Valuentum Securities, Inc. 4/1/2019 Edition 2, Volume 4

HIGH YIELD DIVIDEND NEWSLETTER

We Added Vanguard REIT ETF (VNQ) and Removed Realty Income (O)

Changes to simulated High Yield Dividend Newsletter
Adding: 10% in Vanguard Real Estate ETF (VNQ)
Removing: Huge winner in Realty Income (O)
Watching: AT&T (T), Australia ETF (EWA) and Schlumberger (SLB)

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"ALL IN, WE'RE VERY EXCITED ABOUT WHAT HIGH YIELD DIVIDEND INVESTING MAY BRING FOR 2019, AS LONG AS THE FED DOESN'T SPOOK THE MARKETS AGAIN WITH A HAWKISH OUTLOOK AND OMINOUS TRAJECTORY OF RATE HIKES." – BRIAN NELSON, CFA

A version of this article was released to High Yield Dividend Newsletter members March 14.

We can't begin to tell you how excited we are about high-yield dividend investing this year! When we first started the High Yield Dividend Newsletter in January 2018, we were a bit concerned, perhaps even overly-cautious in our writings. We did our best to warn about some of the outsize risks of high-yield dividend investing, not the least of which is how share-price declines are also fundamental in nature.

But we know our newsletter stands out from the crowd. Here's why: We're not just throwing any idea up there and hoping it will work out. We're going the distance with our work and watching any idea that we highlight like a hawk for any fundamental weakness or an indication that the dividend is in jeopardy.

Quite simply, we just couldn't imagine highlighting just any MLP and just because it has a high dividend/distribution yield, for example. Let's take Sanchez Midstream Partners (SNMP), for example. The stock was yielding 16%+ in early 2018, but while others may have been excited about it, we just couldn't do that to our members.

The stock has since cratered some 80%+, and it cut its distribution by two thirds! The high-yield space is one that is fraught with tremendous risks (see -- there we go again with our cautiousness!), but we really want you to know this. What we've achieved in 2018, even if only to

avoid a dividend/distribution cut is remarkable, and we did much more than that.

So why do we like the high yield dividend space in 2019? Well, part of our biggest concern with high-yield dividend investing, aside from the capital-market-dependency of many constituents, has been the Fed. We were getting worried the Fed would put the pedal to the metal with rate hikes, but after considering a lot of the comments from James Bullard, president of the Federal Reserve Bank of St. Louis, we don't think the Fed is going to purposefully and meaningfully invert the yield curve in an aggressive manner. There are too many behavioral ramifications.

But what does that mean? Well, we don't think the Fed is going to be the cause of a recession by inverting the yield curve purposefully, which then might drive the behavior (saving more, selling stocks, etc.) that actually causes a recession. We think the mid-single-digit yielders are now becoming attractive again, provided that the credit markets stay healthy and the economy doesn't start to falter. Some banks have been ratcheting up the rates on certificates of deposits (there are some 3% APRs out there for local community banks over 18-month to 2-year terms), but the rates on cash may have already hit the upper limit for the time being, at least for the foreseeable future.

High yield dividends are back. We think this is why we saw a huge bounce in shares of many of the ideas in the High Yield Dividend Newsletter portfolio following the December 26 bottom in the markets. Since inception, the High Yield Dividend Newsletter portfolio has had some winners and some losers, but there's never been a distribution cut. Omega Healthcare (OHI) and Realty Income (O) have performed tremendously...which brings us to the next point.

Why did we remove one of our favorites, Realty Income? We, of course, still view it as a safe-haven among the REIT community, but its shares have rallied north of $70, well above our enterprise-cash-flow-derived fair value estimate in the mid-$50s. We thought it was wise to take this huge winner off the table and replace it with a more-diversified play on real estate, the Vanguard Real Estate ETF (VNQ). We added 10% to the VNQ to put the High Yield Dividend Newsletter portfolio at "fully invested," replacing the 5% cash position from removing big winner Omega Healthcare earlier this month and the Realty Income position today.

We like the Vanguard Real Estate ETF because it has an ultra-cheap expense ratio of just 0.12%, and it offers diversification across the REIT sector without getting "too cute" with any one particular idea. We already did very well with Omega and Realty Income, and we still include Digital Realty Trust (DLR), Public Storage (PSA), and Iron Mountain (IRM) as our top individual REIT ideas in the High Yield Dividend Newsletter portfolio, but this ETF gives us even more diversified exposure at a very low cost to boot. Here's the VNQ's sector breakdown, from Vanguard:

Portfolio composition

Equity sector diversification

	Real Estate ETF as of 01/31/2019	MSCI US IM Real Estate 25/50 Index (Benchmark) as of 01/31/2019
Diversified Real Estate Activites	0.20%	0.20%
Diversified REITs	4.70%	4.70%
Health Care REITs	9.90%	10.00%
Hotel & Resort REITs	5.00%	4.90%
Industrial REITs	7.10%	7.00%
Office REITs	10.10%	10.00%
Real Estate Development	0.40%	0.40%
Real Estate Operating Companies	0.30%	0.30%
Real Estate Services	2.60%	2.60%
Residential REITs	13.90%	13.80%
Retail REITs	14.50%	14.60%
Specialized REITs	31.50%	31.50%

Sector categories are based on the Global Industry Classification Standard system.

Image source: Vanguard's website.

Just a few more things to update. AT&T's (T) shares are ones that we are watching closely. Though we are attracted to its near-7% dividend yield, the company operates in the fast-changing telecommunications industry, and it holds a considerable amount of net debt on the books that could come back to haunt it during the worst economic times. We're sticking with this idea, however, for as long as its free cash flow remains robust and management remains focused on deleveraging. Here's what we wrote in the February edition of the High Yield Dividend Newsletter:

> 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.

Just a few comments on the iShares MSCI Australia ETF (EWA) in the High Yield Dividend Newsletter portfolio. We include this idea as a way to gain even more geographic diversification to the portfolio. We don't want to be too US-centric with our ideas, and the EWA offers a geographic benefit as well as a nice dividend yield, too. It holds companies such as Commonwealth Bank (CBA), BHP (BHP), Westpac (WBC), Woolworths (WOW), and Wesfarmers (WES), among others. The 30-day SEC Yield for the EWA is 4.26%, as of January 2019.

We're not reading too much into some of the economic data out of Australia more recently, with data suggesting that the Australian economy nudged higher by 0.2% in the fourth quarter, only modestly lower than forecast, but still close to being flat. Most are pointing to a slowdown in consumer spending and construction weakness in the country, and the ebbs and flows of the Chinese economy probably aren't helping as China goes back-and-forth with the US on trade policy. Still, we're sticking with the EWA, however, as its unique banking constituents and Australian-domiciled plays offer considerable diversification benefits, in our view.

We added Schlumberger (SLB) to the High Yield Dividend Newsletter portfolio on January 18 of this year, and the company's shares have been relatively flat since that time. Schlumberger's share price is bouncing off of levels not seen since the Financial Crisis, and its mid-single-digit dividend yield fits well into the context of the High Yield Dividend Newsletter portfolio. Free cash flow came in at $2.47 billion in fiscal 2018, slightly below dividends paid, but it was significantly better than the $1.67 billion mark in fiscal 2017. We're watching its free cash flow like a hawk, but Schlumberger's comments during its fourth-quarter press release were encouraging:

> After a very strong free cash flow performance in the second half of 2018, we are confident in our ability to further improve our liquidity position in 2019, through our focus on top-line growth, incremental margins, capital discipline, and careful management of working capital.

That's it for now. All in, we're very excited about what high yield dividend investing may bring for 2019, as long as the Fed doesn't spook the markets again with a hawkish outlook and ominous trajectory of rate hikes. Ideas have rallied hard since the December 26 doldrums, and while we still love Realty Income, we think the time is right to remove it. We won't hesitate to add it back in the future though, but only at the right price. We're available for any questions and thank you for your membership.

Risks Remain Prevalent For mREITs

Mortgage REITs have held up better than other income plays, including master limited partnerships (MLPs), but the group is still not without tremendous risks. The space remains inherently risky as it is sensitive to difficult-to-predict mortgage markets, and many in the group employ significant leverage to augment net interest margins. We prefer more diversified plays on income, and while we dig deep into mREITs in this piece, we think caution is still very much in order.

The Yield Curve Curve Is A Key Driver

Image shown: Mortgage REITs have held up better than master limited partnerships (MLP) since mid-2015, but they haven't exactly done well. For income investors, they may be the lesser of the two pain areas, but we're still not really excited about them.

The mortgage REIT (mREIT) industry is not easy for many to understand, and even a great understanding of the space may not lead to investment success either. Many have stated that this area is not one in which individual investors should dabble, and we generally agree. For one, the success of an mREIT, as they are called, depends heavily on its ability to acquire assets (agency securities) at favorable spreads over borrowing costs, which can rise materially in the event that short-term interest rates increase or the market value of its investments decline. What many missed years ago was the the impact of rising interest rates on the group's book value, where other comprehensive losses (OCL) overwhelmed any gross operating returns to drive book values lower.

Similar to other financial-oriented entities, MREITs are heavily dependent on short-term interest rates, which impact borrowing costs, while longer-term rates on mortgage backed securities often are a key source of their interest income. The spread between the two is the entity's profit generating mechanism, or net interest margin (NIM), and mREITs typically use leverage ("lever up") in attempt to maximize the profitability of this spread. In isolation, the current flattening/inversion of the yield curve would be detrimental to the spread these entities depend on to generate income, as mortgage rates have a tendency to move roughly in tandem with long-term Treasury yields.

	As of December 31,		
	2018	2017	2016
30-Year mortgage current coupon	**3.50%**	3.00%	3.13%
Mortgage basis	**82 bps**	59 bps	68 bps
10-Year U.S. Treasury rate	**2.68%**	2.41%	2.44%
LIBOR			
1-Month	**2.50%**	1.56%	0.77%
6-Month	**2.88%**	1.84%	1.32%

Image source: Annaly Capital Management 2018 10-K

The image above shows developments in yield spreads in recent years, which have generally improved. However, the rising interest rates that have accompanied these spreads also impact the value of an mREIT's underlying book of business, which is marked-to-market as an adjustment called other comprehensive losses (OCL). In some ways, when an mREIT benefits in one area of its business, the other area may suffer: widening spreads help NIMs and gross return on equity, but rising interest rates can impact the book value of its business. How the yield curve looks and the trajectory of interest rates are the key variables behind an mREIT's operation, and both are notoriously difficult to forecast. Mortgage REITs then throw tons of leverage on top of the business model, too. Can you say risky?

That said, the Fed seems to be taking a pause when it comes to short-term rate hikes, and this may be a good thing assuming that spreads don't further tighten, but the long end of the curve isn't factoring in as much inflation as we would like to make the mREIT business model really fire on all cylinders. Inflation is a core component of interest rates and higher inflation expectations over the long haul would drive interest rates at the long end of the curve higher. Perhaps the true blessing for mREITs in the Fed pausing is that other comprehensive losses on their book of business may turn into other comprehensive income in the coming periods, and this may help book value a bit,

driving some capital appreciation in excess of the dividend payment.

Economic Variables Do Not Change in Isolation

As previously mentioned, the increasingly dovish stance taken by the Fed with respect to further interest rate increases is generally a positive for the group, as immediate upward pressure on short-term rates directly from the Fed appears to be non-existent at this juncture. Lower benchmark interest rates are a positive for the book value of mREITs due to inverse relationship of discount rates, which are influenced by interest rates, and the value of the securities these entities hold on their books. The borrowing end of mREITs' interest rate spread may be settling in near current rates, too, depending on how demand for short-term fixed income vehicles develops in the near future. Inflation expectations then become critical.

On the other end of the interest rate spread for mREITs sit yields on mortgage-backed securities and other real estate backed vehicles, and a healthy housing market and strong mortgage credit performance are supporting the health of this factor of the group's net interest margins. While the 10-year US Treasury yield, which currently sits below the 3-month Treasury yield, often provides a reasonable basis for the directional moves of mortgage rates, the correlation is not perfect. For example, in 2018, the spread between the 30-year agency mortgage-backed security and the 10-year US Treasury yield widened as a result of increased volatility in the capital markets and the Fed's balance sheet runoff.

How this spread between long-term Treasury yields and mortgage rates will behave in the future is subject to a number of factors, not the least of which is the Fed's balance sheet runoff plans. The ongoing reduction of securities, including Treasury bonds and mortgage-backed securities, held on the Fed's balance sheet, which is currently expected to continue through September of this year, could put upward pressure on rates of both long-term Treasury bonds and mortgage-backed securities as a flood of both could temporarily oversupply the market's appetite for either group.

However, if current demand for the safety of 10-year Treasury bonds remains, the spread between long-term Treasury yields and rates on the meaningfully more-risky mortgage-backed securities could follow a similar trajectory as that of 2018. In this respect, a flattening, or even inverting, yield curve does not necessarily spell disaster for mREITs in itself, but the risks are certainly present for net interest margins to face pressure should mortgage-backed security rates decline meaningfully. However, these rates are inherently difficult to predict due to uncertainty surrounding their average livespan, relatively high credit risk, and risks related to prepayments, which can be exacerbated in times of declining interest rates, in addition to the ties of mortgage rates and underlying interest rates.

Net Asset Value and Interest Rate Sensitivity

As can be seen in the image below, mREITs' net asset value (NAV), portfolio market value and net interest margin are sensitive to minor changes in mortgage-backed securities rates and interest rates, with the former having a more meaningful impact on asset and portfolio value. While a short-term upward shock in the mortgage-backed security rates, which could materialize as a result of ongoing Fed runoff and the market's lack of appetite for risky securities, may impact net asset value in the short term, it could open mREITs up to the possibility of wider spreads on longer duration assets as the current credit tightening cycle appears to be winding down.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
Item 7. Management's Discussion and Analysis

Change in Interest Rate [1]	Projected Percentage Change in Economic Net Interest Income [2]	Estimated Percentage Change in Portfolio Value	Estimated Change as a % on NAV [3][4]
-75 Basis points	(18.6%)	—%	(0.1%)
-50 Basis points	(11.0%)	0.1%	0.9%
-25 Basis points	(4.9%)	0.1%	0.9%
Base interest rate	—	—	—
+25 Basis points	1.9%	(0.2%)	(1.8%)
+50 Basis points	3.2%	(0.6%)	(4.3%)
+75 Basis points	3.1%	(1.0%)	(7.3%)

MBS Spread Shock [1]	Estimated Change in Portfolio Market Value	Estimated Change as a % on NAV [3][4]
-25 Basis points	1.5%	11.5%
-15 Basis points	0.9%	6.9%
-5 Basis points	0.3%	2.3%
Base interest rate	—	—
+5 Basis points	(0.3%)	(2.3%)
+15 Basis points	(0.9%)	(6.8%)
+25 Basis points	(1.5%)	(11.2%)

(1) Interest rate and MBS spread sensitivity are based on results from third party models in conjunction with inputs from our internal investment professionals. Actual results could differ materially from these estimates.
(2) Scenarios include Residential Securities, commercial real estate investments, corporate debt, repurchase agreements, other secured financing and interest rate swaps. Economic net interest income includes the net interest component of interest rate swaps.
(3) Scenarios include Residential Securities, residential mortgage loans, MSRs and derivative instruments.
(4) NAV represents book value of equity.

Image source: Annaly Capital Management 2018 10-K

As we mentioned previously, perhaps the most important driver behind changes in an mREIT's net asset value is other comprehensive income/(loss), or OCI, and changes in OCI include net unrealized losses

on investments marked to market. In 2018, mREIT bellwethers Annaly Capital Management (NLY) and AGNC Investment Corp (AGNC) reported other comprehensive losses of $854 million and $598 million, respectively, as interest rates faced upward pressure throughout the year. Annaly Capital's $2 billion in reported losses on available-for-sale securities in the year were partially offset by reclassification adjustment for net losses included in net income, while AGNC reported a total loss on investment securities of more than $1 billion due to unrealized losses on investment securities measured at fair value through net income and losses on sale of investment securities in 2018.

Conclusion

While there appears to be some relatively positive developments for mREITs in the group's near-term outlook, mortgage markets are inherently difficult to predict. The opaqueness of this market only adds to the interest rate and substantial leverage risk associated with mREITs. For example, as of the end of 2018, Annaly and AGNC reported leverage ratios of 7x and 9x, respectively. Though their respective definitions of economic leverage and tangible net book value "at risk" leverage ratio may vary slightly, **the fundamental point remains sound: these are highly-levered, risky entities that depend on a number of factors beyond their control to generate profits.**

Though we prefer to avoid the risks related to exposure to any one individual equity within the mREIT group, diversified exposure to the space might make sense in the context of a high yield income portfolio. We include the Global X SuperDividend ETF (SDIV) in Valuentum's simulated High Yield Dividend Newsletter portfolio, which includes ~20% exposure to the mREIT space as of the end of 2018, and no one holding accounts for more than ~1.2% of the fund's net assets. According to the ETF's home page, its annual distribution yield currently sits at 9.4%, and its distribution is paid monthly.

High Yield Spotlight: Unique REIT Business Model Helps STAG Industrial (STAG) Stand Out Against the Herd

STAG Industrial Inc (STAG)—**4.8% dividend yield**— is a real estate investment trust (REIT) that focuses on single-tenant industrial properties throughout the United States, though it owns some multi-tenant properties as well. At the end of 2018, STAG owned 390 buildings across 37 states with approximately 76.8 million square feet of rentable space. That consisted of 320 warehouses & distribution buildings, 58 buildings for light manufacturing, nine flex & office buildings, and three buildings classified as 'Value Add Portfolio' assets. STAG's occupancy rate stood at 95.5% at the end of last year. Even better, **no single tenant represents over 2.3% of STAG's annual base revenue** and no industry generates over 15.0% of the REIT's annual revenue base.

We like the resilience of STAG's business model (STAG stands for Single Tenant Acquisition Group), and the REIT yields 4.9% as of this writing. The dividend is paid out in monthly installments, and it has increased its monthly payout by 19% since the end of 2013. Its latest investor relations presentation highlights the REIT's maintenance of a 71% tenant retention rate since its IPO, and the company has a weighted average lease term of 4.9 years as of the end of 2018. This provides for a more visible trajectory of future funds from operations and helps ensure STAG will be able to continue making good on its dividend obligations going forward, which is dependent upon continued access to the capital markets.

Targeted Strategy

STAG targets the ownership of properties that house operations that are critical to its tenants' business, which represent sticky revenue streams. Moving critical operations tends to incur both substantial direct expenses (such as moving costs, costs relating to the need to retrofit the new location to support those critical operations, the need to return the location to a rentable state before ending the lease, and so forth) and indirect expenses (namely downtime, and potential inefficiencies during and after the move). That's the angle STAG is working, and we think it's a strong strategy.

In addition, e-commerce continues to drive demand for warehouse space, and STAG boasts the second largest property lineup of industrial REITs in the US in terms of average building size, both of which help increase the mission critical nature of its properties for its tenants. The REIT also targets its properties on the secondary market, which helps reduce tenant improvement costs and capital spending necessary for property upgrades.

Funds From Operations, Net Operating Income, and Dividend Growth

STAG's reported funds from operations (FFO) attributable to common stockholders and unit holders has expanded significantly in recent years, as it leapt 24% in 2018 on a year-over-year basis to ~$198 million after a ~48% year-over-year increase in 2017. Net operating income (NOI) followed a similar but slightly less impressive trajectory over the past two years as the metric climbed 16% in 2018 over 2017 levels after increasing 21% on a year-over-year basis in 2017**. As previously mentioned, the REIT's *monthly payout* has grown nicely from late 2013, when it sat at $0.10, to $0.1192 per share today.** In 2018, STAG's dividends and distributions amounted to nearly 85% of tis FFO attributable to common stockholders, which is a bit high, but we expect FFO to continue reaping the benefits of its unique strategy moving forward.

Risks

There are numerous risks involved when investing in the REIT space, and STAG's single-tenant focus poses a binary problem for the company. Either the space is rented out and cash flow is coming in, or STAG is scrambling to fill that vacancy. In the event of a prolonged economic downturn, questions will arise as to whether STAG will be able to maintain its high occupancy rate. While its historical track-record is strong, it largely occurred during a time when America's economy, and the industrial space, was expanding, just as it still is today. When economic activity starts to slow down, that's when the resiliency of STAG's business model will truly be put to the test.

STAG has a diversified client and industry base. Most of its tenants operate in the Capital Goods, Automobiles & Components, Materials, Transportation, and Consumer Durables & Apparel industries. A number of those industries are cyclical in nature and susceptible to economic downturns, which is why it's important that STAG locates properties that can't easily be replaced or abandoned. That of course is a function of STAG's tenants making those locations integral parts of their critical operations, which isn't always guaranteed.

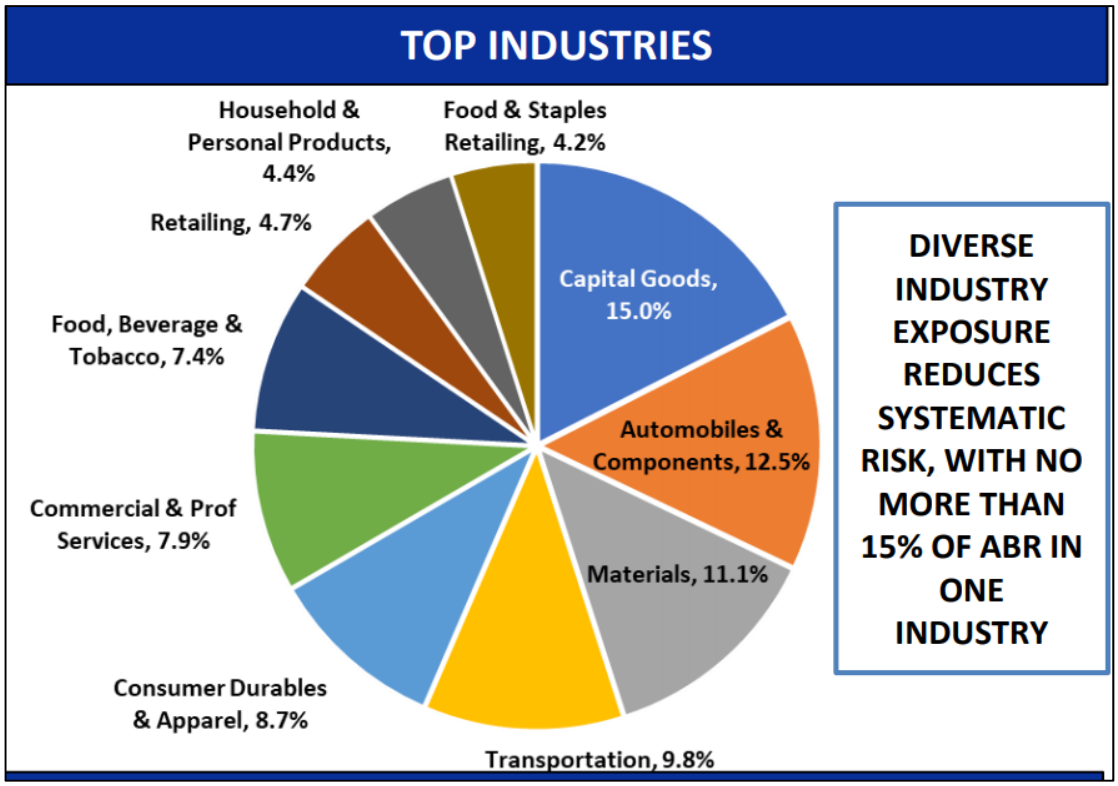


Image Shown: STAG caters to tenants that operate across a wide array of industries. Source: STAG investor presentation

Management has taken numerous precautions to remove unsystematic risk from the REIT's business profile and we recognize that as a major plus, but the firm is still exposed to the weaker financials of some of its tenants in the event of an economic downturn. The inherent interest rate sensitivity of the REIT space is at play with STAG as well, but with the Fed taking an increasingly dovish tone, we do not expect benchmark borrowing costs to face upward pressure in the near term.

Solid Credit Profile

STAG carries an investment grade credit rating from Moody's at Baa3 with a stable outlook. Fitch also gives STAG an investment grade credit rating at BBB with a stable outlook. It's essential that REITs retain good credit ratings in order to maintain adequate access to the capital markets with a competitive cost of capital that also enables relatively seamless debt rollovers. At the end of 2018, the company only had $8 million in cash & cash equivalents, along with $15 million in restricted cash. This compares to more than $1.3 billion in long-term debt, and the REIT reported a net debt-to-adjusted EBITDA of 4.9x as of the end of 2018. Note that none of its debt matures until September 2020 at the earliest, giving STAG some breathing room, and it holds ~$575 million in an undrawn revolver and term loan, which provides additional liquidity.

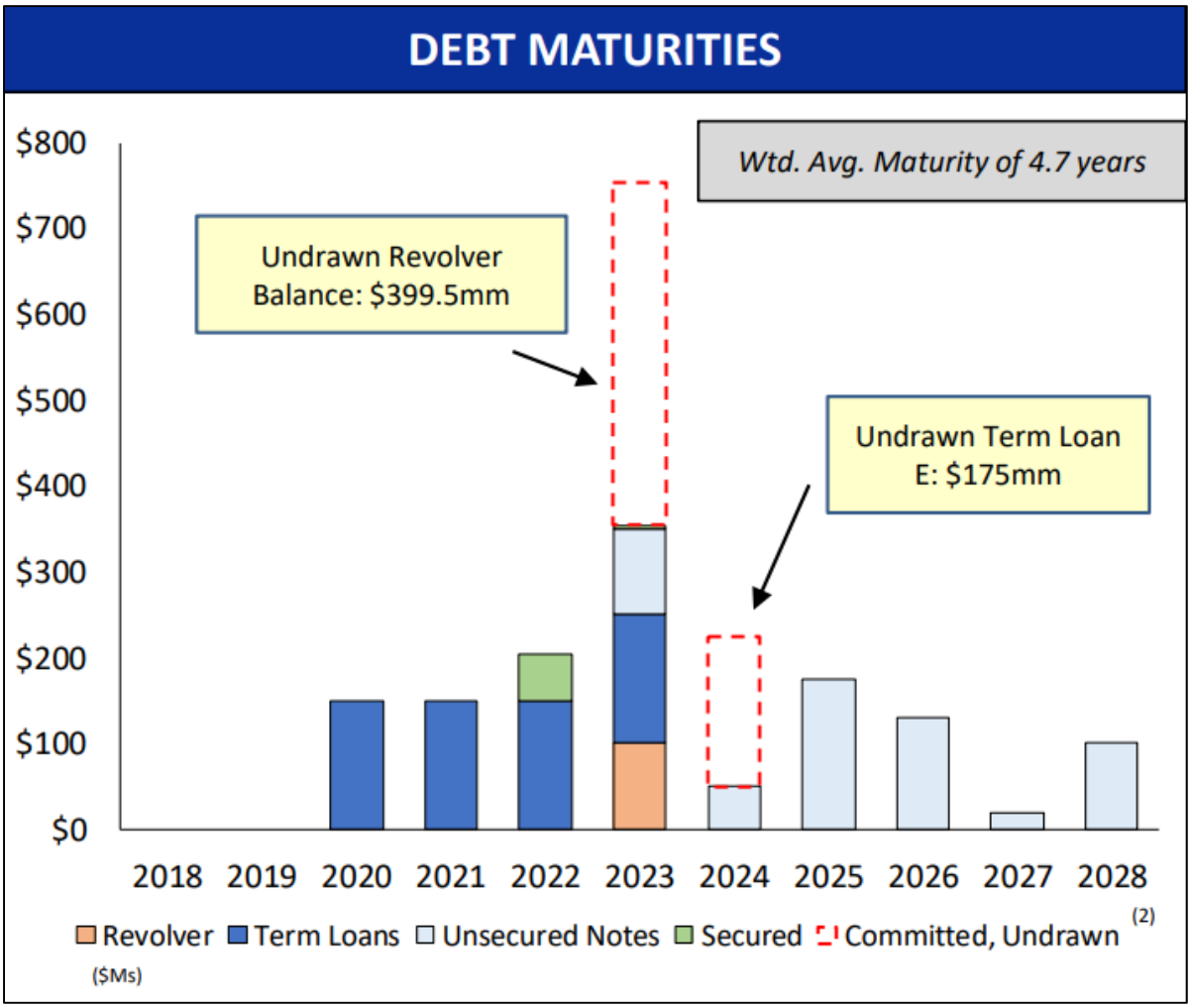


Image Shown: STAG has no debt maturities until 2020 and a notable amount of liquidity available. Source: STAG investor presentation.

Management is targeting net debt-to-adjusted EBITDA ratio of 4.75x–6x over the long haul, however, the company plans to "operate at the lower-end of that band." We would prefer STAG target a lower leverage ratio as America's economic growth cycle is very mature, but the ratio is not egregious when considering it in the context of a REIT with an investment grade credit rating.

When asked about that target during STAG's latest quarterly conference call with investors, management responded with:

> *"That's right. 4.75x to 6x is our range for the year. We've been operating around 4.95 for the past few quarters. So I think we'll be operating around that range for the foreseeable future."*

All things considered, we think STAG's debt profile and liquidity needs are being well-managed as things stand today, especially after considering the additional liquidity available via its revolver. Near the end of last year, the company raised $140 million through its ATM equity issuance program in part to bolster its net debt position. It's likely that was to ensure the REIT exited 2018 with a net debt to adjusted EBITDA ratio below 5.0x, and as of April 1, it launched a 6 million public offering of common stock with plans to use the proceeds to repay debt, fund acquisitions, allocate towards working capital, and/or general corporate purposes. This speaks to the need for ongoing healthy functioning of the capital markets for REITs to survive.

Conclusion

STAG's business model is a nicely differentiated within the intriguing industrial REIT space, which is what piqued our interest for this edition of the High Yield Dividend Newsletter. The REIT looks to continue capitalizing on the demand for its real estate that the proliferation of e-commerce is helping drive, and it has a sticky tenant base, solid FFO and NOI momentum in recent years, reasonable leverage, and a strong 4.9% dividend yield as of this writing with monthly payouts. While STAG carries its fair share of risks, not the least of which is exposure to potentially weak credits in the event of a macroeconomic downturn, its diversified client and industry base offers some protection when viewed in conjunction with the stickiness of housing the critical operations of its tenants.

STAG INDUSTRIAL

TENANT PROFILE

TENANTS ARE SIGNIFICANT ENTERPRISES WITH LARGE SPACE REQUIREMENTS

- Single-tenant industrial real estate focus generally results in larger tenant sizes compared to a multi-tenant strategy
- Historical credit loss of less than 0.1% of revenues since IPO

TENANT PROFILE AS OF DECEMBER 31, 2018 [1]	
Number of Tenants	349
Average Tenant Size (Square Feet)	210,142
Average Annualized Base Rental Revenue Per Square Foot	$4.22
Average Annualized Base Rental Revenue Per Tenant ($000s)	$888

CREDIT PROFILE AS OF DECEMBER 31, 2018 [1]	
Tenants Publicly Rated	55.2%
Tenants Rated Investment Grade	30.3%
Tenant Revenue > $100 million	86.2%
Tenant Revenue > $1 billion	61.7%

CREDIT TEAM

- In-depth, initial and ongoing quantitative and qualitative credit analysis by dedicated Credit Team
  - Four team members underwrite every current and prospective credit within the portfolio
- Assign every tenant an internal credit rating with daily to annual monitoring protocols
  - Internal credit rating generates the default curve used in the underwriting model and helps inform Asset Management as tenant-level decisions are made
  - Maintains internal credit review and watch lists
- Responsible for credit rating, probability of reorganization or liquidation upon default, GICS industry exposure classification, and continued credit coverage with monthly update to senior management
- Process includes in-depth management calls and discussions with third party references

EXTENSIVE CREDIT UNDERWRITING EXPERTISE

19

(1) Based on Annualized Base Rental Revenue and the inclusion of tenants, guarantors, and / or non-guarantor parents

Image shown: Overview of STAG's client base. Image source: STAG investor presentation

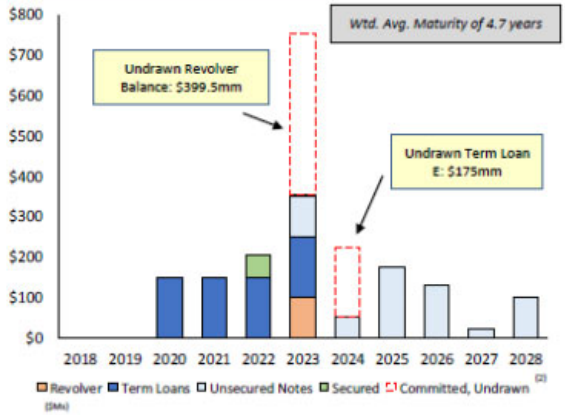
CONSERVATIVE BALANCE SHEET

CAPITAL STRUCTURE

Share price as of 12/31/2018	$24.88
Shares and units outstanding [1]	116,235
Total equity capitalization	**$2,891,932**
Series C preferred equity	75,000
Total preferred equity	**$75,000**
Revolving credit facility	100,500
Unsecured term loans	600,000
Unsecured notes	575,000
Secured debt	57,012
Total debt	**$1,332,512**
Total capitalization	**$4,299,444**
Debt / total capitalization	31.0%
Debt + preferred / total capitalization	32.7%
Net debt + preferred / Real Estate Cost Basis	39.8%
Net debt / run rate Adjusted EBITDA*re*	4.9x
Credit Rating	Moodys Baa3 / Fitch BBB

($000s except share price)

DEBT MATURITIES



- Low leverage balance sheet:
  - Debt + preferred / total capitalization of 32.7% and net debt + preferred / Real Estate Cost Basis of 39.8%
  - Target net debt / EBITDA of 4.75 to 6.0x
- Well-laddered debt maturities with no greater than 15% of debt maturing in any one year, excluding the revolver
- Almost entirely unencumbered asset base – only $57 million of secured debt provides optionality and flexibility for balance sheet management
- $577 million of liquidity including an undrawn $175 million unsecured term loan
- Current investment grade ratings from Moodys (Baa3 / stable) and Fitch (BBB / stable)

(1) Includes common shares, participating securities, and units outstanding
(2) Consists of $399.5M undrawn revolver balance and $175M undrawn Term Loan E

20

Image shown: STAG's capital structure and debt maturities. Image source: STAG investor presentation

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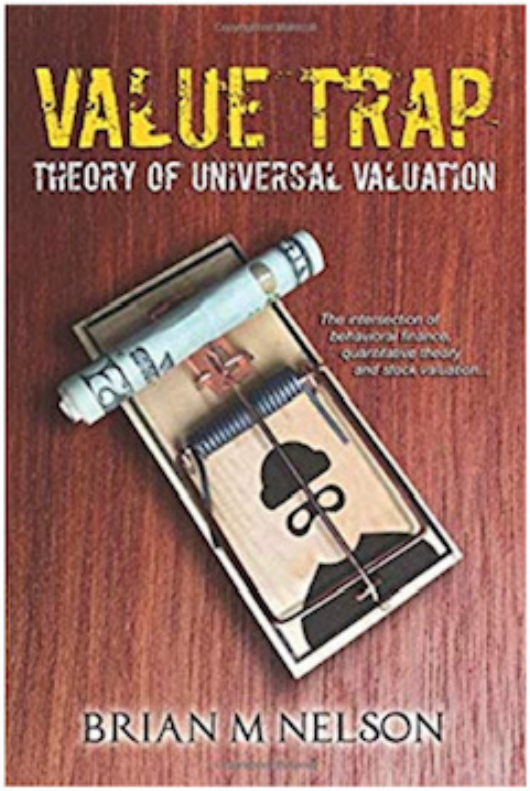

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Big Bank Roundup, Bank of America Catches Our Eye

By Matthew Warren

In this article, let's catch up with how far the big 6 banks in the US have come since the height of the financial crisis exactly a decade hence. We will highlight the improvements in the banking system, some of the key risks, and a few high level thoughts about the individual franchises leading the US banking system. We like Bank of America the most, and we include diversified banking exposure in the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio.

When you take a look at the big 6 banks in the US (SPY, DIA), the picture that emerges is very different than it was exactly a decade ago, when we were at the trough of the stock markets and peak stress in the banking system. Back then, banks were falling like dominoes in the US and various other countries around the world. Lehman Brother's failure accelerated the chaos and regulators and lawmakers were frantically trying to put back together a system that was falling apart in accelerating fashion. A run on the banks had morphed into a run on the money market funds.

All of this because of a cycle of bad loans feeding a frenzy in the US housing market, feeding a frenzy of bad lending. People were borrowing from their homes and credit cards to keep up with the Jones. Unsustainable jobs and unsustainable earnings streams were everywhere you looked. Those that catered to discretionary spending were on a sugar high. Residential mortgage backed securities (RMBS) were being created from sub-prime liar loans and the bottom tranches most exposed to loss were being recycled into Collateralized Debt Obligations (CDOs) with plenty of new AAA paper created out of thin air.

Out of junk.

And when the bubble burst, home prices slowed, stopped, and reversed. Home building collapsed from well ahead of household formation to near zero. Sub-prime mortgage banking collapsed and the whole industry would have collapsed without the federal government backstopping Fannie, Freddie (FMCC), and the FHA. Hedge funds holding CDOs collapsed. And eventually, the Wall Street houses whose investment banks were warehousing and then originating RMBS and CDOs for huge near-term profits, were stuck without a chair when the music stopped. Investment bank funding started to dry up as fixed income investors didn't want to roll over their risk exposures to the next day, week, month, or year. Bloated, opaque investment and money center bank balance sheets were being scrutinized for bad paper and busted deals stuck in the warehouse.

This frantic collapse was finally contained by a Federal Reserve that promised to fund (provide liquidity and purchase troubled assets) any and all systemically important institutions and a (second time around) yes-vote by Congress to create the TARP program, which led to an incredibly important capital injection into the country's biggest banks. With capital and liquidity addressed, investors finally regained confidence that the banks would have the time and space to allow earnings power to offset credit losses inherent in all of the balance sheets, to wildly varying degrees.

The Financial System Is Much More Stable

In the wake of all this came new and quite powerful regulations which have indeed changed the landscape for the better. Banks have since undergone annual stress tests, which mean they must prove they have enough capital to withstand potential down cycle loss contained in the assets on their balance sheets. This annual to-do forced them to consider carefully what they were putting on their balance sheets and how much capital they were holding to handle potential large losses in a sharp economic downturn scenario. Capital plans must also be approved by regulators, which means that the big banks cannot pay out dividends or repurchase shares without the express approval of the regulators. If the regulators want a bank to retain more equity against potential loss, then that is exactly what has transpired.

The end result of all this is a much more stable system, if perhaps less rapid growing or dynamic. It is less prone to disaster. The banks hold more equity, more liquidity, and are arguably carrying much less risky loans on their balance sheet, though this assertion will be tested in the next major economic down cycle. Importantly, investors also seem to be rewarding stability, return on capital, and cash returns to shareholders instead of the most rapid possible earnings growth. This is very different

from the end of the last cycle when investors were chasing low quality earnings growth like a herd driven off a cliff. So, is there no race to the bottom in terms of quality degradation this time around? Time will tell, but the signs are encouraging.

Where are we in the credit cycle one might ask themselves? The answer is: This has been a very long cycle, though not a steep climb given the slow and steady GDP and bank asset growth. Cost of funds has been incredibly low as deposits have remained sticky at near zero yields for an extended period of time, despite the Fed having steadily marked up short-term interest rates. Cost of labor and other costs of production have steadily come down as a percent of revenues as the long cycle has continued. Cost of impaired credit has remained incredibly low for an extended period of time with only a few problem spots turning up in places like auto lending (SC, ALLY, GM, F, HMC) and increasing concerns around commercial construction and some commercial property lending. Commercial and industrial loan losses have been quite benign despite some concerns that have popped up in areas like energy (XLE). The combined picture is one of very benign conditions that have lasted for a very long period of time and one wonders if bank profitability is over ripe to be challenged come the eventual downturn in the economy. Only then will all of the regulatory improvements be tested in real time. I would argue that I don't see anything like the excesses of a decade ago.

Addressing the Two Major Risks for Bank Investors

So what is the real risk for bank investors, and why did bank shares trade off so aggressively in the stock market downturn in the fourth quarter of 2018? Is it a knee-jerk reaction with people expecting another housing and consumer credit bust? Do people simply fear the stove by which they were last burnt? My thesis is that the biggest risk to the big 6 banks come from two distinct sources that have been hanging over the markets like a shroud in the background for at least the last decade.

The first risk is counterparty risk from European banks failing like dominoes, whether due to a substantial economic downturn or a breakup of the European Union or both. The big 6 banks all have high, though varying, counterparty risk to each other and of course to banks across the pond. While they would tell you that they have very disciplined risk exposures to any one bank and hedges in place, one wonders how well hedges would work in a scenario like the one I am describing. The second major risk is a financial crisis in China (FXI, MCHI) and the economic fallout that would occur from that. Both a European bank crisis and/or a Chinese banking and economic crisis would be mutually reinforcing to the downside and a major cause of global deflation. As we witnessed a decade ago, deflation is truly a devil for a banking system to contend with. Any country, bank, or person with substantial debt outstanding is in real trouble when earnings and assets start to deflate, but the amount of nominal debt outstanding remains fixed. It is simply a meat grinder. Let's hope Europe and China either hobble along or sort out their imbalances without sliding into crisis.

The Relative Fundamental Positioning of the Big 6 Banks

And as to the relative positioning of the big 6 banks? I would argue that three of the big banks are interesting to some degree and the other three really are not that interesting. I would place JP Morgan (JPM), Bank of America (BAC), and Wells Fargo (WFC) in the interesting camp. They have solid franchises with millions of households and small businesses contributing to their deposit franchises, a true competitive advantage over time. They have the relationships and distribution networks in place to gather and hold deposits on the one hand; and find credit-worthy demand for loans on the other hand.

All three banks have substantial fee-based income streams in place to bolster the deposit and lending franchise. In a world where retail banking requires scale and massive investment in digital banking, these banks can afford to compete and eat the lunch of the thousands of smaller banks in the country which are share donors. This adds to meager overall system growth opportunities. It adds to profitability and return on capital. These banks are well capitalized, hold substantial liquidity, and are all quite efficient given their business mix.

Citigroup (C), Goldman Sachs (GS), and Morgan Stanley (MS) are much less attractive firms. Citigroup is subscale as a national bank in the US. Goldman Sachs

and Morgan Stanley have large opaque balance sheets with a high degree of wholesale funding. They have very fledgling US retail banking operations. A great deal of their earnings is highly cyclical and subject to market share gains and losses in the oversaturated global trading and investment banking universes. The latter three are worth watching and do have some merits. However, they are lower quality than the former three.

The institution that I find the most interesting right now is Bank of America, given its substantial improvement over the past several years. If this trajectory can continue, shareholders will be rewarded. They have the relationships in place to keep harvesting better and better returns on capital. We currently value Bank of America's shares at $30 each, but we could see upside to the mid-$30s on the basis of our residual income modeling framework. The Financial Select Sector SPDR ETF (XLF) is included in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio.

A Diamond in the Rough, Enbridge Inc is One of Few Midstream Companies Worth a Look

By Callum Turcan

Midstream and utility giant Enbridge Inc boasts a 6.1% dividend yield as of this writing and has undergone a massive transformation over the past few years. In 2017, Enbridge purchased Spectra Energy in an all-stock deal valued at $28 billion USD in a bid to gain greater exposure to the natural gas and natural gas liquids side of the oil & gas infrastructure space in North America.

A year later, Enbridge announced it was consolidating Enbridge Energy Partners and Spectra Energy Partners (two midstream master limited partnerships) along with Enbridge Energy Management and Enbridge Income Fund Holdings under one roof. Now Enbridge, established back in 1949, is focusing on growing its North American midstream operations (particularly its pipelines business), managing its regulated natural gas distribution utilities (targeting modest growth over time), and growing its renewable energy footprint (with an eye on offshore European wind projects).

Enbridge Shifting Towards A More Sustainable Cash Flow Position

One of the biggest problems within the midstream space is that often these companies don't focus on free cash flow and instead tout distributable cash flow figures. Ostensibly, distributable cash flow and the related distribution coverage ratios are sold to investors as being like free cash flow due to the idiosyncrasies of the industry. However, the truth is that the distributable cash flow metrics (and thus the distribution coverage ratios) don't take into account the total capital expenditures of a given midstream company, just its capital expenditures classified as maintenance.

That means these companies are effectively sweeping billions of dollars in spending under the rug every year, an unsustainable business model from a cash flow perspective (a company can't be free cash flow negative forever while spending billions on capital expenditures and payouts to investors). When raw energy material prices went belly up in late-2014, that eventually led to sharp payout cuts across the midstream space as high weighed average cost of capital made tapping capital markets a tough sell. Only companies that generate free cash flow can offer investors sustainable income.

Enbridge is transitioning away from the old midstream model and towards one that focuses on maintaining a more sustainable cash flow position, a process that required the firm to consolidate its midstream MLPs under one roof. Here is a quote from Enbridge's Chief Accounting Office Allen Capps during the company's latest quarterly conference call (these figures are in Canadian dollars):

"The 10% dividend increase we announced in December of last year remains very well supported. As we discussed at Enbridge Day, ***by 2020 we expect to be generating about $3.5 billion of free cash flow after dividends and maintenance capital, which together was self-generated balance sheet capacity staying in line with our credit metric targets should we create about $5 billion to $6 billion of available cash to fund investment in new assets****…*

We see plenty of opportunity to deploy this available capital into low risk growth projects. When combined with the steady underlying growth in our base business, this investment should

drive our DCF per share growth to between 5% to 7% post-2020 ***without the need for any follow-on equity offerings****. Beyond 2020, dividends will likely grow in line with cash flow, but we will make that determination on an ongoing basis as part of our capital allocation process."*

The good news is Enbridge is communicating to the market that after dividends and maintenance capital expenditures, the company will be generating $3.5 billion CAD in "excess" cash flow by 2020, which could be used to cover its growth spend. Note that the firm expects to spend $1.2 billion CAD on maintenance capex in 2019. As long as the firm's growth spend is contained, Enbridge would be able to both fully cover its capital expenditures and dividends on an organic basis.

Enbridge has already made great strides in improving its cash flow profile. In 2016, Enbridge's net operating cash flow of $5.2 billion CAD barely covered $5.1 billion CAD in capital expenditures and left nothing to cover $1.2 billion CAD in common dividend payments. That picture quickly changed within just a few years.

In 2017, Enbridge generated $6.7 billion CAD in net operating cash flow yet spent $8.1 billion CAD on net capital expenditures (factoring in $212 million in capital expenditure reimbursements). Faced with negative free cash flow, Enbridge's $2.8 billion in common dividend payments were completely covered by debt and equity issuances.

Last year, Enbridge was finally able to generate meaningful free cash flow. The company generated $10.5 billion CAD in net operating cash flow and spent $6.8 billion CAD on capital expenditures, leaving enough free cash flow to cover $3.5 billion CAD in common dividend payments. However, that doesn't factor in distributions to non-controlling interests, which have historically been quite material every year, or additions to intangible assets, which came in at $540 million CAD in the year.

Going forward, it appears management plans to use debt to cover a portion of Enbridge's growth ambitions, which was highlighted by management noting the company had the capacity to investment $5–$6 billion CAD per year towards growing its asset base when including *"self-generated balance sheet capacity."*

It's imperative to understand that Enbridge's ability to keep making good on its dividend requires the firm to retain access to capital markets. The company's huge debt load, which we are about to get into, needs to be rolled over and the company isn't retaining much cash for debt reduction. We see Enbridge as maintaing access to capital markets in light of its recent credit rating upgrade by Moody's.

Managing Its Credit Profile

Enbridge has no interest in issuing out meaningful amounts of additional equity to raise funds and instead will likely turn to the credit markets. As part of its purchase of Spectra Energy and its corporate consolidation, Enbridge made sure to sell off non-core assets to shore up its leverage ratio. That included the 2018 divestments of its Canadian natural gas and gas gathering business to a group led by Brookfield Asset Management for $3.3 billion USD and a handful of midstream assets catering to the Mid-Continent region in America for $1.1 billion USD to ArcLight Capital Partners. See this excerpt here from its 2018 annual report (note that Enbridge is referring to CAD unless otherwise stated):

"We've maintained our focus on a pure pipeline and utility business model by selling $7.8 billion in non-core assets, including Canadian and U.S. gathering and processing businesses. Today, we have three premium energy infrastructure franchises—liquids and gas pipelines and our natural gas utility. These are great low-risk businesses with strong competitive advantages and embedded growth.

The proceeds from these sales were used to accelerate debt repayment and strengthen our balance sheet. Our debt to EBITDA metric came down to 4.7X at year-end, well below our original target of 5.0X. *This added financial flexibility enabled us to suspend the dividend reinvestment program, completing our transition to a self-funding growth model;* ***we will use internally-generated cash flow to finance projects moving forward, rather than issue new common equity****."*

All of the major credit rating agencies give Enbridge an investment grade credit rating as you can see below, with Moody's recently upgrading the firm. Enbridge

exited 2018 with roughly $64 billion CAD in net debt, making its ability to roll that burden over essential.

The midstream company expects to generate $13 billion CAD in adjusted EBITDA this year, up 1% versus 2018 levels and 26% versus 2017 levels. Enbridge's EBITDA growth for 2019 is being held back by delays at its Line 3 replacement project.

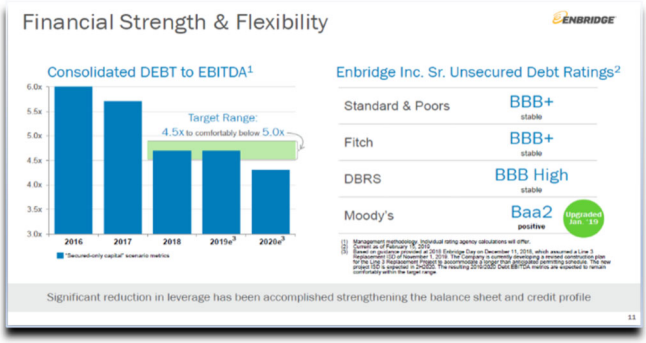


Image shown: Enbridge plans to steadily lower its leverage ratio over time to maintain its investment grade credit rating and retain access to capital markets. This process involves turning new cash flow generating assets online while better managing its growth spending levels and maintaining high utilization rates across its asset base Image source: Enbridge

Growth Commentary and Regulatory Hurdles

Enbridge possess numerous growth avenues but one of its core opportunities stems from the firm owning an enormous amount of pipeline infrastructure that caters to Alberta's upstream oil sands industry.

One of those assets is known as the Mainline System. This crude oil pipeline network can route millions of barrels per day down from the oil sands patch to Edmonton and Hardisty in Alberta, before shipping a large portion of those volumes off to markets in Eastern Canada, the Midwestern United States, and the Mid-Continent region of America. Pipeline interconnections enable barrels shipped to key oil hubs like Patoka, IL, and Cushing, OK to reach major refining complexes in America along the Gulf Coast, East Coast, and Southern regions.

One of Enbridge's biggest growth catalysts is the completion of its Line 3 replacement project. This development, if it does get completed, will fully replace over 1,000 miles of pipeline that makes up the Line 3 system. As this system is over 50 years old, the capacity of Line 3 was intentionally cut in half back in 2008 due to parts of the pipeline corroding away. When completed, the replacement project will bring Line 3's capacity back up to peak capacity, enabling 760,000 barrels of crude per day to travel from Hardisty, Alberta, to Superior, Wisconsin. However, part of the system runs through Minnesota and that's where Enbridge's problems lay.

Construction on the Canadian portion of this development is ongoing, and the pipeline has been fully completed in Wisconsin, but, Enbridge is stymied by permitting delays in Minnesota (primarily the result of political, regulatory, and legal pushback against an oil sands pipeline project). Previously, this $9 billion CAD project was expected to come online this year, providing a major boost to Enbridge's cash flow generation heading into 2020. Now the company is targeting a 2020 start-up date;

"In Canada, the [Line 3] pipeline has been installed and remaining work on related facilities is nearing completion. In Wisconsin, construction is complete. In Minnesota, following a thorough 43-month regulatory review, the Minnesota Public Utilities Commission granted its approval. The State of Minnesota has now provided a timeline to finalize its remaining permits before the end of 2019 and we expect the remaining federal permits will be finalized shortly thereafter. As a result of this progress, we now expect the project to be in-service in the second half of 2020."

If this development is further delayed, that will negatively impact Enbridge's growth trajectory. On the other hand, if Enbridge is successfully able to secure those permits and finish construction next year, the Line 3 development will go a long way in improving its credit profile due to the sheer size of the endeavor and that impact it will have on its net operating cash flow.

Beyond replacing and revamping Line 3, Enbridge has a sea of growth projects in the works including the Gray Oak Pipeline (a Permian oil pipeline project), a series of natural gas pipeline investments (such as expanding natural gas pipeline and distribution capacity in America's Northeast region), the Hohe See development (an offshore wind project located almost 100 kilometers off the coast of Germany in the North

Sea), and other developments relating to its core competencies.

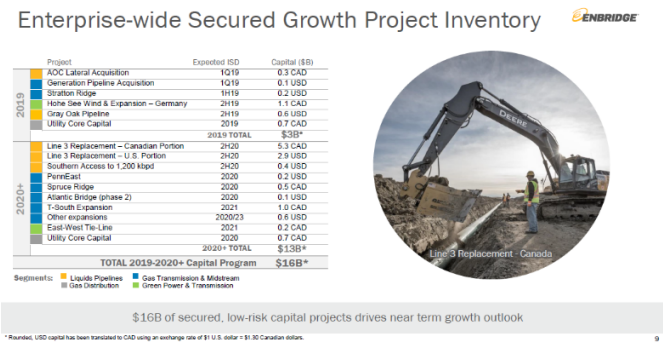


Image shown: Enbridge's growth runway with a focus on projects nearing completion within two years Image source: Enbridge

Enbridge's growth runway is quite substantial with upside to be had in North America (including Mexico via gas pipeline exports) and Europe. Its investments in the utilities space (from offshore wind farms in Europe to gas utility operations in Canada) makes Enbridge a more diversified income play within the midstream universe and offers long-term upside in terms of new renewable energy assets (supported by government programs), growing its rate base, and adding customers to its network.

Concluding Thoughts

The midstream industry is full of terrible investments with horrendous coverage ratios and untenable debt positions, but Enbridge may offer some reprieve. Its 6.1% dividend yield is made more attractive by an improving cash flow position (one that offers substantial free cash flow generation upside), a debt burden coming under control, and a sea of growth projects set to come online by the end of 2020.

While the remaining hurdles for getting the Line 3 replacement program completed are substantial, Enbridge has been informed that the development should receive the appropriate permits by the end of this year, giving investors a timetable to work off of. We're not looking to pull the trigger on this idea in the simulated High Yield Dividend Growth Newsletter portfolio, but the Canadian midstream giant is worth putting on your radar as it gears up for growth in the years ahead.

Tanger Factory: Play on the North American Outlet Mall Growth Story with a 6.8% Dividend Yield

Tanger Factory (SKT) is one of the largest owners and operators of outlet centers in the US and Canada. The REIT owns/operates more than 40 outlet centers with a total gross leasable area of over 15 million square feet. It boasts practically full occupancy rates (95%+ since 1981), and its properties contain approximately 400 store brands.

Tanger has a long runway for growth. The outlet industry is relatively small -- the REIT estimates quality outlet space at less than 70 million square feet, which is smaller than the retail space in Chicago. We'll be looking for expansion within the US and Canada and for the pursuit of opportunistic acquisitions.

We had been impressed with the consistency of Tanger's same center NOI expansion. Aside from its -1.3% showing in 2018, the measure has been positive since 2008, and this includes a 1.4% increase during the depths of the Great Recession in 2009. The Gap (GPS) and Ascena Retail (ASNA) are its top two clients at 8% and 6.8%, respectively, of annual base rent, as of 2018.

Tanger's occupancy has fallen to less than 97% as of 2018 from ~99% in 2013, and short-term lease renewals and modifications were made (15% of renewals in 2017) to maintain high capacity levels. However, this increased re-leasing risk in the near term, and we cannot rule out additional tenant bankruptcies as the retail space remains challenged.

As Tanger Factory is well positioned for continued growth as demand for outlet space continues for developers with access to capital. The size of the outlet industry (less than 70 million square feet, or less than retail space in Chicago) should facilitate organic growth. The firm has ended each year since its IPO in 1993 with an occupancy rate of 95% or higher, a display of the steady demand for its properties, and the majority of the tenants that make up such occupancy rates are publicly-held, high credit quality retailers. AFFO averaged ~$242 million from 2016-2018, well in excess of annual runrate cash dividend obligations of ~$131 million.

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.

Dividend Track Record — **HEALTHY**

Fiscal Year	Div's/Share ($)	Div Growth %	EPS ($)	Payout Ratio
Dec-03	0.62	NA	0.59	104.2%
Dec-04	0.63	1.6	0.28	223.2%
Dec-05	0.64	2.4	0.14	457.1%
Dec-06	0.67	4.7	0.65	103.1%
Dec-07	0.71	6.0	0.72	98.6%
Dec-08	0.75	5.6	0.71	105.6%
Dec-09	0.76	1.3	0.72	105.6%
Dec-10	0.77	1.3	0.32	240.6%
Dec-11	0.79	2.6	0.52	151.9%
Dec-12	0.83	5.1	0.57	145.6%
Dec-13	0.89	7.2	1.14	78.1%
Dec-14	0.95	6.7	0.77	123.4%
Dec-15	1.31	37.9	2.20	59.5%
Dec-16	1.10	-16.4	2.01	54.5%
Dec-17	1.35	23.5	0.72	187.8%
Dec-18	*1.40*	*3.5*	*1.23*	*114.0%*
Dec-19	*1.44*	*3.0*	*1.23*	*116.8%*
Dec-20	*1.49*	*3.0*	*1.26*	*117.5%*
Dec-21	*1.53*	*3.0*	*1.31*	*117.1%*
Dec-22	*1.58*	*3.0*	*1.36*	*115.6%*

Light green shading denotes a dividend increase, while light red shading denotes a dividend decrease. Heavy green shading denotes a significant dividend increase, while heavy red shading denotes a significant dividend decrease or an excessive payout ratio. NA = Not Applicable.

Image note: Tanger Factory paid a special dividend in 2015.

The AAII Chicago Chapter Presents ...

Saturday, April 13, 2019

VALUE TRAP: THE THEORY OF UNIVERSAL VALUATION

Brian Nelson, CFA
President of Equity Research & ETF Analysis, Valuentum Securities

YOU WILL LEARN

- The pitfalls of valuation multiple analysis and the risks of extrapolating some empirical quantitative conclusions
- A critical framework to view and interpret stock price movements and stock valuation
- The universal nature of enterprise valuation to all things finance from competitive advantage analysis to dividend growth investing and beyond

Brian Nelson, CFA, is the president of equity research and exchange-traded fund (ETF) analysis at Valuentum Securities. He is the architect behind Valuentum's research methodology and processes, developing the company's VBI Buying Index.

Before founding Valuentum in early 2011, Nelson worked as a director in the equity and credit research department at Morningstar. Prior to joining Morningstar, Nelson worked for a small-cap fund covering a variety of sectors for an aggressive growth investment management firm in Chicago.

Nelson holds a bachelor's degree in finance with a minor in mathematics, magna cum laude, from Benedictine University. He has an MBA from the University of Chicago's Booth School of Business and is a holder of the right to use the Chartered Financial Analyst (CFA) designation.

Brian Nelson, CFA, will cover the pitfalls of valuation multiples [e.g., price-earnings (P/E) ratio, price-to-sales (P/S) ratio], traditional quantitative analysis (e.g., value factor, size factor) and the contradiction between factor investing and the efficient markets hypothesis. He will show how enterprise valuation rests at the intersection of behavioral economics, quantitative theory, equity valuation and therefore finance itself. Nelson will talk about how enterprise valuation can be used to identify bubbles and mispricings and how it's valuable to dividend-growth and income frameworks. He will also cover how enterprise valuation is connected to economic moat and economic castle theory, and how it can be applied practically in an equity portfolio setting.

There will be a bonus handout for the first 100 attendees.

- Brian Nelson, CFA
President, Investment Research

- Kris Rosemann
Head of Data, Associate Investment Analyst

- Callum Turcan
Independent Contributor

- Matthew Warren
Independent Contributor

Disclosure: Brian Nelson, Kris Rosemann, Callum Turcan, and Matthew Warren do not own any shares of any securities mentioned in their authored articles. Please contact info@valuentum.com for more information regarding Valuentum's editorial policies.

THE SIMULATED HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO

We can't begin to tell you how excited we are about the high yield space during 2019. We think we did pretty good during 2018 given the uncertainty regarding Fed policy, but as you've noticed since the December 2018 bottom in the market, high yield dividend equities have come roaring back!

We think this is the beginning of what could be a nice run in the space given a more "dovish" stance by Fed policy. We also think the High Yield Dividend Newsletter portfolio positions us fairly well for whatever the market may throw at us. We're pretty well-diversified, and we've started to identify some pretty good individual equity ideas of late.

The high yield dividend equity arena trades a lot like junk bonds, meaning that interest rates play a key role in how equities will perform. As interest rates fall, high yield stays in vogue, but as interest rates rise, many look elsewhere. This impacts pricing greatly.

We know there's a lot of competition in this area, but we're laser focused on identifying high yielding stocks that have sustainable yields, and if the income stream becomes threatened, we won't hesitate to say goodbye to a name. 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	7.99%
Global X SuperDividend ETF	SDIV	5.0%	1.60	8.70%
Global X SuperIncome Preferred ETF	SPFF	10.0%	0.81	6.97%
iShares International Select Dividend ETF	IDV	5.0%	1.75	5.61%
iShares MSCI Australia ETF	EWA	5.0%	1.18	5.41%
iShares U.S. Preferred Stock ETF	PFF	5.0%	2.13	5.83%
PowerShares Senior Loan Portfolio	BKLN	5.0%	1.04	4.61%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	4.09	6.20%
Vanguard Real Estate ETF	VNQ	10.0%	2.77	3.18%
EQUITY				
AT&T	T	5.0%	2.04	6.38%
BP PLC	BP	5.0%	2.46	5.58%
Digital Realty Trust	DLR	5.0%	4.32	3.60%
Enterprise Products Partners	EPD	5.0%	1.74	5.93%
Iron Mountain	IRM	5.0%	2.44	6.83%
Magellan Midstream Partners	MMP	5.0%	3.99	6.53%
Public Storage	PSA	5.0%	8.00	3.66%
Schlumberger	SLB	5.0%	2.00	4.47%
Tallgrass Energy LP	TGE	5.0%	2.02	7.94%
		100.0%		**5.78%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 4/1/2019. Core Est. Div. Yield is on trailing basis.

SCREEN OF THE MONTH – TOP HOLDINGS IN THE VANGUARD REAL ESTATE ETF (VNQ)

Company (ticker)	Real Estate Sector	Weighting (%)	Dividend Yield	Credit Rating
Vanguard Real Estate II Index Fund (VRTPX)	Multiple	11.10%	4.23%	NMF
American Tower Corp. (AMT)	Communications	6.20%	1.83%	Baa3
Simon Property Group Inc. (SPG)	Retail	4.50%	4.50%	A2
Crown Castle International Corp. (CCI)	Communications	3.90%	3.52%	Baa3
Prologis Inc. (PLD)	Industrial	3.50%	2.95%	A3
Equinix Inc. (EQIX)	Data Center	2.70%	2.19%	Ba2
Public Storage (PSA)	Self-Storage	2.70%	3.67%	A2
Welltower Inc. (WELL)	Healthcare	2.20%	4.48%	Baa1
Equity Residential (EQR)	Residential	2.20%	3.01%	A3
AvalonBay Communities Inc. (AVB)	Residential	2.10%	3.03%	A3

SCREEN OF THE MONTH – TOP HOLDINGS IN THE INVESCO SENIOR LOAN ETF (BKLN)

Name	Credit Rating	Weighting (%)	CouponRate
Financial & Risk US Holdings, Inc.	B/B2	1.99%	6.24%
BURGER KING	BB-/NR	1.96%	4.75%
Charter Communications Operating	BBB-/Ba1	1.96%	4.50%
CENTURYLINK, INC.	BBB-/BA3	1.92%	5.25%
Envision Healthcare Corporation	B+/B1	1.68%	6.25%
CHANGE HEALTHCA	B+/B1	1.62%	5.25%
Caesars Resort Collection	BB/BA3	1.54%	5.25%
Level 3 Financing Inc	BBB-/BA1	1.50%	4.74%
Grifols Worldwide	BB+/BA2	1.49%	4.66%
Bass Pro Group	B+/B1	1.48%	7.50%
RPI Finance Trust	BBB-/Baa3	1.44%	4.49%
VALEANT PHARMACEUTICALS INTL, INC	BB-/Ba2	1.42%	5.51%
First Data	BB/Ba2	1.40%	4.49%
Dell International LLC	BBB-/Baa3	1.38%	4.50%
AkzoNobel Specialty Chemicals	NR/NR	1.35%	5.76%
Petsmart Inc.	CCC/B3	1.29%	5.49%
Sprint Communications Inc	BB-/BA2	1.25%	5.00%
Western Digital	BBB-/Baa2	1.23%	3.98%
Vistra Operations Company LLC	BBB-/Ba1	1.18%	4.49%
Las Vegas Sands	BBB-/Ba1	1.15%	4.25%

DIVIDEND REPORT PAGE 2 – GLAXOSMITHKLINE (GSK)

GlaxoSmithKline GSK FAIRLY VALUED

Buying Index™ 6 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record - in USD	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$36.00 - $54.00	HEALTHY	POOR / 1	POOR	5.75%

Assessment of Company Dividend Strategy

Key Strengths

It's hard not to like GlaxoSmithKline's leading positions in respiratory disease and HIV, but the company's Vaccines business is also one of the largest in the world, even if it is only ~15% of the company's revenue. Its Consumer Healthcare business offers additional diversification. Core operating profit and free cash flow have faced pressure of late due to the ongoing transition of its pharma portfolio, but the prospect of filing up to 20 assets with regulators by 2020 eases that pain somewhat. The firm expects to pay an ordinary dividend of 80 pence per share in 2019, the same as 2015-2018 (proceeds from the Novartis transaction facilitated a special dividend of 20 pence in 2015). It is targeting free cash flow coverage of dividends of 1.25x-1.5x by 2020.

Potential Weaknesses

We generally like GlaxoSmithKline's medium-term outlook to grow core earnings per share at a mid-to-high single-digit pace through 2020, which should help support dividend growth in its functional currency. The firm is expecting £1 billion in cost savings by 2020. Expect a flat ordinary payout in the near term, with significant development milestones of potential new medicines influencing the pace of dividend growth in the intermediate term. A lofty debt load pressures its Dividend Cushion ratio (£22.1 billion at the end of 2018 including short term debt), and its recent purchase of Tesaro for £4 billion will add to that. Its dividend per ADS is translated into US dollars, causing volatility, and the depository charges a $0.02 annual fee per ADS.

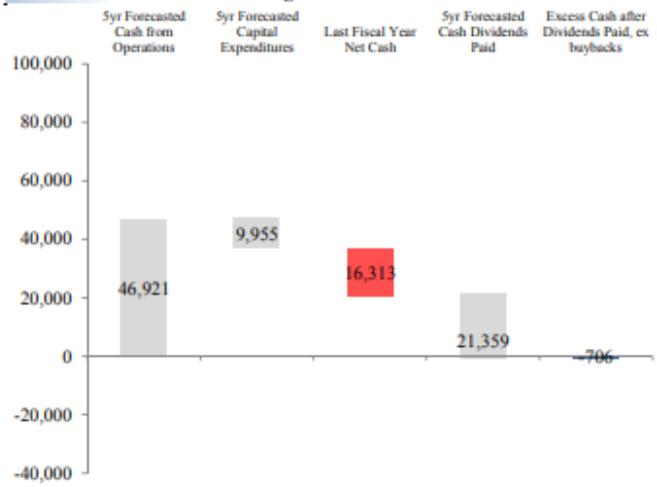
Graphical Relationship, Earnings and Dividends (per share)

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. GlaxoSmithKline'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.

Dividend Cushion Cash Flow Bridge

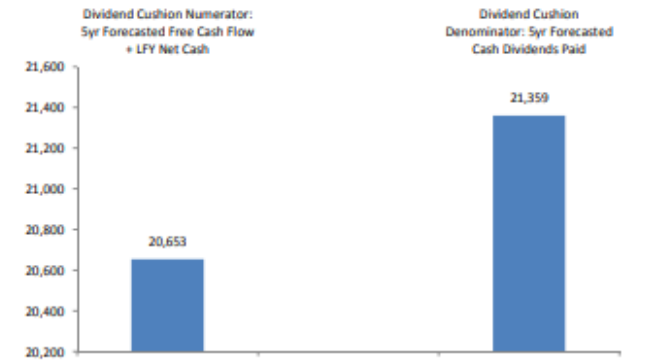


Source: Company Filings, Valuentum Projections

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, GlaxoSmithKline'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.

Dividend Cushion Ratio Deconstruction



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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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