Valuentum Securities, Inc. **3/1/2019** Edition 2, Volume 3

HIGH YIELD DIVIDEND NEWSLETTER

PARTING WAYS WITH OMEGA HEALTHCARE AND ITS UNIQUE CHALLENGES

We're removing Omega Healthcare from the simulated High Yield Dividend Newsletter portfolio as it continues to face challenges from its top operators. We're not convinced its struggles will be fully transient, and the uncertainty has reached levels we're not comfortable with, especially after considering the robust outperformance it has delivered since our beginning of 2018 highlight date.

Image shown: Omega Healthcare's share price performance since the beginning of 2018.

Omega Healthcare was a strong performer through most of 2018 as it overcame low expectations that resulted from struggles from key operators of its facilities, but shares faced selling pressure following the February 12 release of the REIT's fourth quarter 2018 results. We're not sticking around as the company continues to face challenges in the skilled nursing facility space, and another one of its top operators is providing material uncertainty for Omega. The REIT is currently trading in the ~$36 range, which is a ~30% gain over a highlight price of $27.44, not to mention the high-single-digit dividend yield it carries.

Texas-based long-term care and rehab services provider Daybreak, which accounts for nearly 4% of total annualized contractual rent/interest and is Omega's home state as a result of low occupancy rates and one of the lowest Medicaid reimbursement rates in the country. Here's what management had to say regarding Daybreak in its 2018 10-K:

> "During the third quarter of 2017, we placed Daybreak on a cash basis for revenue recognition as a result of nonpayment. During the fourth quarter of 2017, we executed a Settlement and Forbearance Agreement with Daybreak which permitted Daybreak to defer payments of up to 23% of their contractual rent for the remainder of 2017, subject to certain

"WE'RE NOT STICKING AROUND AS THE COMPANY CONTINUES TO FACE CHALLENGES IN THE SKILLED NURSING FACILITY SPACE, AND ANOTHER ONE OF ITS TOP OPERATORS IS PROVIDING MATERIAL UNCERTAINTY FOR OMEGA. THE REIT IS CURRENTLY TRADING IN THE ~$36 RANGE, WHICH IS A ~30% GAIN OVER A HIGHLIGHT PRICE OF $27.44, NOT TO MENTION THE HIGH-SINGLE-DIGIT DIVIDEND YIELD IT CARRIES." – KRIS ROSEMANN

conditions. Daybreak was in compliance with the agreement at September 30, 2018; however, during the fourth quarter of 2018, Daybreak fell behind on rent by approximately two months and accordingly was not in compliance with the 2017 Settlement and Forbearance Agreement as a result of not paying the full contractual amounts due.

As a direct result of the challenges presented by the current operating environment in Texas as discussed under Overview and Outlook above, Daybreak requested further rent deferral. On January 30, 2019, we entered into a Second Amendment to Settlement and Forbearance Agreement under which we agreed to defer approximately $4.2 million of rent in the fourth quarter of 2018 and approximately $2.5 million (or approximately one month's rent) in each of the first two quarters of 2019. We believe these rent deferrals position Daybreak to continue to embark on certain operational improvements and to provide Daybreak time to receive the benefits of a significant increased participation in a Texas program providing SNF operators enhanced reimbursement for quality of care in its nursing facilities."

Higher than normal general and administrative expenses, due largely to legal expenses related to former top ten operator Orianna Health Systems, which ultimately filed for bankruptcy, and a $4 million underpayment of rent from Daybreak, impacted fourth quarter results. Since Daybreak is accounted for on a cash basis, the payment shortfall was felt immediately. Adjusted funds from operations (AFFO) in the fourth quarter of 2018 came in at $0.73 per share, down from $0.79 in the year-ago period.

Omega expects 2019 to bring materially lower general and administrative costs, and it should close on its recent agreement to acquire MedEquities in the second quarter of the year. Its operators continue to face a challenging labor market, but it anticipates an ongoing shift to a patient driven payment model to provide an improvement in patient outcomes and operator profit levels. An increase in acquisition rates following suppressed levels in 2018 should provide funds from operations growth as we move forward in 2019. Timing of the deployment of proceeds from the divestiture of its Orianna portfolio provides a degree of uncertainty, as does its agreement to receive reduced rental payments from Daybreak in the first half of the year.

Omega's 2019 guidance ranges were larger than normal to account for the possibility of a material equity issuance in the year as part of its deleveraging efforts. The REIT expects adjusted funds from operations per share to be in a range of $3.00-$3.12 for the year, compared to $3.04 in 2018, but improvements in its financial performance are anticipated in the back half of the year. Management issued fourth quarter 2019 guidance along with its full-year guidance to illustrate these expectations, and it projects AFFO per share to be in a range of $0.78-$0.81 in the final quarter of the year, which would mark a notable improvement over its fourth quarter 2018 results.

While the increasingly dovish tone from the Fed may very well continue to support the capital market access necessary for paying its dividend and supporting its future growth plans, we're most comfortable parting ways with Omega Healthcare in the simulated High Yield Dividend Newsletter portfolio at this time. Shares are currently trading roughly in-line with our fair value estimate, and the REIT's adjusted Dividend Cushion ratio currently sits at 0.9, which highlights the risks facing the company even after giving it credit for continued access to the capital markets.

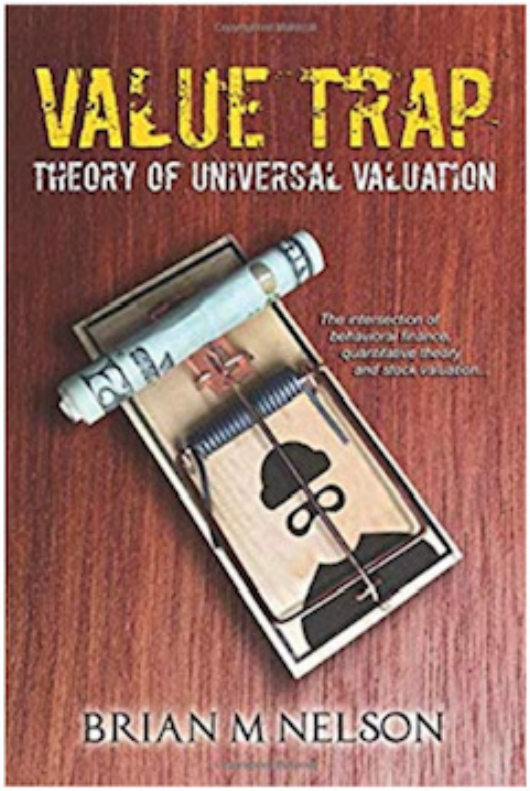
IT'S HERE!

Brian M Nelson

Value Trap: Theory of Universal Valuation

ISBN-13: 978-0998038490, ISBN-10: 0998038490

#1 New Release in Stock Market Investing



Format: Paperback

$13.99

FREE Shipping

THE WAIT IS NO LONGER! PRESIDENT OF INVESTMENT RESEARCH BRIAN NELSON'S NEW BOOK SPENT AN EXTENDED PERIOD OF TIME AS THE #1 BEST SELLER ON AMAZON FOR VALUATION. ORDER A PAPERBACK COPY ON AMAZON OR PURCHASE A DIGITAL DOWNLOAD AT THE VALUENTUM STORE.

Iron Mountain Making Progress on Growth Portfolio Revenue Mix

Simulated High Yield Dividend Newsletter portfolio idea Iron Mountain (IRM) continues to work towards its goal of generating 70% of total revenue from its developed portfolio (North America and Western Europe) with the remaining 30% from its growth portfolio (emerging markets, data center and adjacent businesses) by 2020. As of the first half of 2018, this mix was 82/18, but a productive back half of the year brought the mix to 75/25 in the fourth quarter of the year. Management expects the reaching of this goal to bring ~5% organic revenue growth and at least 5% organic adjusted EBITDA growth on average. However, we'll be watching the effectiveness of its ongoing foray in to data center ownership as hyperscale operators grow their respective negotiating power, putting potential downward pressure on releasing spreads for years to come.

Iron Mountain's reported revenue in the fourth quarter of 2018 advanced 7.1% from the year-ago period thanks to strength in both its 'Storage' and 'Service' segments, and adjusted gross profit rose 7.2% from the year-ago period. Adjusted EBITDA margin expanded by one percentage point from the comparable quarter of 2017 to 33.9% as recent data center acquisitions and revenue management flow through combined with improving service margins and cost synergies remaining from the Recall deal. Adjusted funds from operations jumped 25.9% on a year-over-year basis, and the REIT's dividend paid in the fourth quarter was 4% higher than that in the year earlier.

Iron Mountain's dividend remains dependent on access to capital markets as traditional free cash flow generation regularly comes up short in covering cash dividends paid, and its adjusted Dividend Cushion ratio, which gives it credit for such access, sits at 1.1 at last check. The REIT space has benefit materially recently as a result of the Fed's increasingly dovish commentary, which suggests a slowing of the previously assumed tightening of credit markets. Management points to its net lease adjusted leverage of 5.6x being in line with that of the JP Morgan REIT composite as a sign of a well-positioned balance sheet, and it has no significant maturities until 2023. Iron Mountain just missed its target of the ratio hitting 5.5x at the end of 2018, but it still may be able to hit its previously set target of ~5.0x by the end of 2020.

In 2019, Iron Mountain expects revenue to be $4.2-$4.4 billion, which represents 1.8% growth at the midpoint, and adjusted EBITDA is expected to be in a range of $1.42-$1.53 billion, compared to $1.436 billion in 2018. Organic storage rental revenue growth of 1.75%-2.5% and total organic revenue growth of 2%-2.5% is anticipated. Earnings per share guidance comes in a range of $1.08-$1.18 compared to $1.10 in 2018, and adjusted funds from operations are projected to be $870-$930 million in 2019 compared to $874 million in 2019.

We expect to continue highlighting Iron Mountain in the simulated High Yield Dividend Newsletter portfolio as it undergoes a revenue mix shift towards higher-growth markets, but the secular pressures facing its storage business in developed markets should not be ignored. Shares are currently changing hands in the upper half of our fair value range, and they carry a dividend yield of ~6.9% as of this writing.

BP Delivers Solid Performance in 2018; Provides Long-Term Demand Update

BP (BP) finished 2018 on a strong note, with its fourth quarter report, released February 5, revealing ~65% growth in underlying replacement cost profit. Underlying replacement cost profit before interest and tax jumped more than 80% from the year-ago period thanks to growth in all business areas, and the measure more than doubled in the full-year 2018 as both its 'Upstream' and 'Rosneft' businesses more than doubled their respective underlying replacement cost profit before interest and tax.

Operating cash flow at BP came in at $26.1 billion when excluding Gulf of Mexico oil spill payments, which totaled $3.2 billion in the year, up from $24.1 billion in 2017, and organic capital expenditures fell to $15.1 billion from $16.5 billion in 2017. Free cash flow generation of $11 billion, when excluding Gulf of Mexico oil spill payments, was easily in excess of cash dividends paid to shareholders of $6.7 billion. The company's net debt load sat at $43.1 billion at the end of 2018.

BP expects underlying production to grow in 2019 due to major projects, but actual results will depend on timing of project start-ups, acquisition and divestment activities, OPEC quotas, and entitlement impacts in the company's profit-sharing agreements. In the early portion of the year, BP expects broadly flat upstream production due to divestments in the North Sea and Alaska and maintenance and turnaround activity in the Gulf of Mexico being roughly offset major projects ramping up and the addition of BHP's US onshore assets to its upstream portfolio. Significantly lower refining margins and narrower North American heavy crude oil discounts are expected to impact its downstream operations in the near term. Gulf of Mexico oil spill payments are expected to fall to ~$2 billion in 2019 on an after-tax basis.

In the period from 2019-2021, BP expects to spend $15-$17 billion in organic capital expenditures, and it is targeting 10%+ return on average capital employed (ROACE) by 2021, assuming $55 per barrel oil prices. Return on average capital employed came in at 11.2% in 2018, up from 5.8% in 2017, and the company expects to complete $10+ billion in divestitures over the next two years. Underlying upstream production is expected to finish the 2016-2021 period with a 5%+ CAGR, and the image below depicts BP's pre-tax free cash flow expectations for its 'Upstream' segment in the years ahead.

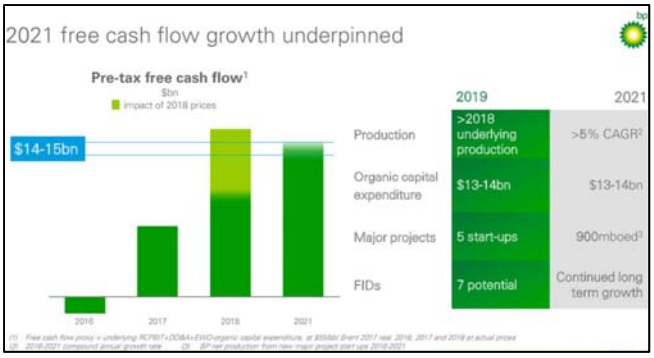


Image Source: BP fourth quarter presentation

Over the course of the coming decades, BP expects oil demand to remain strong, even if the targets set in the Paris Agreement are met, but in what BP labels a 'rapid transition' to a lower carbon world, demand for crude oil would drop by 20% by 2040. Renewables are expected to be the fastest growing energy source, as their share in primary energy productions expected to rise to ~15% in 2040 from ~4% currently.

Slowing Chinese energy demand was also an interesting point in BP's long-term outlook as concerns surrounding the country's economic expansion persist. After the nation's energy demand advanced 5.9% over the last two decades, it is now expected to grow by only 1% through 2040 as the economy shifts from energy-intensive industrial production to an increasing focus on services, not to mention its more strict pollution standards. BP's forecast for China's energy demand was down 7% compared to its forecast a year earlier due to the above factors. India appears set to take over the top spot in terms of global energy demand growth in the early part of next decade.

All things considered, we like what we're seeing from BP in terms of its near-term outlook, and the ongoing dissipation of its Gulf of Mexico oil spill payments bode well for future free cash flow generation. Major products coming online in 2019 should help offset potential weakness in its downstream operations, and we tend to agree with the major points of BP's long-term outlook for demand for crude oil. Shares are currently trading roughly in-line with our fair value estimate of $42 each, and BP's Dividend Cushion ratio sits at 0.8 at last check. We expect to continue highlighting shares, which yield ~5.8%, in the simulated High Yield Dividend Newsletter portfolio.

Williams Companies: Great Assets, Terrible Spending Habits

Williams Companies' financial and operational performance provide a dichotomy to highlight why management needs to target free cash flow in order to truly reward existing income-seeking shareholders.

Williams Companies Inc (WMB) yields 5.6% as of this writing and supports those payouts primarily through the cash flow generated by its natural gas infrastructure. That includes major gas pipeline networks, gathering systems, storage facilities, processing plants and other midstream operations. Last year, the master limited partnership and the general partner merged and are now under the umbrella of one publicly traded midstream company. Ostensibly, this merger was billed as a shift towards becoming a more efficient enterprise but it was

really all about removing Incentive Distribution Rights (IDRs) from the picture. IDRs give the general partner (GP) an outsized portion of the MLP's incremental cash flow generation (specifically, cash flow as defined by the non-GAAP distributable cash flow metric).

In order to better understand Williams Companies, it is best to view the dichotomy between its asset base's impressive economic moat versus the company's poor financial performance on a free cash flow basis. The company has the potential to be materially free cash flow positive but is hindered by large growth-related capital expenditures, or in other words, investments that the firm doesn't necessarily need to make. Management doesn't appear to be targeting free cash flow anytime soon, instead preferring to utilize debt to cover Williams Companies' outspend.

Two Great Pipelines

The backbone of Williams Companies' asset base is built around two enormous natural gas pipeline systems in America; the 10,000-mile long Transco network and the 4,000-mile long Northwest Pipeline. Williams owns 100% of these assets and acts as the operator. Pipelines, at least in theory anyway, are thought to be prime cash flow cows within the midstream space. As long as utilization rates remain high, a sign those pipelines are firmly in demand, the operator generates large amounts of fee-based revenue that is primarily influenced by volume (and to a lesser extent, rate cases). Depreciation expenses represent the majority of the operating expense incurred by pipelines under normal circumstances, which is why they are considered cash flow cows.

Williams' Transco network runs across 12 states in the Northeast, Mid-Atlantic and Gulf Coast regions, connecting key producing basins in Appalachia and the Gulf Coast to enormous demand centers all across America. That includes major metropolitan areas in the Northeast and large downstream operations along the Gulf Coast. Going forward, the company is progressing forward with its Leidy South Expansion that seeks to bolster Transco's ability to route additional gas supplies out of Appalachia and towards markets along the East Coast. Management doesn't expect that project to get completed until the Winter of 2021.

Williams' Northwest Pipeline system connects gas supplies sourced from the Rocky Mountains region, the San Juan Basin, and even supplies from Western Canada to buyers across Western America. Williams' Northwest Pipeline faces relatively little competition in several of the big areas it operates in, including Washington State, Oregon, and parts of California. The company expects to complete a modest expansion of the system in Seattle by the end of this year, and farther out, has secured a contract to add a lateral to the system that would connect to a proposed methanol production plant along the Washington-Oregon border. That development isn't expected to be operational until 2022.

Before pushing forward, let's cover some key midstream-specific nomenclature. Long-haul natural gas pipelines are referred to as transmission systems, which are designed to connect producing basins with key demand centers, whether directly or through interconnections with other pipeline networks. Williams, as the operator of these pipelines, is considered the 'carrier' while the companies that are utilizing these pipeline transportation services are considered to be the 'shippers'. The volume-based fee shippers pay the carrier is called a tariff, which is based on a variety of factors (whether the transported volumes are protected by long-term contracts or are at the mercy of spot market rates, the amount of volume committed to the system, the length of those long-term contracts, and where the receipt and delivery points are).

Broadly speaking, shippers tend to be upstream firms that are seeking to get raw energy resource products to downstream buyers, or downstream firms looking to transport refined products to end markets. Long-haul natural gas pipelines are built to route natural gas that has already been processed (usually by cryogenic processing plants, which separate 'wet' natural gas liquids from 'dry' methane) and is ready for end markets.

Those end markets include most of what you would expect, such as utilities (gas distribution to residential and commercial properties), power generation, industrial uses (as a feedstock during the production of ammonia, methanol, and fertilizer), but there is also sizable demand from petrochemical plants and refineries. Gas exports to Mexico via pipeline and liquified natural gas exports provide additional egress capacity for American production.

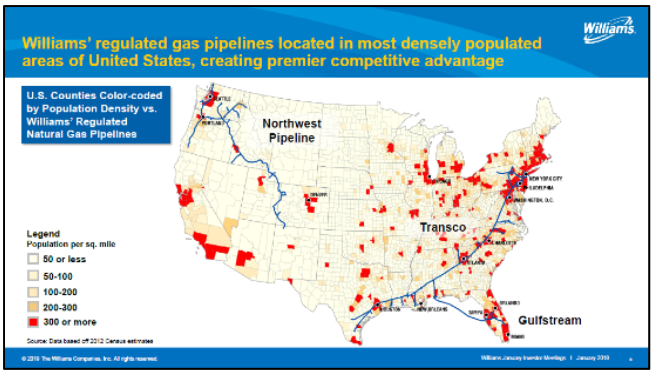


Image shown: Map highlighting the footprint of the Transco and Northwest pipeline networks from Williams Companies

What makes these pipeline assets significant to America's natural gas industry is that these networks can't be easily replaced (or at all), not in the 21st century. Any pipeline developer pursuing a greenfield pipeline project that seeks to run across multiple states is bound to encounter extensive regulatory and legal hurdles, and that's assuming the project gets approved on the federal level in the first place. There are also political and protest-related obstacles to consider when launching such an endeavor. As one pipe in the ground is worth ten on the drawing board, Williams' long-haul gas pipelines arguably are protected by a significant economic moat. It's highly unlikely America will see another large greenfield natural gas pipeline network built in our lifetimes. Therefore, expansions along existing systems have been necessary to support America's rising domestic production and consumption levels.

Supply-Demand Dynamics Favorable

Due in large part to the rise of fracking, which is colloquially understood to mean utilizing hydraulic fracturing and horizontal drilling to tap into reservoirs previously thought to be uneconomical, America's annual natural gas production jumped by 35% from 2007 to 2017, according to the EIA. A lot of those additional volumes came from Appalachia, namely the Marcellus and Utica shale plays that the Transco system directly caters to. Rising supplies in Oklahoma, Louisiana, and Texas can also be serviced by the Transco network. The EIA's Short-Term Energy Outlook notes that the organization expects American dry gas production to rise by another 8% this year on an annual basis, before climbing an additional 2% next year. Domestic consumption is expected to rise moderately over this period.

Appalachian natural gas production has skyrocketed from less than 3 billion cubic feet per day at the start of this decade to over 30 Bcf/d by early-2019. This was the impetus behind the Atlantic Sunrise project, which significantly expanded Transco's ability to transport Appalachian gas supplies to demand centers along the system. This expansion came online in October 2018 and should act as a nice tailwind for growth this year. As mentioned previously, Williams plans to continue expanding the Transco system.

Suring domestic supply pushed North American natural gas prices significantly lower over the past ten years, making American gas supplies very economically competitive in overseas markets. The nation's capacity to export liquefied natural gas is set to double this year on an annual basis, while American gas pipeline export capacity to Mexico has almost tripled since 2011. Rising export capacity enables rising domestic gas supplies to reach additional end markets thus supporting future supply growth, a boon for Williams. As domestic demand growth has its limits and is in part based on the weather (as that heavily influences power burn rates), export capacity expansions represent one of the best ways to keep the momentum going.

Domestic demand for natural gas climbed by 17% from 2007 to 2017. Electricity generated by natural gas was the largest source of American power generation in 2017 at 32%, ahead of coal's 30% share. Keep in mind that coal was on average the source of over half of America's electricity generation from 1949 to 2005, making this a structural shift and not a short-term blip. Low domestic natural gas prices not only spurred investments in export capacity, but also investments in new natural gas-fired power plants in America. Several additional gas-fired plants were forecasted to come online last year in states that Transco can service (either directly or via interconnections), including Pennsylvania, Virginia, and Maryland.

Transco Rate Increases

In light of the economic moat that protects its Transco asset, Williams is pursuing rate increases along the system and noted in its 2018 10-K filing that:

> "On August 31, 2018, Transco filed a general rate case with the FERC for an overall increase in rates. In September 2018, with the exception of certain rates that reflected a rate decrease, the FERC accepted and suspended our general rate filing to be effective March 1, 2019, subject to refund and the outcome of a hearing. The specific rates that reflected a rate decrease were accepted, without suspension, to be effective October 1, 2018, as requested by Transco, and will not be subject to refund."

That proposed rate increase would add $0.3 billion to its revenue generation according to Williams' January 2019 IR presentation, equal to a 3% boost over 2018 levels. As part of this rate case, Williams has also proposed a $1.2 billion modernization program in order to maintain operational readiness and reduce methane leaks (which behooves shippers that utilize the system, the environment, and should bolster Williams' safety record as less natural gas is unintentionally lost in transit).

Higher operating expenses over the past few years represent another factor driving Williams to seek tariff rate increases. Negotiations with shippers are ongoing and management had this to say on the process during the firm's fourth quarter conference call:

> "So we would expect to see the -- what's called the top sheets from FERC in mid-March, and that's really their staff's reaction to our filing. And they would provide the sideboards, if you will, so what we could then go to settlement negotiations with for staff and our customers on. And so the first or the start, I should say, the next settlement conference is scheduled for the end of March. And so at that point in time, we'll have a pretty good idea of how likely it is that a settlement can occur. And obviously, that's the path we would prefer to go down. I think that's the best for our customers and ourselves to be able to agree upon that and not litigate the case. And that's what the expectation is right now, for us to achieve an outcome in settlement that's satisfactory to both Williams and our customers."

This is a straightforward source of upside for Williams as it would both enable, at least as proposed, the firm to generate additional revenue from an existing asset and would create a new growth opportunity for the company via the five-year modernization program. However, nothing is for certain and Williams may not end up getting the tariff increases it wants. It appears this process is expected to play out over the coming months.

Debt and Cash Flow Problems

Below is a look at Williams' credit ratings from the big three agencies, which was provided in its 2018 10-K filing. The company's credit is investment-grade, but just barely.

Rating Agency	Outlook	Senior Unsecured Debt Rating	Corporate Credit Rating
S&P Global Ratings	Negative	BBB	BBB
Moody's Investors Service	Stable	Baa3	N/A
Fitch Ratings	Positive	BBB-	N/A

Image shown: Williams Companies' credit rating from the three major agencies.

In 2018, Williams generated $3.3 billion in net operating cash flow which was up 7% on an annual basis. That was outmatched by $5.9 billion in cash flow outlays including $2.8 billion in net capital expenditures (defined as capex minus contributions in aid of construction), $1.4 billion in common dividend payments, $1.1 billion in contributions to equity-method investments (which was up by $1.0 billion over 2017 levels, likely a one-off event), and $0.6 billion in distributions to non-controlling entities. $1.3 billion in divestment proceeds helped bridge the gap, but ultimately debt was needed to cover Williams' outspend. Note only $0.5 billion of Williams' capital expenditures went towards maintenance capex last year, the rest was allocated towards growth projects.

One of the greatest flaws of the midstream model is relying aggressively on debt and/or equity issuances to cover outspends, which is arguably a key reason why investors have fled the space over the past few years. The deeply flawed non-GAAP distributable cash flow metric and distribution coverage ratios are always thrown out as proof investor payouts will never get cut, but time and again that has proven to not be true. Valuentum members were ahead of the curve in this regard, thanks to Brian Nelson's high profile call on the pending collapse in Kinder Morgan (KMI) and the rest of the midstream space in June 2015.

Williams Companies recently increased its dividend by 12% on an annual basis while its growth-related capex budget for 2019 was kept broadly flat versus 2018 levels. Management is expecting decent cash flow growth in 2019 as the company forecasts its adjusted EBITDA will climb by 8% year-over-year to $5.0 billion at the midpoint of guidance. That likely won't be enough to cover its expected cash flow outlays, indicating additional debt issuance is ahead. Equity issuance is unlikely at Williams, as management has shown a strong preference for issuing debt in the current climate.

At the end of 2018, Williams' consolidated debt load jumped by 7% to $22.4 billon from the same time a year earlier, giving the firm a total debt-to-adjusted EBITDA ratio just north of 4.8x. Having a debt to adjusted EBITDA ratio over 4.5x is worrisome in the midstream space, and Williams Companies exited 2018 with only ~$0.2 billion in cash on hand, indicating limited financial flexibility. By the end of 2019, management is targeting a consolidated debt to EBITDA ratio that is marginally below 4.8x, but that isn't a significant improvement.

Last year, Williams spent $1.2 billion on interest expenses (includes a small amount of capitalized interest expenses), meaning roughly a quarter of its 2018 adjusted EBITDA went to servicing its debt load. Any debt reduction in the short-term will likely be entirely due to proceeds from asset sales. Management gave this statement during the firm's fourth quarter conference call:

"We're constantly looking at optimizing our portfolio and. Where we are working really hard, I can tell you the entire team, with the board's support, is working hard to reduce our leverage. And so we continue to work various transactions and asset sales that would help complement that. So to answer your question, we are actively pursuing those type of transactions."

However, this strategy has its limits for numerous reasons. Williams continues to issue debt to cover its ongoing growth spending, making long-term reductions impossible until that changes. Divestments effectively frontload future cash flow in the form of an upfront payment, but those lost income streams offset the positive impact of its growth program.

Free cash flow is the best way to pay off debt as that can lead to sustainable reductions over time. Come 2020, the main lever Williams can pull to get a better handle on its liabilities is to target spending reductions. It's highly unlikely management would consider cutting Williams' dividend as things stand today, leaving only growth-related capex cuts as the midstream company's primarily way of fixing its financial position.

Conclusion

Williams Companies has a stellar asset base, but that isn't good enough to ensure its future cash flows will be strong enough to enable the company to keep making good on its promised dividend payments. Until management accepts that targeting free cash flow and bringing down Williams Companies' leverage ratios are the best ways to sustainably grow the business, any upside the firm's asset base potentially offers will have to be split between its shareholders and its creditors. While its growing 5.6% yield looks appealing on the surface, Williams Companies has a lot of work to do before its income is secure, and we are amply comfortable with the degree of midstream exposure our simulated High Yield Dividend Newsletter portfolio currently contains.

Disclosure: Callum Turcan, author of this piece, owns shares of Energy Transfer LP and Kinder Morgan Inc.

MLPs Starting to Adopt Free Cash Flow?

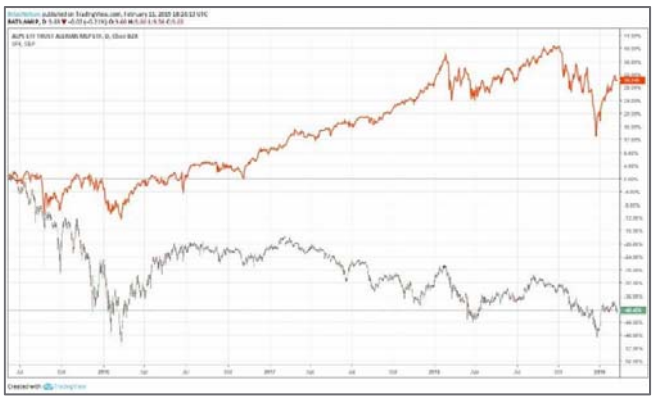


Image shown: Since mid-June 2015, the price of an ETF tracking the midstream MLP energy space (AMLP) has fallen more than 40% while the S&P 500 (SPY) has rallied more than 30%.

I have some great news for investors. In my lengthy piece from last Tuesday, February 5, I talked about how master limited partnerships (MLPs) may be starting to embrace the very important metric **free cash flow**. If you remember, **free cash flow** is generally calculated as cash flow from operations less *all* capital spending.

On the other hand, distributable cash flow, or the most widely-disseminated metric across midstream equities, generally excludes growth capital spending, while still including benefits from that growth capital spending in net income. There's a big imbalance. I make the plea to retire distributable cash flow in my book, *Value Trap: Theory of Universal Valuation.*

On January 31, Enterprise Products Partners (EPD), the largest pipeline MLP, said the following on its conference call in response to a question:

***Question**: ...in your comments, I noticed that there was a lot of focus on **free cash flow**. Is this a structural shift perhaps in how you sort of see messaging your financial flexibility going forward? Are you sort of shifting away from DCF and having an increasing focus on **free cash flow**? Is that something we should expect going forward.*

Enterprise Products Partners' CFO Randall Fowler: *Well, we -- I think the transition that we're making is from the MLP-centric model that, if you would, we had our own specialized financial metrics. And as we come in, the incremental valor of investment is from more traditional funds, institutional investors that are not accustomed to our MLP language. And I guess, 2 things. One, with us going more to a self-funding model, **we can come in and utilize traditional financial metrics**. So a little bit, we're just making that transition from an MLP-centric model, consuming a lot of capital and really trying to appeal to generalist investor. And we need to talk their language, which is GAAP measures, whether it's earnings per unit and price on earnings per unit, whether it's multiple of cash flow from operations or in terms of **free cash flow**.*

We think this is a huge step forward for the midstream MLP industry in improving transparency and communications with investors. Since mid-June 2015, when Valuentum made its landmark call on MLPs, shares of the group have fallen more than 40%, while the S&P 500 has rallied more than 30%. Dozens of MLPs have cut their distributions, and approximately 40% of energy infrastructure is now C-Corp, up from practically nothing prior to the Kinder Morgan re-consolidation. **We applaud the midstream industry for taking investors' concerns seriously**, and we hope to see many more follow Enterprise Products Partners' lead in emphasizing free cash flow. Read more about this news from S&P Global, "Enterprise's shift on cash flow reflects 'metamorphosis' of US pipeline firms:"

---

*Enterprise Products Partners LP, the biggest pipeline master limited partnership, took a step in that direction when it emphasized **free cash flow** - interpreted broadly as cash flow from operations minus capital expenditures - and de-emphasized distributable cash flow as the primary way to illuminate how much money it has available to pay out to investors and for debt reduction...Enterprise's move was a public acknowledgement of a trend away from the sometimes opaque financial reporting of MLPs in recent years...*

*..."The marketplace ... was ignoring the concept that growth capital associated with driving future distributable cash flow is also shareholder capital," **Brian Nelson, president of the investment research firm Valuentum Securities Inc.**, wrote in a September 2018 note to clients. "It becomes questionable whether distributable cash flow, because it does not deduct for growth capital spending, is a useful measure at all."*

Valuing MLPs

The following is an excerpt from Brian Nelson's recent book Value Trap: Theory of Universal Valuation.

There are a number of ways to account for business performance across various business structures, whether an entity is a corporate, real estate investment trust (REIT), or MLP, but cash flow will always be cash flow. In finance (and in valuation), a business cannot be worth more or less than the present value of its future enterprise free cash flows, adjusted for its net balance sheet (a net debt or a net cash position), as well as any other "hidden" factors (e.g. an overfunded pension)--no matter if the entity is structured as a corporate, a REIT or MLP.

The prices of these entities may become disconnected from their true intrinsic values, or even estimates of

what the market should believe is their true intrinsic value, if for example, "yield-based pricing" (systematic valuation on distributable cash flow) is pursued in an ultra-low interest rate environment (as in what happened with midstream MLPs in 2015). However, value will always be value, distinct from price. A dollar of enterprise free cash flow generated by a retailer is a dollar generated by a software company is a dollar generated by a midstream entity. The present value of dollars coming in versus dollars going out forms the basis of any robust valuation context.

For those focused on value-contributions of each individual project of a pipeline operator as only being incremental (using arbitrary and impractical book equity as a base in economic-profit models), what may be helpful is to consider an MLP as one big project, one big NPV calculation, and therefore, one enterprise free cash flow model, where the timing of enterprise cash flows matters and net debt is considered. In the image on the next page, the link between the industry specific metric distributable cash flow and the basic construct of an enterprise free cash flow model is established.

Figure 27: Formula That Ties Enterprise Value to Distributable Cash Flow

Master Limited Partnership Valuation

It has become common practice to value master limited partnerships on a Price to Distributable Cash Flow (DCF) basis. However, such a valuation technique, if not supported by an enterprise free cash flow process (1), is susceptible to systematic overvaluation when comparable company analysis is applied.

The following formula links enterprise free cash flow valuation to the P/DCF multiple, showing how the latter is a function of the former, much like enterprise free cash flow valuation *derives* the P/E multiple. The numerator is the standard function used in corporate valuation, while the denominator is an MLP's forward distributable cash flow.

Note how the timing of large capital expenditures (negative) and outsize net debt positions (negative) impact the intrinsic worth of capital-intensive and debt-heavy MLPs.

Forward Price / Distributable Cash Flow (P/DCF) Ratio Derived

$$\frac{\left[\sum_{t=0}^{\infty}\frac{A(t)}{(1+d)^t} - B(0) - C(0) + D(0)\right] \Big/ E(0)}{F(1)}$$

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,

E (0) is Weighted Average Diluted Shares Outstanding at time 0,

F is Distributable Cash Flow per Share, and

d is Weighted Average Cost of Capital (WACC).

(1) Enterprise free cash flow, or free cash flow to the firm (FCFF), is calculated as earnings before interest after taxes less net new investment (total capital spending less total depreciation) +/- working capital changes.

Similar to how enterprise valuation is tied to the P/E ratio, the numerator of the ratio in the image above represents a construct of the enterprise valuation model, which takes the present value of a company's enterprise free cash flow and net balance sheet impact and divides that by units outstanding. The denominator is the industry-specific term distributable cash flow estimated for next year. The formula derives the value that should be placed on the business via the enterprise valuation construct, and then this value estimate helps to inform the multiple of forward expected distributable cash flow that may be reasonably applied to units on the market to determine a fair price. As with the P/E ratio, the value-derived distributable cash flow multiple differs from the price-observed multiple, which is taken by dividing a unit's share price observed on the marketplace by its future distributable cash flow.

Systemic Liquidity, Concerns Over Slowing Global Economic Growth, and Default Rates

The corporate debt-to-GDP ratio in the US has never been higher, but default rates and expectations for near-term default rates have not followed suit. Systemic liquidity expectations and pre-tax profit forecasts may paint a constructive picture, but it isn't all roses.

The implications of the Fed's increasingly dovish tone have been vast, but nothing may be more important than the impact it has had on expectations for systemic liquidity moving forward. The ratio of US nonfinancial corporate debt-to-GDP continues to march higher, and the third quarter of 2018 marked the 26th consecutive quarter in which the ratio grew on a year-over-year basis, according to Moody's. However, default rates fell from the year-ago period in 14 of those 26 quarters thanks to ample systemic liquidity and solid pre-tax profits.

The Fed continues to take a more flexible approach to interest rate hikes, and the potential for benchmark borrowing costs to remain relatively suppressed impacts default rates directly. The availability of cheap credit saved a large number of highly-levered entities following the collapse of crude oil prices in the middle of this decade, even as pre-tax profits faced substantial pressure, and futures markets are now assigning a ~5% probability that the Fed will enact at least one rate hike in 2019. Suppressed benchmark borrowing costs are providing a basis of stabilization of the financial markets,

as evidenced by the strong performance of equities thus far in 2019.

As a result of the Fed's dovish tone, Moody's lowered its baseline forecast of the US high-yield default rate for the fourth quarter of 2019 to 2.4% in early February from 3.3% just a month earlier. Consensus expectations for pre-tax profit growth from current production of 4.1% in 2019 and 2.3% in 2020 support expectations for default rates to remain subdued, but concerns over global economic growth are not without a basis in reality and present corporate credit quality with an added degree of risk, even if benchmark borrowing costs do not move materially higher.

Spending in emerging markets may pose the most significant threat to global economic growth, and trade tensions only add to the uncertainty surrounding the health of these dynamic markets. Chinese imports of US goods have been understandably impacted by the US-China trade war, and the measure dropped 41% on a year-over-year basis in January 2019, marking the largest decline on record. This record drop followed annual declines of 25% and 36% in the months of November and December 2018, respectively, and 2018 brought weakened manufacturing and export performance from some of the largest economies around the globe. January marked the eighth consecutive month of new export order declines in China, and the country's official manufacturing PMI is mired in contraction territory.

These growth concerns are not reserved for China, however. Industrial production in Europe, which fell at the greatest sequential rate since 2009 in December 2018, has caught the eye of many a market observer. Demand softness from China is playing a role, and the usual suspects such as Greece, Italy, and uncertainty over Brexit continue to weigh on expectations as well. However, weak consumption in France and a slowdown in German manufacturing may point to greater issues for the EU as the two countries account for roughly half of the European economy. Alarm bells are far from ringing, but the potential for euro-area GDP expansion in 2019 to slow materially is present. Current European Commission GDP growth forecasts for the year currently sit at 1.3%, and the potential for escalating EU-US trade tensions provides downside risk to this forecast.

In the past we have highlighted the record percentage of US corporate debt rated one notch above junk territory and what rising borrowing costs in conjunction with potential headwinds to pre-tax profits could mean for the financial health of this growing segment of US corporates, but the improved outlook for systemic liquidity as a result of caution on the part of the Fed may have effectively put an end to those concerns for the time being. However, the fact that interest rates are facing a potential ceiling while market observers continue to tout the strength of the US economy may point to significant cracks in the long-term economic health.

The combination of rising debt levels and subdued or even declining default rates is not a pairing that is sustainable over the long haul, but we are not sounding alarm bells with respect to the next sustained global economic downturn. Systemic liquidity and pre-tax profits are core contributors to default rate expectations, and entities with substantial debt loads, such as those found within the high-yield space, are the most exposed to potentially negative developments related to either factor. It is no surprise that US equities, which are displaying record-high leverage levels in aggregate, have benefit substantially from the Fed's dovish stance as it relates to systemic liquidity, but elevated debt levels will almost certainly come home to roost at some point in the future. The only uncertainty of such a development lies in the timing, which is likely to be directly related to a significant change in systemic liquidity and/or pre-tax profits.

- Brian Nelson, CFA
President, Investment Research

- Kris Rosemann
Head of Data, Associate Investment Analyst

- Callum Turcan
Independent Energy Contributor

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 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 performance of the High Yield Dividend Newsletter periodically, 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	8.32%
Global X SuperDividend ETF	SDIV	5.0%	1.59	8.57%
Global X SuperIncome Preferred ETF	SPFF	10.0%	0.83	7.11%
iShares International Select Dividend ETF	IDV	5.0%	1.70	5.36%
iShares MSCI Australia ETF	EWA	5.0%	1.18	5.49%
iShares U.S. Preferred Stock ETF	PFF	5.0%	2.13	5.86%
PowerShares Senior Loan Portfolio	BKLN	5.0%	1.03	4.53%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	4.04	6.10%
EQUITY				
AT&T	T	5.0%	2.04	6.62%
BP PLC	BP	5.0%	2.46	5.78%
Digital Realty Trust	DLR	5.0%	4.32	3.77%
Enterprise Products Partners	EPD	5.0%	1.74	6.26%
Iron Mountain	IRM	5.0%	2.44	6.82%
Magellan Midstream Partners	MMP	5.0%	3.99	6.49%
Public Storage	PSA	5.0%	8.00	3.77%
Realty Income Corporation	O	5.0%	2.71	3.92%
Schlumberger	SLB	5.0%	2.00	4.43%
Tallgrass Energy LP	TGE	5.0%	2.02	8.85%
		95.0%		**5.76%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 3/1/2019.

SCREEN OF THE MONTH – REAL ESTATE INVESTMENT TRUSTS IN OUR COVERAGE UNIVERSE

Company Name	Symbol	Est. Div. Yield	Div Cushion	Div Growth	Div Safety	Div Track Record	VBI	Fair Value Estimate	Economic Castle
Omega Healthcare	OHI	6.9%	0.9	VERY POOR	POOR	HEALTHY	7	$36.00	Attractive
Kimco Realty	KIM	6.8%	0.7	VERY POOR	POOR	RISKY	7	$16.00	Neutral
Macerich	MAC	6.6%	-0.8	VERY POOR	VERY POOR	RISKY	4	$43.00	Neutral
SITE Centers	SITC	6.4%	-2.0	VERY POOR	VERY POOR	RISKY	6	$14.00	Neutral
Tanger Factory	SKT	6.3%	0.6	POOR	POOR	HEALTHY	4	$22.00	Attractive
WP Carey	WPC	5.9%	0.7	VERY POOR	POOR	HEALTHY	7	$74.00	Attractive
Retail Properties of America	RPAI	5.6%	0.1	VERY POOR	VERY POOR	HEALTHY	3	$12.00	Neutral
Taubman	TCO	5.3%	-0.2	VERY POOR	VERY POOR	HEALTHY	4	$61.00	Neutral
Ventas	VTR	5.2%	1.4	GOOD	GOOD	HEALTHY	6	$56.00	Neutral
LTC Properties	LTC	5.1%	0.8	VERY POOR	POOR	HEALTHY	6	$48.00	Attractive
HCP	HCP	5.0%	0.9	VERY POOR	POOR	RISKY	6	$28.00	Attractive
Welltower	WELL	4.8%	1.6	GOOD	GOOD	HEALTHY	6	$64.00	Neutral
CoreSite Realty	COR	4.7%	0.5	POOR	GOOD	HEALTHY	6	$93.00	Neutral
Simon Property	SPG	4.6%	1.0	POOR	GOOD	RISKY	3	$171.00	Attractive
Realty Income Corp	O	4.2%	1.2	EXCELLENT	GOOD	HEALTHY	5	$56.00	Neutral
Universal Health Realty	UHT	4.1%	1.1	VERY POOR	POOR	HEALTHY	6	$57.00	Neutral
Healthcare Realty Trust	HR	3.9%	1.5	POOR	GOOD	RISKY	6	$26.00	Neutral
SL Green	SLG	3.8%	-0.7	VERY POOR	VERY POOR	RISKY	3	$81.00	Neutral
Digital Realty Trust	DLR	3.8%	1.8	EXCELLENT	GOOD	HEALTHY	3	$96.00	Neutral
Regency	REG	3.6%	0.3	VERY POOR	VERY POOR	RISKY	3	$61.00	Neutral
CyrusOne	CONE	3.6%	-0.7	POOR	POOR	HEALTHY	3	$54.00	Neutral
Federal Realty	FRT	3.2%	0.1	VERY POOR	VERY POOR	HEALTHY	6	$102.00	Neutral

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 – PIPELINE COMPANIES IN OUR COVERAGE UNIVERSE

Company Name	Symbol	Est. Div. Yield	Div Cushion	Div Growth	Div Safety	Div Track Record	Leverage	VBI	Fair Value Estimate	Economic Castle
Golar LNG Partners	GMLP	12.1%	1.3	VERY POOR	POOR	RISKY	HIGH	6	$14.00	Attractive
DCP Midstream	DCP	9.6%	2.2	GOOD	GOOD	HEALTHY	HIGH	3	$39.00	Neutral
NuStar	NS	9.5%	1.1	VERY POOR	POOR	RISKY	HIGH	6	$27.00	Unattractive
Buckeye Partners	BPL	9.2%	1.2	VERY POOR	POOR	RISKY	HIGH	6	$34.00	Unattractive
Holly Energy	HEP	8.7%	1.3	EXCELLENT	GOOD	HEALTHY	HIGH	6	$31.00	Attractive
Energy Transfer	ET	8.1%	3.3	GOOD	GOOD	HEALTHY	HIGH	6	$21.00	Neutral
Western Gas	WES	7.9%	1.7	EXCELLENT	GOOD	HEALTHY	HIGH	6	$48.00	Neutral
Enbridge	ENB	6.4%	1.8	EXCELLENT	GOOD	HEALTHY	HIGH	6	$39.00	Neutral
Enterprise Product Partners	EPD	6.4%	2.0	GOOD	GOOD	HEALTHY	HIGH	6	$30.00	Neutral
Magellan Midstream	MMP	6.3%	1.1	EXCELLENT	GOOD	HEALTHY	HIGH	6	$68.00	Attractive
Plains All American	PAA	5.0%	-0.8	VERY POOR	VERY POOR	RISKY	HIGH	6	$26.00	Attractive
Kinder Morgan	KMI	4.6%	1.0	GOOD	GOOD	RISKY	HIGH	6	$23.00	Neutral

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.

DIVIDEND REPORT PAGE 2 – OMEGA HEALTHCARE (OHI)

Omega Healthcare OHI FAIRLY VALUED

Buying Index™ 7 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$27.00 - $45.00	HEALTHY	POOR / 0.9	VERY POOR	6.91%

Assessment of Company Dividend Strategy

Key Strengths

Omega Healthcare is the largest skilled nursing facility focused REIT with nearly 975 operating facilities in its portfolio as of December 31, 2017. The company is currently slightly above its target leverage range of a debt-to-adjusted EBITDA ratio of 4x-5x, and it continues to aim for a target dividend payout ratio of less than 85% of adjusted funds from operations or less than 90% of adjusted funds available for distribution. The first quarter of 2018 marked the 22nd consecutive quarter of quarterly dividend increases, but it marked the end of the streak as management prudently sustained the payout. Adjusted funds from operations averaged ~$520 million annually from 2015-2017, slightly in excess of yearly run-rate cash dividend obligations of ~$503 million.

Potential Weaknesses

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.

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. Omega Healthcare'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.

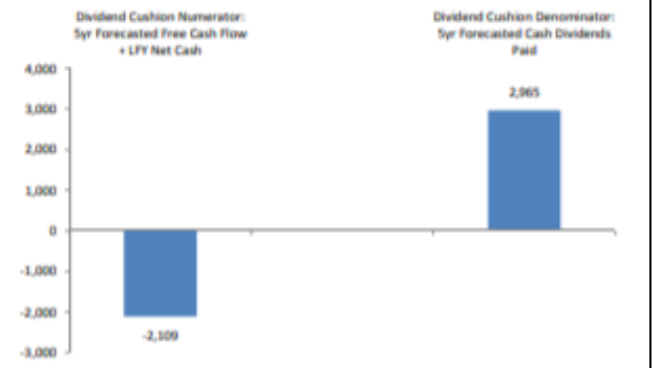
Raw, Unadjusted Dividend Cushion Cash Flow Bridge - Raw

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, Omega Healthcare'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



The information and data contained in this report is not represented or warranted to be timely, complete, accurate, or correct. This report is for informational purposes only and should not be considered a solicitation to buy or sell a security. Before acting on any information in this report, you should consider whether the information is suitable for your particular circumstances and, if necessary, seek professional advice. Assumptions, opinions, and estimates are based on our judgment as of the date of the report and are subject to change without notice. Valuentum is not responsible for any errors or omissions or for results obtained from the use of this report. Redistribution is prohibited without written permission. To license Valuentum research, contact us at valuentum@valuentum.com.

DIVIDEND REPORT PAGE 2 – PUBLIC STORAGE (PSA)

Public Storage PSA FAIRLY VALUED

Buying Index™ 3 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$135.00 - $225.00	HEALTHY	GOOD / 1.4	EXCELLENT	3.99%

Assessment of Company Dividend Strategy

Key Strengths

Investors have come to love Public Storage, with the REIT trading at a very lofty multiple of its expected funds from operations. Revenue has been fantastic at Public Storage, and operating income has performed even better, the latter advancing to $1.4+ billion in 2017 from ~$750 million in 2011; cash distributions per share have doubled over the same time. It has paid a quarterly dividend in each of the past 18+ years, and we love its A-rated corporate credit quality. Public Storage's dominance in major metro areas is a key competitive advantage in our view, especially given concentration/density benefits, and its brand is a key recognizable asset. Operating cash flow has averaged nearly $1.9 billion during the past three years (2015-2017).

Potential Weaknesses

We have had no qualms with Public Storage's operating performance, as same store revenue and property NOI continue to grow nicely in its US self-storage operations. Oversupply is expected to provide headwinds to pricing in the near term. Growth outside the US may not be as easy, as self-storage tends to be a smaller market in Europe, which it targets through its Shurgard brand. We're somewhat disappointed that the firm will become more active in the corporate debt markets, as we tend to be relatively debt-averse when it comes to income holdings. The REIT remains capital-market dependent, and this could come back to haunt investors during weak times of credit availability. Dividend obligations are not minor at ~$1.6 billion per annum.

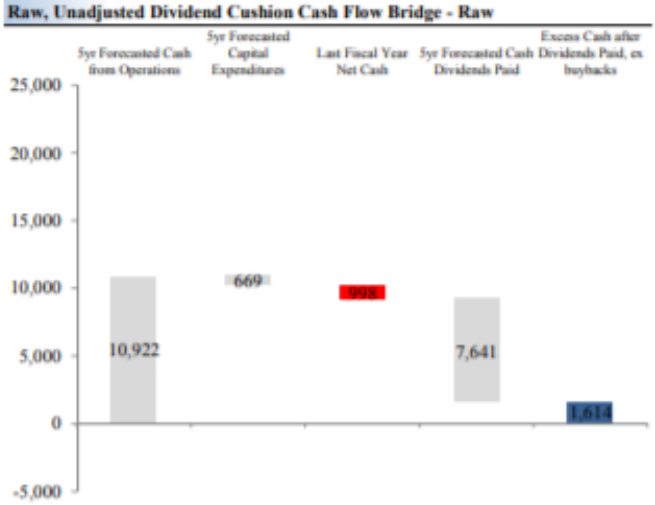
Graphical Relationship, Earnings and Dividends (per share)

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. Public Storage'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 greater 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

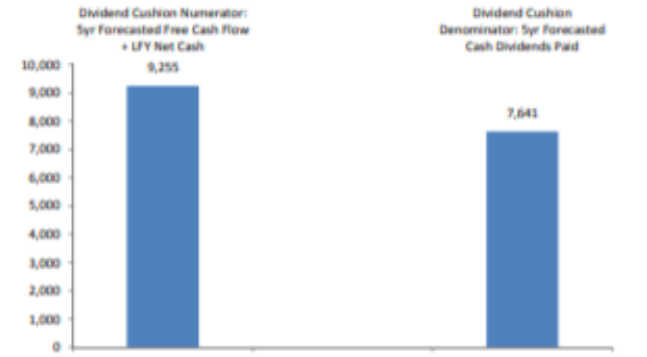


Source: Company Filings, Valuentum Projections

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, Public Storage's numerator is larger than its denominator suggesting strong 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



The information and data contained in this report is not represented or warranted to be timely, complete, accurate, or correct. This report is for informational purposes only and should not be considered a solicitation to buy or sell a security. Before acting on any information in this report, you should consider whether the information is suitable for your particular circumstances and, if necessary, seek professional advice. Assumptions, opinions, and estimates are based on our judgment as of the date of the report and are subject to change without notice. Valuentum is not responsible for any errors or omissions or for results obtained from the use of this report. Redistribution is prohibited without written permission. To license Valuentum research, contact us at valuentum@valuentum.com.

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.

Copyright © 2019 by Valuentum, Inc. All rights reserved. No part of this publication may be reproduced in any form or by any means.

The information contained in the High Yield Dividend Newsletter or any report from Valuentum is not represented or warranted to be accurate, correct, complete, or timely. This newsletter is for informational purposes only and should not be considered a solicitation to buy or sell any security. No warranty or guarantee may be created or extended by sales or promotional materials, whether by email or in any other format. The securities or strategies mentioned herein may not be suitable for all types of investors. The information contained in this report does not constitute any advice, especially on the tax consequences of making any particular investment decision. This material is not intended for any specific type of investor and does not take into account an investor's particular investment objectives, financial situation or needs. This report is not intended as a recommendation of the security highlighted or any particular investment strategy. Before acting on any information found in this report, readers should consider whether such an investment is suitable for their particular circumstances, perform their own due diligence, and if necessary, seek professional advice. The sources of the data used in this report are believed by Valuentum to be reliable, but the data's accuracy, completeness or interpretation cannot be guaranteed. Assumptions, opinions, and estimates are based on our judgment as of the date of the report and are subject to change without notice. Valuentum is not responsible for any errors or omissions or for results obtained from the use of this report and accepts no liability for how readers may choose to utilize the content. In no event shall Valuentum be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the information contained in this document. Investors should consider this report as only a single factor in making their investment decision. Valuentum is not a money manager, is not a registered investment advisor, and does not offer brokerage or investment banking services. Valuentum has not received any compensation from the company or companies highlighted in this report. Valuentum, its employees, independent contractors and affiliates may have long, short or derivative positions in the securities mentioned herein. Information and data in Valuentum's valuation models and analysis may not capture all subjective, qualitative influences such as changes in management, business and political trends, or legal and regulatory developments. Redistribution is prohibited without written permission. Readers should be aware that information in this work may have changed between when this work was written or created and when it is read. There is risk of substantial loss associated with investing in financial instruments. Valuentum's company-specific forecasts used in its discounted cash flow model are rules-based. These rules reflect the experience and opinions of Valuentum's analyst team. Historical data used in our valuation model is provided by Xignite and from other publicly available sources including annual and quarterly regulatory filings. Stock price and volume data is provided by Xignite. No warranty is made regarding the accuracy of any data or any opinions. Valuentum's valuation model is based on sound academic principles, and other forecasts in the model such as inflation and the equity risk premium are based on long-term averages. The Valuentum proprietary automated text-generation system creates text that will vary by company and may often change for the same company upon subsequent updates. 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. The portfolio in the High Yield Dividend Newsletter is hypothetical and does not represent real money. Past simulated performance, whether backtested or walk-forward or other, is not a guarantee of future results. Actual results may differ from simulated portfolio information being presented in this newsletter. For general information about Valuentum's products and services, please contact us at valuentum@valuentum.com or visit our website at www.valuentum.com.