta shale is the only unconventional play experiencing significant development activity. The play's oil production has grown from 20,000 barrels per day at the start of 2016

to 60,000 barrels per day by the end of 2018, according to energy consulting firm Rystad Energy. While impressive, that pales in comparison to the size of American unconventional plays and as such doesn't yet represent a needle moving growth opportunity for a firm the size of Schlumberger.

The Bakken and Eagle Ford plays (mature unconventional plays in America) each produce over 1 million barrels of crude oil per day, while output from the prolific Permian Basin is fast approaching 4 million barrels per day. Schlumberger's investments in Argentina represent a bet on the Vaca Muerta achieving a similar level of success.

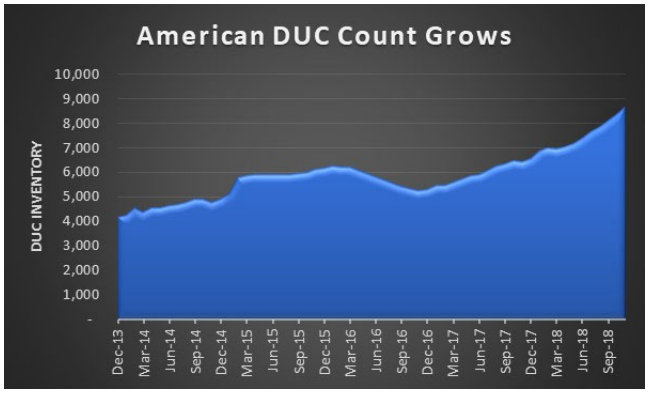
Rystad Energy notes that there are reasons to be optimistic going forward as the number of well completions in the Vaca Muerta is expected to climb higher through the early-2020s, rising from 104 well completions in 2017 to 249 by 2021. While natural gas-rich opportunities have been the prime target so far due to a generous government subsidy program, the industry plans to pivot towards more oil-rich opportunities next. Under multiple different scenarios, Rystad Energy expects oil production from the Vaca Muerta play will rise up to 140,000–200,000 barrels per day by the end of 2021. Keep in mind that trajectory will ultimately be heavily influenced by capricious oil markets.

Domestic Fracking Woes

Schlumberger is coming under fire from a few directions when it comes to fracking in the US. Management has repeatedly mentioned that pricing pressures from upstream firms playing hardball is negatively impacting its business, and that point was reiterated during the firm's fourth quarter conference call. As a lot of pressure pumping and other oilfield service capacity was brought online when times were better, there is no shortage of oilfield service equipment in most circumstances (for workers that is a different story, for instance there is an ongoing shortage of commercial truck drivers).

While drilling activity in America has held up nicely, that hasn't necessarily been the case when it comes to well completion activity. Drilled but uncompleted wells (DUCs) are an understated part of the internal workings of the unconventional upstream industry. For a variety of reasons, upstream companies intentionally delay completing those drilled well locations. Some of those reasons include expectations for higher raw energy resource prices in the future and inability to access pipeline takeaway capacity. Note that the rule of thumb is 40% of the cost of bringing an unconventional well online is represented by drilling expenses and the remaining 60% is represented by completion expenses.

The number of DUCs in America had grown to over 8,700 as of November 2018, according to the US Energy Information Administration. A little over 4,000 of those DUCs are located in the Permian Basin, the prolific play in Southeast New Mexico and West Texas. For comparison, there were about 4,200 DUCs across all of America at the beginning of 2014. An ever-rising amount of DUCs has clearly been a big trend over the past several years, and questions are popping up over when or if those locations will ever get completed (as some are simply for acreage retention purposes).



Source: EIA – Graph made by author

Ostensibly, elevated levels of drilling activity (made apparent through rising oil and gas rig counts) in the US during 2018 was seen as proof that the "fracking boom" was still well underway. In reality, the industry has learned to accomplish a lot more with a lot less. Frac crews are completing wells a whole lot quicker and new wells are many times more productive than their older peers. Schlumberger is still in the process of navigating this tricky terrain, and that's a source of downside that needs to be kept firmly in mind. Pricing pressures and declining revenue were the primary reasons why its company-wide operating margin fared so poorly during the final quarter of 2018.

Concluding Thoughts

Looking ahead to 2019, management expects a positive supply/demand balance to lead to gradually more promising outlook for oil prices as the OPEC+ production cuts take hold and the relatively-reduced activity in the North American onshore space impacts production growth trends. Exemptions from Iran export sanctions will expire--if they are not renewed will provide further restriction to global supply--and the potential resolution of the US-China trade conflict has the potential to stimulate global demand, though we note a slip up in negotiations could have the opposite effect.

Nevertheless, volatility in oil prices has raised uncertainty regarding E&P spending levels in 2019, and Schlumberger notes that its customers are taking a more conservative approach to the year. Management believes it has seen a normalization of E&P capital spending towards what it calls "a more sustainable financial stewardship of the global resource base." It expects investments on the part of North American onshore E&P operators to be tied much more closely to free cash flow generation, a trend we wholeheartedly support, and international operators are expected to begin investing in production capabilities after four years of underinvestment to maintain cash flow.

Management is projecting single-digit revenue growth in international markets in 2019 at current oil prices given its expectations for relatively higher levels of spending, but the alignment of investments to internal cash flow generation in the North America onshore space muddies the picture for the region in 2019. Our fair value estimate for Schlumberger currently sits at $52 per share, and shares are changing hands in the lower half of our fair value range.

Schlumberger is taking the necessary steps to shore up its dividend as management slashes spending elsewhere. The next question at hand is whether Schlumberger will be able to start generating operating cash flow growth despite ongoing weakness in its 'Production' division. Wall Street is supportive of management's fiscal discipline, but that may not be enough as global oil prices are expected to trade lower in 2019 compared last year's levels. Any negative impact on unconventional upstream spending will be quickly reflected in its financial performance. We've added the company to the simulated High Yield Dividend Newsletter portfolio on the basis of its upside potential, but Schlumberger isn't out of the woods yet.

AT&T's Top-Line Grows; Wireless Subscriber Additions Miss Estimates

Media giant AT&T (T) faced some selling pressure following its fourth quarter report, results released January 30, despite consolidated revenues advancing 15.2% on a year-over-year basis. The acquisition of Time Warner was partially offset by the impact of the new ASC 606 revenue recognition standard, and declines in its legacy wireline service, wireless equipment, domestic video, and Vrio (DirecTV in Latin America) were overcome by growth in domestic wireless services and Xandr (its new advertising platform) and the impact of WarnerMedia. Management noted solid growth in operating income thanks to the acquisition of Time Warner and the write-off of certain network assets in the comparable period of 2017, and its adjusted operating margin expanded to 19.6% from 15.1%. Adjusted earnings per share, which was altered for a number of asset sales and merger-related items, advanced to $0.86 in the fourth quarter of 2018 from $0.78 in the year-ago period.

AT&T's reputation as a tremendous free cash flow generator was solidified in 2018 as it turned in cash flow from operations of $43.6 billion, 15% higher than that of 2017, and free cash flow jumped nearly 36% to ~$22.4 billion. Cash dividends paid in the year came in at $13.4 billion, suggesting significant coverage of the dividend with internally generated cash flow, but its Dividend Cushion ratio is a paltry -0.2 at last check due to its massive debt load. Management remains focused on deleveraging, and it has lowered its net debt load to ~$171 billion as of the end of 2018 from $180 billion at the time of the closing of the Time Warner merger. Its net debt-to-adjusted EBITDA ratio sits at 2.8x, and shares yield ~6.9% as of this writing.

AT&T expects to continue its robust free cash flow generation in 2019, with guidance for the measure coming in at ~$26 billion for the year. Adjusted earnings per share growth is expected to be in the low-single-digits, which the company expects to result in a dividend payout ratio in the high-50% range. Capital

spending is expected to continue growing in the year as well as it works to achieve its goals of winning in all facets of the next-generation media space, and management is targeting a net debt-to-adjusted EBITDA ratio of 2.5x at the end of 2019. Our fair value estimate for shares currently sits at $38 each.

3 Retail REITs For Income Generation

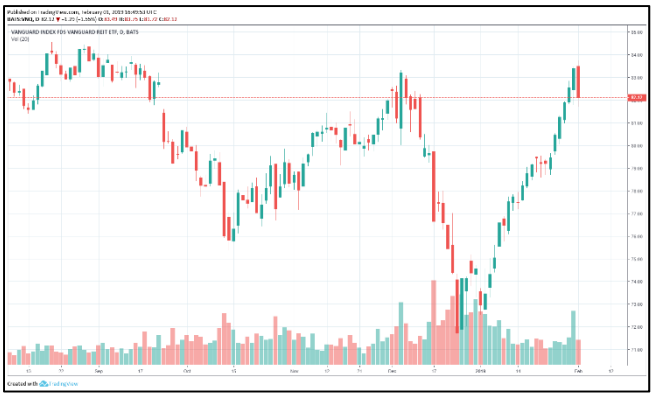


Image Shown: Shares of the Vanguard REIT ETF (VNQ) have rallied nicely since the market bottomed out on Christmas Eve 2018. The dovish tone being taken by the Fed has boosted the space.

The retail real estate investment trust (REIT) space is competitive, and incremental supply from failing retailers could complicate the return profile of many constituents. That said, however, strip center supply additions are near the lowest levels on a historical basis, offering potential opportunities for income expansion via higher rents and lease rollovers. Access to the capital markets will remain critical for participants, and the issuance of additional common/preferred stock should be expected. Geographic and industry diversity, tenant credit strength, and occupancy rates should be monitored closely.

REITs are also inherently sensitive to changing interest rates. Because an investor's required return will always be a spread above the risk free rate, cap rates and interest rates will be tied together. In periods of rising interest rates, for example, property values can be expected to fall to reflect the higher required rates of returns by investors, all else equal. In periods of falling interest rates, property values can be expected to rise to reflect lower required rates of returns by investors, all else equal. In the most general sense, the real estate markets and interest rate cycles are inextricably linked and inversely correlated for this very reason.

In addition, many investors have used REITs as a substitute for bonds in their income portfolios, and higher-yielding alternate opportunities brought about by increased interest rates may impact their decisions to keep holding these positions. In this light, it is only reasonable to expect some investors to shift out of REITs as their individual interest-rate thresholds are breached and alternate higher-yielding opportunities are preferred. However, in the vast majority of cases, retaining diversified exposure to REITs in most portfolios is still practical and prudent for many types of investors. The asset class shift may be minimal.

We're generally neutral on the retail REIT space as a whole, but there are some unique risks related to the space that investors should be aware of, especially as it relates to the dividend payouts of the group. Here's some of what Valuentum's President of Investment Research Brian Nelson had to say about the space in his recent book Value Trap: The Theory of Universal Valuation:

"The Dividend Cushion ratio often exposes the capital-market dependence of most MLPs and some REITs, and the ratio's generation led to the creation of one other variant, the adjusted Dividend Cushion ratio, that considers the conditions of the credit markets at any given time. For example, many MLPs and REITs may not generate sufficient traditional free cash flow to keep paying out an ever-increasing distribution or dividend, meaning these particular entities tend to be very dependent on access to new capital.

As a result, their distributions or dividends are more dependent on the health of external capital market conditions than perhaps on anything else, including underlying fundamentals. The adjusted Dividend Cushion ratio augments the numerator of ratio, bolstered by the assumption of new external capital, creating a positive adjustment during times of good credit. The analyst may revert to the standard Dividend Cushion ratio for these business models during times of tight credit, however, when a dividend cut may grow more likely as external financing support wanes."

We continuously warn of the capital market dependence throughout the dividend reports of REITs within our coverage universe. Here's what we highlight as potential weaknesses in each of those reports:

"Real estate investment trusts pay out 90% of annual taxable income and therefore are unable to meaningfully reinvest internally-generated funds, resulting in external capital-market dependence. The weak internal cash-flow retention of most REITs translates into poor raw, unadjusted Dividend Cushion ratios, which could become severe during the depths of the real estate cycle. Even though a REIT's operating cash flow may be robust, the lack of cash accumulation on the balance sheet and the massive debt needed to purchase/develop new properties can become restrictive. The adjusted Dividend Cushion ratio, accounts for expectations of continued access to the capital markets, which while 'normal,' cannot be guaranteed in times of tight credit."

Nevertheless, we continue to expect solid rates of dividend growth for a number of retail REITs within our coverage universe as a result of expectations for ongoing healthy access to the capital markets. With that in mind, let's take a look a three retail REITs worth putting on your radar for income generation.

Kimco Realty (KIM) - Dividend Yield: ~6.6%

Kimco is one of the US' largest owners and operators of neighborhood and community shopping centers. Its history dates back to 1958, though it didn't go public until 1991. The REIT was added to the S&P 500 in 2006. TJX Co's, Home Depot, and Bed Bath & Beyond are among its top five customers, and it has a large presence in California and Florida.

Kimco's balance sheet is looked upon favorably by the rating agencies. The REIT has investment grade marks from S&P (BBB+), Moody's (Baa1) and Fitch (BBB+). Generally speaking, we think it has a solid balance sheet and access to low-cost capital. The REIT is targeting a mid-single digit annual growth rate for NOI through 2020 and an A-/A3 credit rating. Current occupancy rates at the REIT's properties are roughly 96%, only slightly below all-time highs achieved in 2007 (96.3%). The level is quite attractive considering that its large retail portfolio totals ~460 properties and ~80 million square feet. Nearly all of its top ten tenants are investment grade, and only 13 tenants account for 1%+ of its annual base rent.

Kimco has 50+ years of management expertise and deep local expertise. The REIT also boasts stability, scale as well as geographic and tenant diversification. Investors should be cognizant that it was forced to cut its dividend late in the last decade, however. Management is committed to growing dividends and throwing off the stigma of its dividend cut in the past. Dividend growth investors may be less forgiving, especially those that value a long and uninterrupted track record of growth. The payout remains dependent on access to the capital markets.

Here's what we say about its dividend in the dividend report, and as for its valuation, we think shares are fairly valued, though there could be upside based on our fair value estimate range (see image that follows):

Key Strengths

Kimco Realty boasts a diverse portfolio of ~8,400 leases with ~3,900 tenants, and its lease maturities are well staggered with limited annual rollover. Over the next decade the firm expects ~8% of its gross leasable area to rollover annually. Its credit is rated investment grade, and 4 of its top 5 tenants are rated investment grade by Moody's. As of the end of 2017, no tenant accounted for more than 3.6% of total annual base rent. Management has grown the dividend at an 7% CAGR from 2010- 2018, and FFO averaged ~$637 million from 2016-2017, which compares favorably to annual run-rate cash dividend obligations of ~$506 million. Kimco's dividend cut in 2009 speaks to its capital market dependence, however.

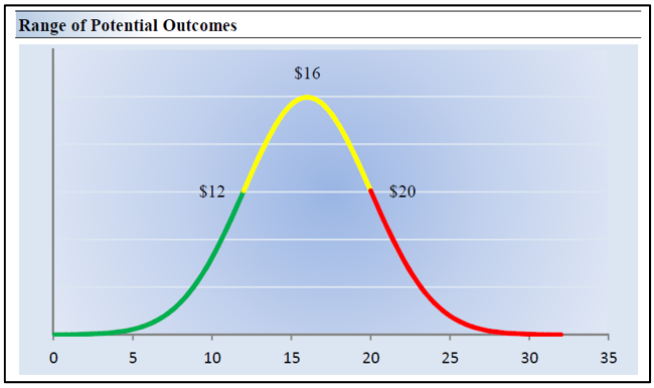


Image shown: Kimco Realty is currently trading at ~$17 per share, but we think the company's valuation upside potential could reach $20 based on the upper bound of our estimate of its intrinsic value.

Realty Income (O) - Dividend Yield: ~4.0%

Realty Income has 5,400+ properties across the US and Puerto Rico. It is an integrated real estate company with

in-house finance/accounting, tenant research, portfolio management, and capital markets expertise. Its property portfolio amounts to over 90 million square feet of leasable space. Occupancy rates are north of 98%, and the REIT's conservative credit profile allows it to be one of the few A-rated REITs on the market today. As of the end of the third quarter of 2018, its weighted average remaining lease term was 9.3 years. 51% of rent comes from investment grade rated tenants.

We like Realty Income's diversification. The REIT generates rental revenue in 49 states and Puerto Rico, and Texas and California account for the most (at 10.5% and 9%, respectively). No one industry accounts for 11% of total rent (c-stores ~10.8%). Its largest tenant, Walgreens, accounts for less than 7% of total rent, and it believes its top 20 tenants are insulated from changing consumer behavior.

Realty Income's stated goals are simple: generate dependable monthly cash dividends from a consistent and predictable level of cash flow from operations. We think management is laser-focused on achieving these goals, and its conservative capital structure helps it withstand economic volatility and helps drive its fantastic dividend track record. The REIT has had more than 95 dividend increases since 1994, more than 80 consecutive quarterly increases, and more than 580 consecutive monthly dividends declared. It seems as though it increases its dividend every few months or so, and its payout has grown at a 4.6% CAGR since its IPO.

Here's what we say about the company's payout in the dividend report, and as for our estimate of its intrinsic value, we think there may not be too much opportunity for capital appreciation from these levels despite our fondness for the REIT's income generation potential (see image that follows):

Key Strengths

Realty Income is known as "The Monthly Dividend Company" thanks to its impressive track record of monthly dividend payments. The firm has increased its cumulative quarterly payout for more than 80 consecutive quarters and has paid more than 560 consecutive monthly dividends. The REIT's consistent fundamentals are the basis of its ongoing dividend strength; its occupancy rate has never fallen below 96%. Portfolio diversification helps maintain such occupancy levels as no one state accounts for more than 10.5% of total rent, and tenants in a given industry do not account for more than 11% of total rent. AFFO averaged just over $720 million from 2015-2017, easily higher than annual run-rate cash dividend obligations of nearly $690 million.

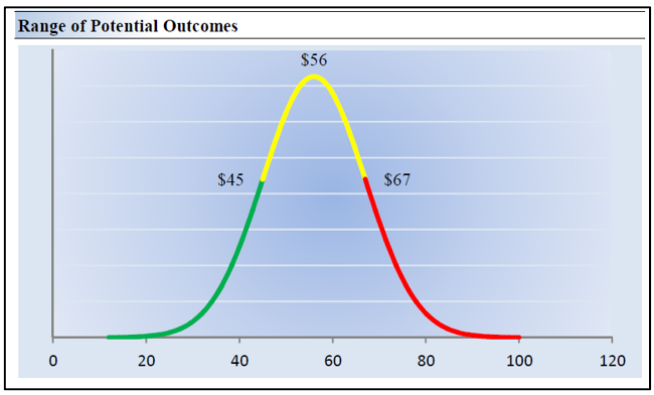


Image shown: Realty Income is currently trading at ~$67 per share, which is near the upper bound of our fair value range. While we are big fans of the REIT's income generating potential, shares may not offer the greatest value proposition at this juncture.

Simon Property (SPG) - Dividend Yield: ~4.4%

Simon Property develops and manages retail real estate properties, which consist primarily of malls, Premium Outlets, The Mills, and community/lifestyle centers. Its portfolio of 205+ properties contains an aggregate of more than 180 million square feet of gross leasable area. As e-commerce continues to disrupt traditional retail, Simon Property is focused on building the mall of the future. It expects enhanced data collection and insight to help better predict consumer behavior, with buy online and pick up in store a budding trend.

Simon Property is working to diversify its NOI makeup by geographic location, property type, and tenant type. Malls currently account for about half of total NOI, with US Simon Premium Outlets and The Mills making up over 40% of total NOI. However, mall traffic has been under substantial pressure as of late, a trend we are not expecting to reverse anytime soon. The REIT's occupancy rate has faced some pressure of late as retailers face an uphill battle, and its top tenants in terms of percent of total base minimum rent for US properties include The Gap (~3.5%), L Brands (2%+), and Ascena Retail (~2%). Its net debt-to-EBITDA ratio of 5.4x at

the end of the third quarter of 2018 leaves a bit to be desired.

Investors should be cognizant of Simon Property's past. The REIT was forced to cut its dividend and earnings forecast in 2009 at the depths of the Financial Crisis. Though it has come a long way since then, the entity is still very much dependent on healthy consumer spending and job creation.

Here's what we say about its dividend in the dividend report, and as for its valuation, we think shares are fairly valued, though there could be upside based on our fair value estimate range (see image that follows):

Key Strengths

Simon Property Group is the largest publicly traded REIT in the S&P 500. Its portfolio consists mainly of US malls and premium outlets, which make up roughly 80% of total NOI. Occupancy rates are solid in the mid-90% range but have faced pressure in recent years as the traditional retail space remains challenged. It has completed more than $40 billion in acquisitions since its IPO in 1993, and international expansion will be a growth driver moving forward. The company has credit ratings in 'A' territory, giving it the highest credit ratings among US retail real estate companies. Dilutive FFO averaged nearly $3.3 billion from 2015-2017, sufficiently above annual run-rate cash dividend and limited partner distribution obligations of ~$2.6 billion.

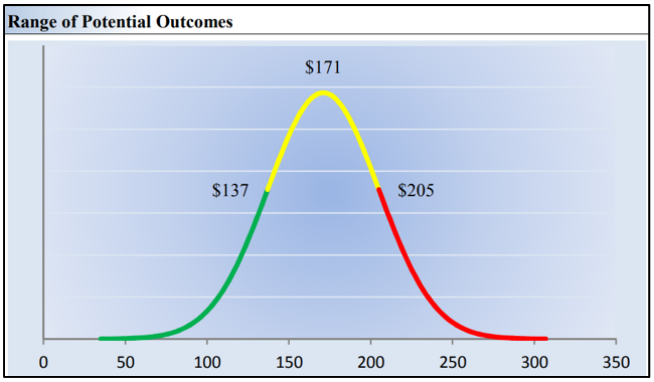


Image shown: Simon Property Group is currently trading at ~$181 per share, which is in the top half of our fair value range.

We think shares have the potential to reach the ~$205 range based on the upper bound of our estimate of its intrinsic value, but we are not particularly interested in adding exposure in our simulated newsletter portfolios at these levels.

Conclusion

Each of these REITs offers a rather hefty payout, and we're expecting ongoing growth in their respective dividends in the near term due to expectations for continued healthy access to the capital markets. This cannot be guaranteed over the long haul, and none of these REITs' dividend is fully insulated from the threat of an overly tight credit market. Because of this, we tend to prefer steady operators with conservative financial profiles, relatively speaking, within the REIT space.

Kimco Realty's large dividend yield, investment grade credit rating, and solid portfolio occupancy make for a compelling case, but we would be more interested if it is able to achieve its targeted credit rating upgrade. Simon Property Group's scale and credit rating are attractive, but its exposure to mall traffic and checkered past give reason for pause. We prefer Realty Income out of these three, despite its shares trading near the upper bound of our fair value range. Its track record of superb consistency, diversification, strong credit rating, and high occupancy levels all make for a compelling consideration out of the retail REIT space.

Digital Realty 2019 Guidance Indicative of Datacenter Pricing Trends

TOP 20 CUSTOMERS							
Customer Rank		Locations	% of ABR[1]	Customer Rank		Locations	% of ABR[1]
1	IBM	27	6.4%	11	Fortune 500 SaaS Provider	7	1.9%
2	Fortune 50 Software Company	17	6.3%	12	at&t	58	1.8%
3	facebook	27	6.3%	13	DXC.technology	11	1.5%
4	Cyxtera	19	3.6%	14	JPMorgan Chase & Co.	16	1.5%
5	Fortune 25 Investment Grade-Rated Company	11	3.5%	15	COMCAST	26	1.5%
6	ORACLE	20	3.3%	16	CenturyLink	80	1.2%
7	rackspace	12	2.7%	17	AVAILABILITY SERVICES	11	1.1%
8	EQUINIX	20	2.6%	18	UBER	3	1.1%
9	verizon	65	2.4%	19	Charter	18	1.1%
10	LinkedIn	7	2.3%	20	NTT Communications	16	1.1%
TOTAL ANNUALIZED BASE RENT							53.2%

Image shown: Digital Realty's top 20 customers by annualized base rent. Source: Digital Realty investor presentation.

Shares of simulated Dividend Growth Newsletter portfolio idea Digital Realty Trust (DLR) faced selling pressure following the release of its 2019 guidance January 9. The update revealed expectations for a high-single-digit decline in rental rates on renewal leases on a cash basis and core funds from operations (FFO) guidance of $6.60-$6.70, the latter of which came in below the market's expectations. However, cash-releasing spreads being expected to decline in 2019 is indicative of the pricing environment for wholesale datacenter capacity across the industry as releasing rates become increasingly dependent upon moves made by large cloud operators such as Amazon (AMZN), Apple (AAPL), and Alibaba (BABA).

According to the Cisco Global Cloud Index report, hyperscale datacenters will account for ~53% of all installed datacenter servers by 2021, which is a material increase compared to an estimated ~38% at the end of 2018, and such a concentration makes the current 24 global hyperscale operators of high importance to datacenter landlords such as Digital Realty. Fortunately for such landlords, however, is the generally impressive credit quality of these operators and the long-duration leases that help to mitigate the negative impact of poorer pricing power.

As of the end of the third quarter of 2018, Digital Realty's top 20 customers accounted ~53.2% if its total annualized rent, and 64 of its 205 data centers were occupied by single customers as of the end of 2017. Its largest customers are subsidiaries of IBM (IBM), an undisclosed Fortune 50 software company, and Facebook (FB) with 6.4%, 6.3%, and 6.3%, respectively, of annualized base rent at the end of the third quarter of 2018. The image at the top of this article provides a breakdown of the REIT's top 20 customers.

As a result of the expected increase in concentration among hyperscale operators, tenant concentration is not anticipated to decrease materially for datacenter landlords, and Digital Realty is no exception. In addition to the industry-wide trend of concentration, the REIT increased its tenant concentration with the 2017 acquisition of DuPont Fabros, but the move also increased its presence in the important Northern Virginia datacenter market. Key risks for Digital Realty include concentration and the resulting weakness in pricing power and near-term lease expirations as leases expiring in 2019 accounted for 22.5% of the REIT's annual rental revenue as of the third quarter of 2018.

Nevertheless, Digital Realty expects 2019 revenue to be in a range of $3.2-$3.3 billion compared to expectations for 2018 revenue to be $3.0-$3.2 billion. Its adjusted EBITDA margin guidance for 2019 (57%-59%) suggests it will be roughly in line with 2018 expected results, and year-end portfolio occupancy rates are also expected to be approximately flat compared to 2018 results (guidance of +/- 50 basis points). Increases in leasing volume thanks in part to new growth projects, should help offset pricing weakness among the REIT's largest tenants.

Digital Realty holds investment grade credit ratings (BBB/Baa2/BBB), so it should continue to have adequate access to capital markets to fund expansion initiatives and dividend growth moving forward. We'll be watching developments related to its largest tenants closely moving forward, but its outlook benefits from its global footprint, which should benefit from its recent move in the growing Brazilian market, and diversified product suite that includes shorter term leases in co-location and interconnection.

We're sticking with our current fair value estimate for shares of $96 a piece for the time being, and the REIT's adjusted Dividend Cushion ratio, which gives it credit for access to capital markets, currently sits at 1.8. We expect to continue highlighting shares, which yield ~3.8% as of this writing, in the simulated Dividend Growth Newsletter portfolio for the foreseeable future.

Phillips 66 Loves Its Shareholders

From the beginning of 2013 to the end of the third quarter of 2018, Phillips 66 spent $21.6 billion on dividends and share buybacks. Eight dividend increases since May 2012 have pushed its annual payout to $3.20 per share, and there remains room for additional payout growth as 2019 gets underway.

By Callum Turcan

Phillips 66 (PSX) is one of the largest downstream companies in the world with a large refining, petrochemical, marketing, and midstream division. In 2012, Phillips 66 split from ConocoPhillips (COP), effectively separating the upstream business from the downstream business and giving most North American

midstream assets to Phillips 66. The company owns a majority controlling interest in its midstream spin-off Phillips 66 Partners (PSXP) and accounts for the firm as a variable interest entity. This means that Phillips 66 consolidates the financial statements of Phillips 66 Partners with its own.

Phillips 66's improving cash flow position prompted us to take a closer look at the company as it gets ready to report fourth quarter earnings on February 8.

Since the start of 2013, Phillips 66 increased its quarterly payout from $0.31 a share to $0.80 at the end of 2018. Management has consistently rewarded shareholders with larger dividends and that has helped earn Phillips 66 an EXCELLENT Dividend Growth rating here at Valuentum. The company currently registers a Dividend Cushion Ratio of 1.4, indicating its current yield is relatively safe but there is room for improvement. As investors increasingly view certain securities as income-generating opportunities worth holding onto for many years, Phillips 66's ability to deliver on that front speaks favorably to its long-term commitment to shareholders.

Management made this important comment during Phillips 66's third quarter conference call:

"Long term, we want to reinvest 60% of cash from all sources back into the business and 40% goes back to our shareholders through a strong dividend and share repurchases. You're not going to see us deviating from that… over the longer term. Any given year, we could bounce around a little bit. This year is going to be hard to hit. We'll hit 60/40, but it's going to be the other way, given we're already at $5.2 billion of share repurchases for the year."

An improving cash flow position will directly benefit Phillips 66 shareholders as a growing level of cash would be returned via buybacks and dividend increases. Communicating how the firm plans to effectively reward investors while also being cognizant of the need to remain competitive and growing is part of the reason why Phillips 66 has outperformed the S&P 500 index since becoming a standalone company in 2012.

Image shown: Phillips 66's share price performance against the S&P 500 (orange line) since its separation from ConocoPhillips in 2012.

Improving Cash Flow Picture

The chart below presents Phillips 66's cash flow generation since 2015, and it reveals nicely improving free cash flow generation.

	2015	2016	2017	2017*	2018*
Cash Flow From Operations	$5,713	$2,963	$3,648	$1,717	$3,434
Capital Spending	$5,764	$2,844	$1,832	$1,295	$1,645
Free Cash Flow	-$51	$119	$1,816	$422	$1,789
Cash Dividends Paid	$1,172	$1,282	$1,395	$1,042	$1,069
Repurchase of Common Stock	$1,512	$1,042	$1,590	$1,127	$4,148

*data through three quarters

Rising operating cash flow in 2017 and through three quarters in 2018 highlights how Phillips 66's rebound has legs. We're eagerly awaiting the release of its fourth quarter earnings report to get a read on how the end of the year panned out.

Management announced that Phillips 66 increased its capital expenditure budget from $1.6 billion in 2018 to $2.3 billion in 2019, which is excluding capital expenditures at Phillips 66 Partners. Phillips 66 Partners expected to spend $0.8 billion gross on capital expenditures in 2018, which is forecasted to rise to $0.9 billion gross in 2019. Valuentum gives Phillips 66 a GOOD Value Creation rating, indicating that management tends to make wise investments that yield an ROIC that carries a nice premium over the firm's WACC.

It is important to note that those capital expenditure figures exclude spending at Phillips 66's equity affiliates which includes its 50% equity stake in DCP Midstream LP (DCP), its 50% stake in CPChem, and its 50% stake in the WRB Refining joint-venture.

Buybacks Continue

Phillips 66 is in the midst of a $12 billion share repurchase program that is equal to roughly 28% of its market capitalization, and at the end of the third quarter of 2018, that program had $2.1 billion in remaining buyback authority. Free cash flow and cash on hand have been utilized to fund repurchases.

This buyback program has had a material impact on the company's outstanding share count. From the first quarter of 2017 to the third quarter of 2018, Phillips 66's outstanding diluted share count has fallen by just under 11%. $5.7 billion was spent buying back stock over this period, which is why it is worth taking a look at Phillips 66's cash flow position on an adjusted basis.

Balance Sheet Overview

Phillips 66 had $11 billion in long-term debt on top of $0.3 billion in short-term debt at the end of September 2018, and that short-term debt represents its only maturities for 2019. Another $0.8 billion in debt matures in 2020, which is roughly split between Phillips 66 and Phillips 66 Partners. It isn't until 2022 that Phillips 66 faces its first large maturity as $2 billion in debt comes due. Phillips 66's $5 billion and Phillips 66 Partners' $0.8 billion revolving credit lines were undrawn as of the end of September 2018, giving each entity ample access to liquidity. Advantageous share buybacks can be covered without needing to issue out debt.

On a trailing twelve-month basis, Phillips 66 generated $7.9 billion in adjusted EBITDA as of the end of the third quarter of last year. The firm had an adjusted EBITDA to total debt ratio of just 1.43x and a consolidated debt-to-capitalization ratio of 31% at the end of September 2018 (given by management in the November 2018 IR presentation).

During that same twelve-month period, Phillips 66 generated $4.2 billion in adjusted EBITDA from its refining division. It is important to keep in mind that sharp swings in crack spreads in the refining space can have a powerful impact on Phillips 66's company-wide financial performance.

Both Phillips 66 and Phillips 66 Partners have investment-grade credit ratings as of November 2018. The relative stability of the financial performance of marketing and midstream operations partially offsets the volatile nature of refining and petrochemical operations. Moody's Corporation (MCO) upgraded its outlook for both firm's credit ratings in November 2018 to stable from negative.

Impact on Phillips 66's Dividend

The factors that support the future growth trajectory of Phillips 66's dividend include a smaller outstanding share count, an improving cash flow situation, and a strong balance sheet. Rising capital expenditures will consume a larger portion of Phillips 66's net operating cash flow this year, but it appears likely the pace of its share buybacks will slow down as the company gets ready to complete its current repurchasing program. Combined with rising net operating cash flow, assuming that trajectory can be maintained, it seems there is still plenty of room for Phillips 66 to further increase its dividend as market conditions allow.

Concluding Thoughts

Phillips 66 has come a long way since its nadir of 2016, when the company had to come to terms with America removing the ban on domestic oil exports and other structural changes in the industry. Declining differentials in various unconventional plays further put pressure on Phillips 66's financials as it was no longer to take advantage of bottlenecks in America's shale patch as it was once able to.

Management is investing heavily in midstream projects to provide more stability to Phillips 66's financial performance over a multi-year period. That story is continuing to play out as the Grey Oak oil pipeline project is expected to be completed by the end of this year, adding hundreds of thousands of barrels in daily crude takeaway capacity to the Permian Basin. Phillips 66 has a large economic interest in the pipeline project and is expected to act as operator of the system. Another key midstream project includes Phillips 66's plan to aggressively expand the Sweeny Hub's natural gas liquids fractionation capacity through a $1.5 billion project due to be completed by the end of 2020.

We will keep Phillips 66 on our radar as the company gets ready to report its fourth quarter earnings. It is worth noting that Phillips 66 does not source a

significant amount of its crude supplies from Venezuela and reportedly hasn't taken a shipment from the country since April 2018. As US sanctions have recently been placed on Venezuela's oil industry and its state-run oil company, already having other sources of heavy crude enables Phillips 66 to circumvent geopolitical obstacles that have the potential to hinder other downstream players.

The author of this piece, Callum Turcan, owns shares of ConocoPhillips.

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President, Investment Research

- Kris Rosemann
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Disclosure: Brian Nelson and Kris Rosemann do not own any shares of any securities mentioned in this newsletter. Callum Turcan owns shares of ConocoPhilips (COP). Please contact info@valuentum.com for more information regarding Valuentum's editorial policies.

THE SIMULATED HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO

We continue to be excited about the launch of the simulated High Yield Dividend Newsletter portfolio, the inaugural edition released January, 1, 2018. We've learned a lot in recent months about what works and what doesn't work for our members. Thank you for the feedback!

Many of our members continue to prefer the list-versus-weighting perspective across our simulated newsletter portfolios. It may also be true that a lot of new members won't feel like they have missed out on anything under a list-versus-weighting format, too, which has been a concern when brand new members see a simulated portfolio that has been around for half decade or longer.

Though we may calculate simulated performance of the High Yield Dividend Newsletter periodically (see page 1), we don't think it is necessary to do so on a monthly basis. The list-and-weighting format facilitates a level of consistency across our newsletter products, and we may consider migrating the simulated High Yield Dividend Newsletter portfolio to a range-of-percentage-weightings, too, as we have with respect to both the simulated Best Ideas Newsletter portfolio and simulated Dividend Growth Newsletter portfolio.

The simulated High Yield Dividend Newsletter portfolio is presented each month in similar fashion (list and weightings) as that of the first edition. If you have any questions, comments, or concerns, please be sure to let us know at info@valuentum.com.

Idea	Symbol	Weighting	Est Annual Div's/Share ($)	Est Div Yield
CORE				
Alerian MLP ETF	AMLP	5.0%	0.81	8.16%
Global X SuperDividend ETF	SDIV	5.0%	1.58	8.25%
Global X SuperIncome Preferred ETF	SPFF	10.0%	0.84	7.30%
iShares International Select Dividend ETF	IDV	5.0%	1.70	5.52%
iShares MSCI Australia ETF	EWA	5.0%	1.18	5.72%
iShares U.S. Preferred Stock ETF	PFF	5.0%	2.14	5.96%
PowerShares Senior Loan Portfolio	BKLN	5.0%	1.00	4.44%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	4.05	6.20%
EQUITY				
AT&T	T	5.0%	2.04	6.80%
BP PLC	BP	5.0%	2.46	5.95%
Digital Realty Trust	DLR	5.0%	4.04	3.72%
Enterprise Products Partners	EPD	5.0%	1.74	6.17%
Iron Mountain	IRM	5.0%	2.44	6.66%
Magellan Midstream Partners	MMP	5.0%	3.99	6.57%
Omega Healthcare Investors	OHI	5.0%	2.64	6.85%
Public Storage	PSA	5.0%	8.00	3.82%
Realty Income Corporation	O	5.0%	2.71	4.00%
Schlumberger	SLB	5.0%	2.00	4.49%
Tallgrass Energy LP	TGE	5.0%	2.02	8.74%
		100.0%		**6.13%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 2/1/2019.

HIGH YIELDING EQUITIES IN OUR COVERAGE UNIVERSE

Company Name	Symbol	Industry	Dividend Yield	ValueRisk	Leverage	Div Track Record	Div Growth	Div Safety	Div Cushion
Vector Group	VGR	Tobacco	16.9%	VERY HIGH	HIGH	HEALTHY	VERY POOR	VERY POOR	-0.2
R.R. Donnelley	RRD	Commercial Services	12.9%	VERY HIGH	MEDIUM	HEALTHY	VERY POOR	VERY POOR	-7.1
Fred's Inc	FRED	Multiline Retail - discount	12.8%	VERY HIGH	LOW	RISKY	VERY POOR	VERY POOR	-2.5
Golar LNG Partners	GMLP	Oil & Gas Pipelines	12.1%	MEDIUM	HIGH	RISKY	VERY POOR	POOR	1.3
Alliance Resource Partners	ARLP	Industrial Minerals	11.5%	HIGH	LOW	RISKY	POOR	GOOD	1.4
Pitney Bowes	PBI	Commercial Services	11.2%	VERY HIGH	HIGH	RISKY	VERY POOR	VERY POOR	-2.1
Centurylink	CTL	Telecom Services - diversified	10.1%	MEDIUM	HIGH	RISKY	VERY POOR	VERY POOR	-3.3
AmeriGas Partners	APU	Utilities	9.6%	LOW	HIGH	HEALTHY	VERY POOR	POOR	0.2
DCP Midstream	DCP	Oil & Gas Pipelines	9.6%	MEDIUM	HIGH	HEALTHY	GOOD	GOOD	2.2
GameStop	GME	Specialty Retailers	9.6%	VERY HIGH	LOW	HEALTHY	POOR	POOR	1.7
NuStar	NS	Oil & Gas Pipelines	9.5%	MEDIUM	HIGH	RISKY	VERY POOR	POOR	1.1
Buckeye Partners	BPL	Oil & Gas Pipelines	9.2%	LOW	HIGH	RISKY	VERY POOR	POOR	1.2
Vodafone	VOD	Telecom Services - diversified	9.2%	HIGH	HIGH	HEALTHY	VERY POOR	VERY POOR	0.0
Tupperware	TUP	Containers & Packaging	9.0%	MEDIUM	MEDIUM	HEALTHY	VERY POOR	POOR	0.8
Holly Energy	HEP	Oil & Gas Pipelines	8.7%	LOW	HIGH	HEALTHY	EXCELLENT	GOOD	1.3
British American	BTI	Tobacco	8.5%	MEDIUM	HIGH	HEALTHY	POOR	POOR	0.7
Energy Transfer	ET	Oil & Gas Pipelines	8.1%	HIGH	HIGH	HEALTHY	GOOD	GOOD	3.3
CoreCivic	CXW	Management Services	7.9%	MEDIUM	HIGH	RISKY	VERY POOR	POOR	0.8
Western Gas	WES	Oil & Gas Pipelines	7.9%	MEDIUM	HIGH	HEALTHY	EXCELLENT	GOOD	1.7
Limited Brands	LB	Retail - Men's, Women's, Kids' Apparel	7.8%	MEDIUM	MEDIUM	RISKY	VERY POOR	VERY POOR	-0.1
Costamare	CMRE	Shipping	7.6%	VERY HIGH	HIGH	RISKY	VERY POOR	VERY POOR	-2.6
Iron Mountain	IRM	Commercial Services	7.4%	MEDIUM	HIGH	HEALTHY	VERY POOR	POOR	1.1
Superior	SUP	Auto Parts Suppliers	7.1%	VERY HIGH	HIGH	RISKY	VERY POOR	VERY POOR	-12.5
Omega Healthcare	OHI	REIT - Healthcare	6.9%	MEDIUM	HIGH	HEALTHY	VERY POOR	POOR	0.9
United Micro	UMC	Semi Equipment	6.8%	VERY HIGH	LOW	RISKY	VERY POOR	VERY POOR	0.2
Kimco Realty	KIM	REIT - Retail	6.8%	MEDIUM	HIGH	RISKY	VERY POOR	POOR	0.7
Schweitzer-Mauduit	SWM	Tobacco	6.7%	MEDIUM	HIGH	HEALTHY	VERY POOR	VERY POOR	0.2
Cedar Fair	FUN	Leisure	6.6%	MEDIUM	HIGH	RISKY	VERY POOR	POOR	1.0
Macerich	MAC	REIT - Retail	6.6%	LOW	HIGH	RISKY	VERY POOR	VERY POOR	-0.8
Spirit Realty	SRC	REIT - Retail	6.6%	VERY HIGH	HIGH	HEALTHY	VERY POOR	VERY POOR	-6.0
BP	BP	Major Oil & Gas	6.5%	MEDIUM	HIGH	RISKY	VERY POOR	POOR	0.8

Note: The Dividend Cushion ratio and qualitative assessments in the table above may change following the date of this publication. Please be sure to access the website at www.valuentum.com for more information. Please also note that Valuentum publishes both an adjusted Dividend Cushion ratio and an unadjusted Dividend Cushion ratio. Many of the equities included in this table have substantial equity-price and dividend-payment risk.

SCREEN OF THE MONTH – TOP HOLDINGS OF THE ALERIAN MLP ETF (AMLP)

Company	Ticker	Weight	Credit Rating*	Dividend Yield
MPLX LP	MPLX	10.27%	Baa3	7.37%
Energy Transfer LP	ET	10.07%	Baa3	8.29%
Enterprise Products Partners LP	EPD	10.03%	Baa1	6.29%
Magellan Midstream Partners LP	MMP	9.86%	Baa1	6.27%
Plains All American Pipeline LP	PAA	9.46%	Ba1	5.27%
Western Gas Partners LP	WES	5.18%	Ba1	7.87%
Buckeye Partners LP	BPL	4.77%	Baa3	9.88%
EQM Midstream Partners LP	EQM	4.06%	Ba1	9.61%
Andeavor Logistics LP	ANDX	4.03%	UR	11.47%
Tallgrass Energy LP	TGE	3.76%	Ba3	8.13%
DCP Midstream LP	DCP	3.24%	Ba2	9.31%
Phillips 66 Partners LP	PSXP	2.87%	Baa3	6.59%
Shell Midstream Partners LP	SHLX	2.68%	NA	7.80%
NuStar Energy LP	NS	2.66%	Ba2	9.31%
Genesis Energy LP	GEL	2.44%	B1	10.21%
Antero Midstream Partners LP	AM	2.36%	Ba2	7.32%
TC PipeLines LP	TCP	1.84%	Baa2	7.91%
EnLink Midstream LLC	ENLC	1.82%	Ba1	10.11%
Cheniere Energy Partners LP	CQP	1.77%	Ba2	5.81%
Crestwood Equity Partners LP	CEQP	1.66%	Ba3	7.31%

*Credit rating according to Moody's (UR) = Under Review
AMLP Expense fee 0.85%

DIVIDEND REPORT PAGE 2 – ENTERPRISE PRODUCT PARTNERS (EPD)

Enterprise Product Partners EPD FAIRLY VALUED

Buying Index™ 6 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Neutral	$23.00 - $38.00	HEALTHY	GOOD / 2	GOOD	6.36%

Assessment of Company Dividend Strategy

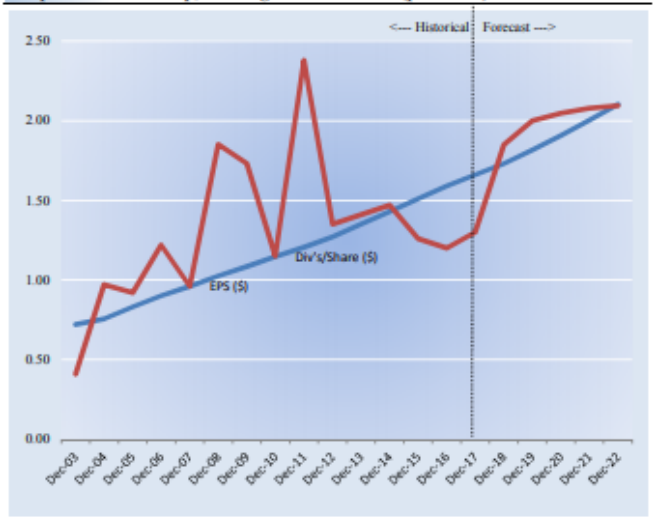
Key Strengths

The credit rating agencies are huge fans of Enterprise Product Partners' debt, giving the MLP high marks at Baa1/BBB+, one of the highest among its peers. This gives it great flexibility to raise capital, and we generally like its simplified structure with no GP IDRs. Since its IPO in 1998, the company has completed $64 billion in organic growth projects and major acquisitions. In this light, there's not much that will derail the MLP's distribution. Enterprise Product Partners' 'distribution coverage ratio' has been at least 1.2x over the past 5 years, but we must emphasize that we are not fond of industry-specific coverage metrics. Its worth noting that distributable cash flow took a hit in 2016 as energy resource pricing remained suppressed.

Potential Weaknesses

Though management has worked diligently to extend its debt maturities, it's hard to overlook the tens of billions of dollars raised via debt since 2009. The MLP has ~$5.7 billion of capital growth projects under construction with more to come through 2019, and spending related to such projects will continue to weigh on free cash flows. Total debt sat at ~$24.6 billion as of the end of 2017. The past several years have been bolstered by non-core asset sales, and reinvestment risk remains a concern. Borrowing capacity on its revolver mitigates risk to a degree, but we would like to see more cash on the books. The firm's unadjusted Dividend Cushion ratio is the most appropriate measure of the risks of the payout, in our opinion, given its capital market dependence.

Graphical Relationship, Earnings and Dividends (per share)



The graph above shows the relationship between a firm's earnings per share and its dividends per share.

Dividend Cushion Cash Flow Bridge Evaluation

The Dividend Cushion Cash Flow Bridge, shown in the image to the right, illustrates the components of the Dividend Cushion ratio and highlights in detail the many drivers behind it. Enterprise Product Partners's Dividend Cushion Cash Flow Bridge reveals that the sum of the company's 5-year cumulative free cash flow generation, as measured by cash flow from operations less all capital spending, plus its net cash/debt position on the balance sheet, as of the last fiscal year, is less than the sum of the next 5 years of expected cash dividends paid. Because the Dividend Cushion ratio is forward-looking and captures the trajectory of the company's free cash flow generation and dividend growth, it reveals whether there will be a cash surplus or a cash shortfall at the end of the 5-year period, taking into consideration the leverage on the balance sheet, a key source of risk. On a fundamental basis, we believe companies that have a strong net cash position on the balance sheet and are generating a significant amount of free cash flow are better able to pay and grow their dividend over time. Firms that are buried under a mountain of debt and do not sufficiently cover their dividend with free cash flow are more at risk of a dividend cut or a suspension of growth, all else equal, in our opinion. Generally speaking, the greater the 'blue bar' to the right is in the positive, the more durable a company's dividend, and the greater the 'blue bar' to the right is in the negative, the less durable a company's dividend.

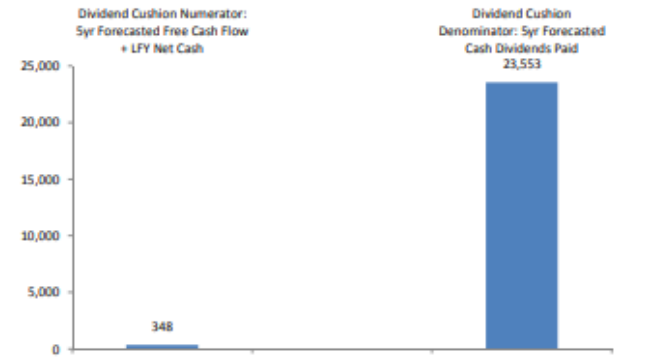
Raw, Unadjusted Dividend Cushion Cash Flow Bridge - Raw

Source: Company Filings, Valuentum Projections

Dividend Cushion Ratio Evaluation

The Dividend Cushion Ratio Deconstruction, shown in the image to the right, reveals the numerator and denominator of the Dividend Cushion ratio. At the core, the larger the numerator, or the healthier a company's balance sheet and future free cash flow generation, relative to the denominator, or a company's cash dividend obligations, the more durable the dividend. In the context of the Dividend Cushion ratio, Enterprise Product Partners's numerator is smaller than its denominator suggesting weak dividend coverage in the future. The Dividend Cushion Ratio Deconstruction image puts sources of free cash in the context of financial obligations next to expected cash dividend payments over the next 5 years on a side-by-side comparison. Because the Dividend Cushion ratio and many of its components are forward-looking, our dividend evaluation may change upon subsequent updates as future forecasts are altered to reflect new information.

Raw, Unadjusted Dividend Cushion Ratio Deconstruction - Raw



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DIVIDEND REPORT PAGE 2 – MAGELLAN MIDSTREAM PARTNERS (MMP)

Magellan Midstream MMP FAIRLY VALUED

Buying Index™ 6 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$53.00 - $83.00	HEALTHY	GOOD / 1.1	EXCELLENT	6.25%

Assessment of Company Dividend Strategy

Key Strengths

Magellan likes to point out that it is an investment-grade MLP with no incentive distribution rights, allowing it a lower cost of capital. Its portfolio is rather diversified between refined products (~54% of operating margin), crude oil (~38%) and marine storage (~8%). As with many of its peers, the MLP notes that it expects future fee-based, low-risk activities to comprise a high percentage of its operating margin. Though economic returns on such investments should be watched closely, the company continues to evaluate more than $500 million of potential growth projects on top of the $2.5 billion projects in progress for 2018-2020. Magellan is targeting 5%-8% distribution growth in 2019-2020 and distribution coverage of 1.2x through 2020.

Potential Weaknesses

Magellan is committed to maintaining a solid investment-grade rating, and at BBB+/Baa1, the MLP is one of the highest-rated among its peers. Distribution growth ahead of core business expansion will drive lower coverage in coming periods, and the MLP is leveraged, albeit not as much as peers. We doubt management will mess with its proven history of distribution expansion, and the MLP has a revolver should near-term needs warrant. It has advanced the quarterly payout for 60+ consecutive quarters since its IPO, but total debt outstanding stood at roughly $4.5 billion as of the third quarter of 2018. Magellan's cost of capital may be lower than some peers' thanks to the lack of incentive distribution rights, but it is still dependent on the capital markets.

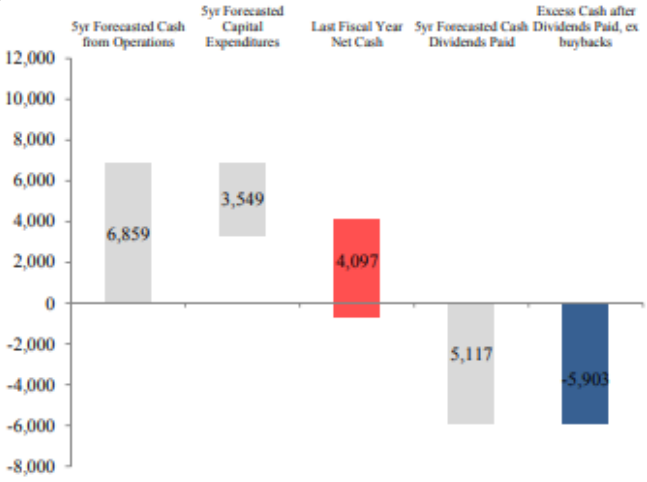
Graphical Relationship, Earnings and Dividends (per share)

The graph above shows the relationship between a firm's earnings per share and its dividends per share.

Dividend Cushion Cash Flow Bridge Evaluation

The Dividend Cushion Cash Flow Bridge, shown in the image to the right, illustrates the components of the Dividend Cushion ratio and highlights in detail the many drivers behind it. Magellan Midstream's Dividend Cushion Cash Flow Bridge reveals that the sum of the company's 5-year cumulative free cash flow generation, as measured by cash flow from operations less all capital spending, plus its net cash/debt position on the balance sheet, as of the last fiscal year, is less than the sum of the next 5 years of expected cash dividends paid. Because the Dividend Cushion ratio is forward-looking and captures the trajectory of the company's free cash flow generation and dividend growth, it reveals whether there will be a cash surplus or a cash shortfall at the end of the 5-year period, taking into consideration the leverage on the balance sheet, a key source of risk. On a fundamental basis, we believe companies that have a strong net cash position on the balance sheet and are generating a significant amount of free cash flow are better able to pay and grow their dividend over time. Firms that are buried under a mountain of debt and do not sufficiently cover their dividend with free cash flow are more at risk of a dividend cut or a suspension of growth, all else equal, in our opinion. Generally speaking, the greater the 'blue bar' to the right is in the positive, the more durable a company's dividend, and the greater the 'blue bar' to the right is in the negative, the less durable a company's dividend.

Raw, Unadjusted Dividend Cushion Cash Flow Bridge - Raw



Source: Company Filings, Valuentum Projections

Dividend Cushion Ratio Evaluation

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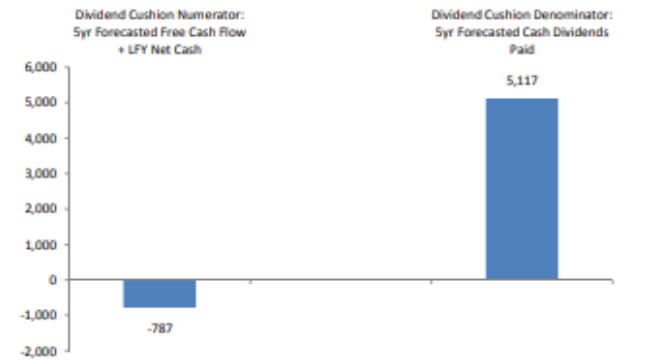
Raw, Unadjusted Dividend Cushion Ratio Deconstruction - Raw



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VALUENTUM

DEFINITIONS

ValueCreation. This is a proprietary Valuentum measure. ValueCreation indicates the firm's historical track record in creating economic value for shareholders, taking the average difference between ROIC (without goodwill) and the firm's estimated WACC during the past three years. The firm's performance is measured along the scale of EXCELLENT, GOOD, POOR, and VERY POOR. Those firms with EXCELLENT ratings have a demonstrated track record of creating economic value, while those that register a VERY POOR mark have been destroying economic value.

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

ValueTrend. This is a proprietary Valuentum measure. ValueTrend indicates the trajectory of the firm's return on invested capital (ROIC). Firms that earned an ROIC last year that was greater than the 3-year average of the measure earn a POSITIVE rating. Firms that earned an ROIC last year that was less than the 3-year average of the measure earn a NEGATIVE rating.

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