OUR DIVIDEND GROWTH NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
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Dividend Growth Ideas: AAPL, BKLN, CBRL, CSCO, DLR, XLE, XLF, GM, KMI, XLV, IDV, INTC, JNJ, MSFT, O, ORCL, SDY
Most-recently Added: KMI, XLV
Most-recently Removed: HAS, NVS
Under Consideration: PH

INSIDE THIS ISSUE

"As always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective."

– Jerome Powell (2019)

Apple and Intel Rocket Higher!

Please note that versions of this article were emailed out to members on July 25 and July 30.

***Image shown:* Apple is a mid-weighted idea in the Dividend Growth Newsletter portfolio. We added to Apple in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio in December 2018, and we added to it yet again in April 2019. We continue to like shares and value them at ~$220 each. We expect a modest upward revision following its latest earnings report.**

By Callum Turcan and Brian Nelson, CFA

We don't get everything right, of course, but lately, we've been really doing a great job getting the right ideas in front of you! I'm super proud of our team at Valuentum, and I hope that you are capitalizing on our research.

We've had an above-market fair value estimate for Apple Inc (AAPL) for as long as we can remember, and at least from mid-2016. When the markets swooned in December 2018/January 2019, we stuck by our guns in this, yet another, great call. Not only did we nail the fair value estimate, as Apple is indicated up to ~$220 in after-hours trading July 30, but the VBI offered some great signals along the way (see next page).

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***NOTE**: The goal of the Dividend Growth Newsletter is to highlight ideas with strong dividend growth potential and update readers about new developments in the market. A simulated portfolio of dividend growth ideas is presented on page 5 of each edition.

Please see *Apple and Intel…*on next page

*Apple and Intel...*from previous page

AAPL Rating History	Price	Fair Value	VBI
22-Apr-19	$207.48	$222.00	6
25-Mar-19	$186.79	$218.00	6
4-Feb-19	$174.24	$217.00	6
7-Jan-19	$150.75	$217.00	6
5-Nov-18	$199.90	$236.00	3
10-Sep-18	$226.41	$236.00	6
4-May-18	$183.83	$220.00	6
12-Jan-18	$177.09	$201.00	6
28-Dec-17	$171.08	$203.00	6
15-Sep-17	$159.88	$199.00	7
2-Jun-17	$155.45	$183.00	6
1-May-17	$147.51	$165.00	5
20-Jan-17	$120.00	$159.00	7
17-Oct-16	$116.60	$147.00	7

We pride ourselves on transparency. The rating history for each company in our coverage universe can be found on page 16 of each firm's stock valuation report. **The fair value estimate is very important to pay attention to, regardless of whether you are seeking capital appreciation or dividend growth.**

Image Source: *Rating history of Apple, Valuentum's 16-page stock report.*

The worst performance of Apple followed a rating of 3 (1= worst), while some of the best performance of Apple came multiple periods after it registered a 7 (10= best). **We continue to work to optimize the signal-to-noise ratio in our work, and we are evaluating expanding our update cycle to half-year periods to better bolster the signaling aspects of the Valuentum Buying Index (VBI).** In our widely-read case study, the VBI showed its ability to rank equity returns over a forward 12-month period, and we think a migration to less-frequent updating may make the most sense to better capture the forward-looking dynamics of the system. We think this will help weed out false breakouts and other noise that could be harmful. Remember, if you are only paying attention to the update cycle, you are missing the forest for the trees. Our goals are to do extremely well in using the tools and metrics we create, the fair value estimate, the VBI, the Dividend Cushion ratio, among others, and to highlight the best ideas for consideration in the newsletter portfolios.

Visit Valuentum.com to view the case-study mentioned above: https://www.valuentum.com/articles/20141003_1

That said, **the price-to-fair value gaps are very important, too.** For example, in another recent study (image right) that measured the instances of price-to-fair value convergence from 2012 through mid-June 2017, the efficacy of fair value estimates in predicting stock prices was impressive. If you haven't already, please take a read of the performance of undervalued stocks in the image above. We talk about this in *Value Trap*. We think using the price-to-fair value consideration coupled with a strong technical/momentum overlay is a great way to capture strong expected returns (i.e. price-to-fair value convergence), as this is the framework behind the VBI. Pay attention to large price-to-fair value gaps and building convergence momentum, or value.....ntum.

Figure 5: 80%+ Convergence of Undervalued Stocks (FV > Price)

	Time Intervals for Convergence								No Convergence in 8
	1	2	3	4	5	6	7	8	
Counts	829	452	295	151	79	42	31	30	475
Percent of Convergence	34.8%	19.0%	12.4%	6.3%	3.3%	1.8%	1.3%	1.3%	19.9%
Average Percent Change for Convergence	9.0%	16.2%	22.8%	27.3%	30.3%	27.0%	22.7%	25.3%	28.2%

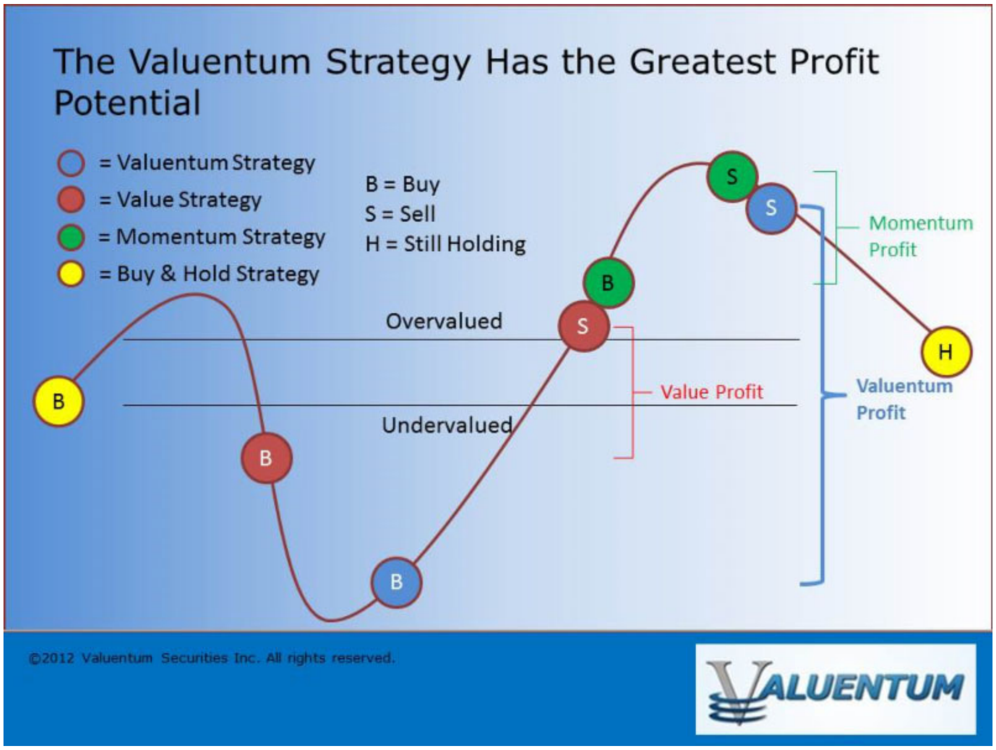
Notes: This data set takes into account only the instances in which the fair value estimate at a given point in time was greater than the corresponding price. The number of instances is recorded in the table, as is the percentage of those instances in which price-to-fair value convergence took place within eight time intervals. The average percentage to price-to-fair value convergence is calculated.

In the sample of undervalued stocks in the study, more than 80% of fair value estimates resulted in price-to-fair value convergence within eight time periods or less, or within approximately 3 years (less than 20% showed no convergence within eight time periods). Though not all time periods in the data set correspond to the same point in time in market history, on the basis of the strong market backdrop that covered nearly the entire time period of the study, we would have expected very strong price-to-fair value convergence for undervalued entities (FV > P). The difference between 80% and what otherwise might have been expected under "random walk," or 50%, is nonetheless statistically significant, supported by a z-test with a very high z-score and p-value very close to 0.

As shown in Figure 5 above, more specifically, nearly 35% of fair value estimates resulted in price-to-fair value convergence within the first time period, approximately 25% of fair value estimates resulted in price-to-fair value convergence during the second time period, just over 12% of fair value estimates resulted in price-to-fair value convergence during the third time period, and approximately 6% of fair value estimates resulted in price-to-fair value convergence during the fourth time period, with the cumulative balance accruing during time periods 5-8, to total 80%. The average percentage to price-to-fair value convergence is remarkable, with prices advancing 20% in some cases in 30% in others, on average, to converge to the fair value estimate.

Please see *Apple and Intel...*on next page

Apple and Intel...from previous page



The illustration to the left shows how we envision the generalized path of ideas that we put forth to members in the Best Ideas Newsletter portfolio.

Not all ideas can possibly fit this mold, of course, and not all ideas work out, but the Valuentum strategy, as outlined, reveals how it "corrects" the pitfalls of both traditional value and traditional momentum styles. Since we drew this image in 2012, many an idea has approximated this curve to varying degrees.

Please note, however, that the greatest focus with ideas in this publication, the Dividend Growth Newsletter is tied to the health of income growth over the long haul, within the context of intrinsic valuation.

Apple was a stock that we highlighted in the book, *Value Trap*, and one that we added to during the past few months, further bolstering its weighting in the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio. The stock has now experienced rapid price-to-fair value convergence since the doldrums of December 2018, and now we're letting it run higher. It just recently broke out from what many technicians call a cup-and-handle, and now we watch as technical and momentum investors pile into the stock.

We may look to remove shares of Apple, but we may only do so as they approach the higher end of the fair value estimate range, and only after they start to roll over. As with Dollar General (an idea in the Best Ideas Newsletter portfolio), that may happen sooner than later, and that's why at these price levels of Apple shares, we're paying much closer attention to its technical/momentum indicators than we would any "rounding errors" in the price-to-fair value ratio. What do we mean by "rounding errors?" **Well, it was easy to say Apple was severely mispriced when it was trading in the mid-$140s earlier this year (it had a huge margin of safety relative to the fair value estimate), but at ~$220, it's a much more difficult question.** In any case, we expect a modest upward revision to the fair value estimate as a result of the news.

Switching gears a bit, on July 25, Intel (INTC), a top-weighted idea in Valuentum's Dividend Growth Newsletter portfolio, beat expectations on both the top and bottom lines during its second quarter, and while revenue was down on a year-over-year basis, it did come in better than guidance. Our thesis on Intel has been somewhat whipsawed given the situation with Apple and Qualcomm (QCOM), but it was relatively good news to see Intel sell its smartphone modem business to Apple given Intel's prior decision not to throw more capital at the endeavor. We would have loved to see Intel take share from Qualcomm, but selling out may be the next best scenario. Intel's shares have leapt back to our fair value estimate on the report which came with raised guidance for 2019.

You can view our weightings in Apple and Intel in the Dividend Growth Newsletter portfolio on page 5. Both are among the top-weighted ideas in the newsletter portfolio, and we continue to like them. We hope you enjoy this edition of the Dividend Growth Newsletter, and please let us know if you have any questions.

Microsoft Posts a Great Quarter to Round Out a Great Fiscal Year

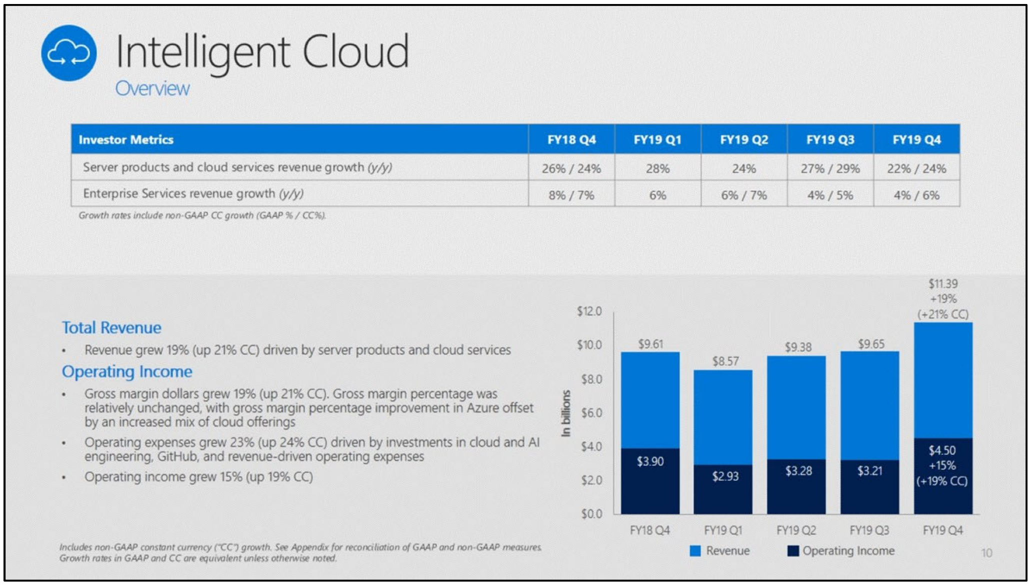


Image Source: *Microsoft Corporation -- IR Presentation*

Microsoft has been one of our favorite dividend growth ideas for as long as we can remember. When we traveled the country at AAII meetings, we highlighted the company as an idea with strong dividend growth potential, showcasing how we calculate its Dividend Cushion ratio. **We continue to like Microsoft's dividend growth potential.**

We remain very optimistic on Microsoft's future dividend growth trajectory, and we would like to note the upper end of our fair value estimate range stands at $154 per share of Microsoft. The market at-large seems largely supportive of Microsoft's latest earnings, and so are we.

By Callum Turcan

Microsoft Corp (MSFT) is included in Valuentum's simulated Dividend Growth Newsletter portfolio, and the company reported solid fourth-quarter FY2019 results on July 18, sending shares higher by a couple percent the next day. Revenue rose 12% year-over-year, a growth rate that moves up ~200 basis points when excluding negative foreign currency headwinds, while Microsoft's adjusted non-GAAP EPS climbed 21% to $1.37. Microsoft's adjusted EPS growth rate would have been ~300 basis points higher, if not for a strong US dollar, but even so, these are great results.

'Intelligent Cloud' and 'Productivity & Business Processes' each posted double-digit sales growth rates year-over-year, while Microsoft's 'More Personal Computing' segment saw just 4% year-over-year revenue growth. Microsoft bills itself as the largest provider of commercial cloud services in the world. CEO Satya Nadella mentioned during the conference call that Azure was the first to move into Africa and the Middle East, at least in terms of having a serious data center presence in those regions, highlighting the long-term view Microsoft is taking when it comes to laying down the foundation for its future growth trajectory. Here is a quote from Mr. Nadella:

> *"We are building Azure as the world's computer, addressing customers' real-world operational sovereignty and regulatory needs. We have 54 data center regions, more than any other cloud provider, and we were the first in the Middle East and in Africa. Azure is the only cloud that extends to the edge – spanning identity, management, security and infrastructure. This year, we introduced new cloud-to-edge services and devices – from Azure Data Box Edge, to Azure Stack HCI, to Azure Kinect – bringing the full power of Azure to where data is generated."*

Please see *Microsoft Posts...*on page 6

The Dividend Growth Newsletter Portfolio

By Valuentum Analysts

DIVIDEND GROWTH IDEAS -- as of August 1, 2019 (intraday)

Company Name	Yrly Div's Paid ($) / Shr	Div Yield %	Fair Value	VBI Rating	Price/FV	Last Close	% of Portfolio
S&P Dividend ETF SPDR (SDY)	2.45	2.40%	-	UR	-	101.99	7.5%-12.5%
Intel (INTC)	1.26	2.43%	$ 53.00	4	0.98	51.88	7.5%-12.5%
Johnson & Johnson (JNJ)	3.80	2.91%	$ 151.00	4	0.86	130.54	7.5%-12.5%
Apple (AAPL)	3.08	1.42%	$ 222.00	6	0.98	217.33	5.5%-7.5%
Cisco (CSCO)	1.40	2.47%	$ 56.00	3	1.01	56.63	5.5%-7.5%
Digital Realty Trust (DLR)	4.32	3.77%	$ 96.00	3	1.19	114.54	5.5%-7.5%
Energy Sector SPDR (XLE)	2.08	3.35%	-	UR	-	62.12	5.5%-7.5%
Health Care Select Sector SPDR ETF (XLV	1.47	1.60%	-	UR	-	92.12	5.5%-7.5%
iShares Int'l Select Dividend (IDV)	1.83	6.05%	-	UR	-	30.24	5.5%-7.5%
General Motors (GM)	1.52	3.66%	$ 49.00	6	0.85	41.53	3.5%-5.5%
Invesco Senior Loan (BKLN)	1.11	4.87%	-	UR	-	22.82	3.5%-5.5%
Microsoft (MSFT)	1.84	1.31%	$ 128.00	6	1.10	140.56	3.5%-5.5%
Oracle (ORCL)	0.96	1.69%	$ 59.00	7	0.96	56.66	3.5%-5.5%
Cracker Barrel (CBRL)	5.20	3.00%	$ 159.00	3	1.09	173.51	2.5%-3.5
Financial Select Sector SPDR ETF (XLF)	0.56	1.98%	-	UR	-	28.26	2.5%-3.5
Kinder Morgan (KMI)	1.00	4.79%	$ 23.00	6	0.91	20.87	2.5%-3.5
Realty Income (O)	2.72	3.91%	$ 56.00	5	1.24	69.60	2.5%-3.5
Cash Consideration	-	-	-	-	-	-	0.0%

UR = Under Review

Dividend yield and dividend per share information for ETFs retrieved from Yahoo Finance.

This portfolio is not a real money portfolio. Data as of August 1, 2019 (intraday).

Goal:

The goal of the Dividend Growth Newsletter portfolio is to highlight ideas with strong dividend growth potential and update readers about new developments in the market. The Dividend Growth Newsletter portfolio seeks to find underpriced dividend growth gems that generate strong levels of free cash flow and have solid balance sheets, translating into excellent Valuentum Dividend Cushion ratios. *Given market conditions and the importance of diversification, not all stocks in the newsletter portfolio can be undervalued, however*. Stocks in the Dividend Growth Newsletter portfolio may have lengthy dividend growth track records spanning decades, but we focus most of our efforts on assessing the future safety and dividend growth potential of ideas.

Every subscriber has different goals and different risk tolerances, so where before in the newsletter portfolios, we would outline the specific percentage weighting, we think providing ranges make much more sense. For example, depending on someone's risk tolerances, a larger cash position in an overheated market may be prudent. On the other hand, the longer one's time horizon, perhaps a smaller cash position may make more sense. The Dividend Cushion ratios are so important, so please stay up to date with them. By our estimates, the efficacy of the Dividend Cushion ratio in warning about dividend cuts is roughly 90%.

We've taken the cash weighting in our portfolio to 0%. The sum of the midpoints of our respective weighting ranges approximates 100% to reflect the range of possible combinations that may result in this allocation.

Microsoft Posts…from page 4

Further, Microsoft's CFO Amy Hood mentioned that:

> *"In FY19, we closed a record number of multi-million dollar commercial cloud agreements, with material growth in the number of $10 million plus Azure agreements. Commercial bookings growth was significantly ahead of expectations, increasing 22% and 25% in constant currency, driven by strong renewal execution and an increase in the number of larger, long-term Azure contracts.*
>
> *As a result, our contracted not recognized revenue was $91 billion, up 25% year over year, reflecting our continued momentum and growing long term customer commitment. We expect to recognize approximately 50% of this revenue in the next 12 months…* ***Commercial Cloud revenue was $11 billion, growing 39% and 42% in constant currency. Commercial cloud gross margin percentage increased 6 points year over year to 65%, driven again by significant improvement in Azure gross margin****."*

Cloud-fueled growth is expected to keep driving Microsoft higher with management forecasting that double-digit revenue growth will continue in fiscal year 2020. **Margin expansion is also greatly appreciated as Azure realizes economies of scale and continuous improvements through the implementation of AI technology.** Microsoft's growth story is heavily weighted toward how well it does with commercial businesses (i.e. retail chains and restaurants) and large enterprise-sized entities (i.e. national governments), with the goal being to secure a long-lasting relationship built on recurring revenue streams.

Strength at the firm's Microsoft 365, the "productivity cloud" offering, was key to its strong fiscal 2019 performance as the company targets growth in the healthcare, hospitality, retail, and customer service industries. From collaborative business setting offerings like Microsoft Teams to AI generated business intelligence insights to the Office apps we all use today, management sees Microsoft 365 offering a lot of upside for both customers and Microsoft's financial performance.

Microsoft ended fiscal year 2019 with $133.8 billion in cash and cash equivalents plus short-term investments on hand, good for a net debt position of $61.6 billion (inclusive of short-term debt). One of our favorite things about Microsoft is its rock-solid balance sheet. Dividend payments must compete with net debt for uses of cash as it relates to future capital allocation priorities, but if the company in question has a large net cash position, its balance sheet can be a source of funds for future payouts. Microsoft's Dividend Cushion ratio stands at 3.6x, providing for tremendous dividend coverage and a great dividend growth trajectory.

Large net cash positions can also be used to fund major and potentially transformative acquisitions, like Microsoft's $26.2 billion purchase of LinkedIn in 2016. Revenue from that division grew by 25% year-over-year during the fourth quarter of fiscal 2019, driven by record levels of engagement. Microsoft is using LinkedIn to further solidify itself as the business world's leading provider of all things software, with an eye on recruitment from an HR perspective as it relates to leveraging social media for useful commercial uses.

For the full year, Microsoft generated $52.2 billion in net operating cash flow, up 19% versus fiscal 2018 levels. Capital expenditures, defined as 'additions to property and equipment,' totaled $13.9 billion allowing for $38.2 billion in free cash flow in fiscal 2019. That easily covered $13.8 billion in dividend payments, with another $19.5 billion allocated towards share repurchases, all of which were covered by free cash flow. Going forward, dividend increases will have to compete with share repurchases, but Microsoft is truly a free cash flow generating machine. We remain very optimistic on Microsoft's future dividend growth trajectory and would like to note the upper end of our fair value estimate range stands at $154 per share of Microsoft. The market at-large seems largely supportive of Microsoft's latest earnings, and so are we.

Disclosure: *Callum Turcan does not own any of the securities mentioned in the article above.*

Kinder Morgan Modestly Disappoints But Its Problems Are Transitory

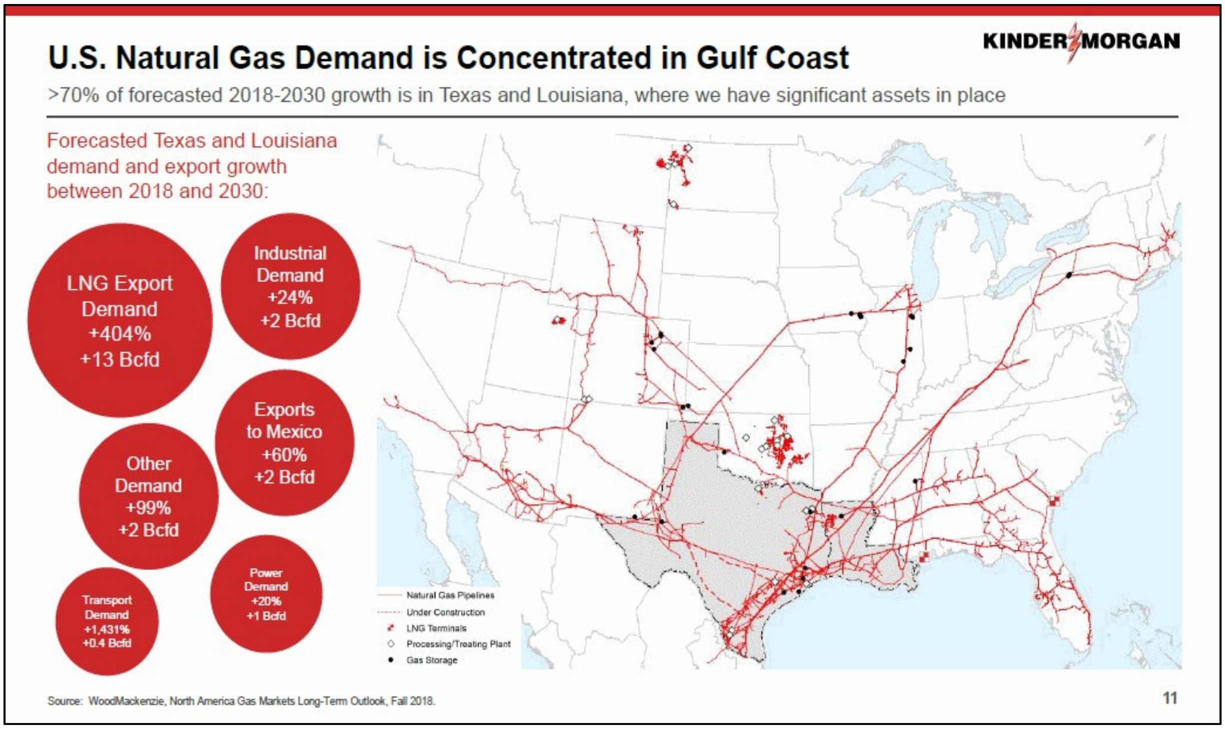


Image Shown: *Kinder Morgan Inc expects a lot of organic growth opportunities will be generated via surging domestic demand for natural gas and rising natural gas export capacity in the US.* ***Image Source:*** *Kinder Morgan Inc – IR Presentation*

By Callum Turcan

Natural gas pipeline giant Kinder Morgan Inc (KMI), a holding in our simulated Dividend Growth Newsletter portfolio, reported second quarter earnings for 2019 on July 17 which generally disappointed. Problems at its Elba LNG development in Georgia and weaker realized prices for raw energy resources produced by its upstream CO2 segment held down Kinder Morgan's financial performance. We appreciate Kinder Morgan's focus on fiscal discipline and see several of its problems as transitory, other than the raw energy resource pricing risk its upstream operations will perennial face. **Once the Elba LNG project finally comes online Kinder Morgan will be better able to focus on what it does best, building new natural gas pipelines and expanding existing networks.** Shares of KMI yield ~4.8% as of this writing.

Quarterly Overview

The midstream company's Natural Gas Pipelines segment is doing very well with a lot of room for upside, as its Gulf Coast Express Pipeline project is ahead of schedule with a targeted in-service date of October 1, 2019, or slightly beforehand. That system will haul natural gas from the Permian Basin in West Texas to the Agua Dulce hub near Corpus Christi along the US Gulf Coast. Another Permian natural gas pipeline, the Permian Highway Pipeline, that Kinder Morgan's developing is expected to start up in October 2020. **These projects should yield additional organic growth opportunities up and down the pipeline, with Kinder Morgan's total project backlog standing at $5.7 billion as of the end of the second quarter.**

Please see *Kinder Morgan…*on next page

*Kinder Morgan…*from previous page

Kinder Morgan's adjusted EBITDA dropped by a tad under 2% in the second quarter year-over-year to $1.8 billion, while its distributable cash flow ("DCF") rose by 1% to $1.1 billion. Very strong performance at its Natural Gas Pipelines segment, where transported natural gas volumes rose 10% year-over-year, was key to offsetting weakness at its CO2, Products Pipelines, and Terminals segments. Only Kinder Morgan's Natural Gas Pipelines segment posted an increase in EBDA last quarter on a year-over-year basis, the other three segments all posted declines.

Debt Commentary

Management's adjusted net debt metric rose from $34.2 billion at the end of 2018 to $34.8 billion at the end of June. As Kinder Morgan's adjusted EBITDA on a trailing-twelve-month basis was broadly flat from the end of 2018 to the end of the second quarter of 2019, the midstream company's leverage ratio (adjusted net debt to adjusted EBITDA) rose from 4.5x to 4.6x during this period.

Please keep in mind the adjustments management made to Kinder Morgan's net debt load include taking into account 50% of the KML preferred shares, excluding debt fair value adjustments, and removing the impact of foreign exchange movements on Kinder Morgan's Euro-denominated debt as that's hedged via currency swaps. When looking at just Kinder Morgan's net debt load as it would conventionally be understood (cash & cash equivalents less short-term debt and long-term debt), that burden stood at $34.7 billion at the end of June 2019, roughly on par which management's adjusted net debt figure.

Minor Guidance Changes

In the earnings press release, management mentioned that delays at the firm's Elba LNG export project and other factors would see Kinder Morgan's 2019 adjusted EBITDA come in "slightly" below estimates calling for $7.8 billion in adjusted EBITDA:

> *"Adjusted EBITDA is currently estimated to be slightly below budget, primarily due to the delay in Elba's in-service date, lower NGL prices impacting the CO_2segment, and the impact of 501-G settlements, partially offset by the strong performance of the West Region natural gas business unit…*
>
> *DCF is expected to be on budget as lower interest expense offsets the slightly lower Adjusted EBITDA. KMI budgeted to invest $3.1 billion in growth projects and contributions to joint ventures during 2019.* ***KMI now expects to be slightly below that amount due to lower capital expenditures in the CO_2 segment. KMI expects to use internally generated cash flow to fund the vast majority of its 2019 discretionary spending, without the need to access equity markets****."*

By the end of 2019, management sees Kinder Morgan's leverage ratio standing at 4.6x, a touch above its long-term goal of 4.5x. We appreciate the minor adjustment in Kinder Morgan's 2019 capital expenditure plans to ensure continued fiscal sustainability but would also like to see that leverage ratio move lower in the future.

Choice Quote from Management

Down below is a quick summary of why Kinder Morgan's Natural Gas Pipelines segment is so important, summed up by Richard Kinder, co-founder and executive chairman of Kinder Morgan, during the firm's conference call:

> *"Looking forward, as we previously said U.S. demand is projected to grow by over 30% between now and 2030 that demand growth is being driven by L&G, power and industrial demand and by exports to Mexico. Turning to the supply side, the U.S. is projected by 2025 to be producing one quarter of all the natural gas in the world, and accounting for over 50% of the growth in supply -- in global supply by that year…"*

Please see *Kinder Morgan…*on next page

*Kinder Morgan…*from previous page

Furthermore;

> *"Now look I'm aware of Mark Twain saying that making predictions is very difficult, particularly when they concern the future. But I believe that under almost any scenario natural gas is a winner for years to come. Connecting these vast supplies -- these vast U.S. supplies to growing demand markets will drive new infrastructure and higher utilization of existing assets.*
>
> *KMI is very well positioned to take advantage of these opportunities, especially in Texas and Louisiana where our extensive network of pipelines is very well situated to serve the rapidly growing LNG export and petrochemical facilities. That's a big reason why we feel good about the long-term future of this company."*

Concluding Thoughts

Kinder Morgan was happy to mention that Fitch Ratings upgraded its investment grade credit rating last quarter, joining the ranks of Moody's Corporation (MCO) and S&P Global Ratings which had both recently upgraded Kinder Morgan's investment grade credit ratings as well. That's the result of management's ongoing focus on fiscal discipline, which we expect will continue going forward. We remain optimistic on Kinder Morgan's dividend growth opportunities, and our fair value estimate still stands at $23 per share.

***Disclosure**: Callum Turcan does not own any of the securities mentioned in the article above.*

Johnson & Johnson Revises Sales Guidance Higher Yet Again

By Callum Turcan

Consumer packaged goods and healthcare giant Johnson & Johnson (JNJ), a holding in both our simulated Best Ideas Newsletter and Dividend Growth Newsletter portfolios (a top-weighted DGN holding), reported second-quarter 2019 earnings July 16 that received mixed reviews from the market. Shares of JNJ initially sold off before recovering later in the trading day.

Quarterly Highlights

Revenue in the period dropped by a tad over 1% year-over-year to $20.6 billion on a GAAP basis, but adjusted operational sales (which exclude foreign currency movements, a headwind to Johnson & Johnson's second quarter performance, and the net impact of A&D activity) rose by almost 4%. **There's underlying demand growth for Johnson & Johnson's products, but as with all American companies with significant overseas sales, a strong US dollar is getting in the way.**

We would also like to mention that Johnson & Johnson sold its Advanced Sterilization Products for $2.8 billion ($2.7 billion in cash, with the remainder coming from the company retaining $0.1 billion in net receivables) through a deal that closed April 1, resulting in a pretax gain of $2.0 billion last quarter. Fortive Corporation (FTV) was the acquirer.

Adjusting for that divestiture and other effects, Johnson & Johnson grew its non-GAAP net income and diluted EPS by 22% and 23%, respectively, versus the same quarter last year. Strong performance by Johnson & Johnson's Darzalex (treats a blood cancer called multiple myeloma) and Stelara (treats moderate to severe plaque psoriasis in adults and children 12 years and older) therapies helped boost the company's adjusted pharmaceutical operational sales by over 4% year-over-year. Considering this division generates roughly half of the company's revenue, that growth went a long way in padding its bottom-line. GAAP revenue from this division was up almost 2% year-over-year in the second quarter.

Please see *Renewing Our Interest…*on page 13

Stocks with High Valuentum Buying Index Ratings and Strong Dividend Growth Prospects

By Valuentum Analysts

The table showcases stocks in our coverage universe that have high Valuentum Buying Index ratings and strong dividend growth prospects. The table represents a list of interesting dividend-paying stocks that may be *among* the most-timely dividend growth ideas to consider based on our stock-selection methodology. You'll see that many of them are already ideas included in the simulated Dividend Growth Newsletter portfolio (see page 5).

Though the dividend growth portfolio may be fully invested at times, we may swap in stocks on this list or stocks on the dividend-growth watch list (see the next page) at the right price or if our analyst team believes that a new add may have more potential total return opportunity than a current idea already within the newsletter portfolio. At any time, however, our favorite dividend growth ideas are included in the simulated Dividend Growth Newsletter portfolio.

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

Company Name	Symbol	Est Div Yield	VBI	Div Growth	Div Safety	Div Cushion
AmerisourceBergen	ABC	2.0%	9	EXCELLENT	EXCELLENT	3.5
Broadcom	AVGO	3.6%	7	GOOD	GOOD	1.0
Carlisle Companies	CSL	1.2%	7	EXCELLENT	EXCELLENT	3.7
Celenese	CE	2.1%	7	EXCELLENT	GOOD	2.7
DowDuPont	DWDP	3.9%	7	EXCELLENT	GOOD	1.3
Huntsman	HUN	2.7%	7	EXCELLENT	EXCELLENT	3.0
LyondellBasell	LYB	4.5%	7	GOOD	GOOD	1.0
Harris Corp	HRS	1.5%	7	EXCELLENT	GOOD	1.6
Eaton	ETN	3.6%	7	GOOD	GOOD	1.2
Core Labs	CLB	3.2%	7	GOOD	GOOD	1.3
Republic Services	RSG	1.8%	7	GOOD	GOOD	1.8
Waste Management	WM	1.9%	7	EXCELLENT	GOOD	1.7
Visa	V	0.7%	7	EXCELLENT	EXCELLENT	5.3
Quest Diagnostics	DGX	2.2%	7	GOOD	GOOD	1.2
Kimberly-Clark	KMB	3.3%	7	GOOD	GOOD	1.0
Dover	DOV	2.0%	7	GOOD	GOOD	1.8
Stanley Black & Decker	SWK	1.9%	7	EXCELLENT	GOOD	1.9
Interpublic	IPG	4.2%	7	EXCELLENT	GOOD	1.4
Baxter Intl	BAX	1.0%	7	GOOD	EXCELLENT	3.4
Stryker	SYK	1.1%	7	EXCELLENT	EXCELLENT	2.9
Pfizer	PFE	3.4%	7	GOOD	GOOD	1.8
Donaldson Co	DCI	1.6%	7	GOOD	GOOD	2.6
Cheesecake Factory	CAKE	2.8%	7	EXCELLENT	GOOD	2.5
American Eagle	AEO	2.6%	7	EXCELLENT	EXCELLENT	3.5
Oracle	ORCL	1.5%	7	EXCELLENT	EXCELLENT	4.5
Foot Locker	FL	2.3%	7	EXCELLENT	EXCELLENT	3.3
Williams-Sonoma	WSM	3.4%	7	EXCELLENT	GOOD	2.0
Equifax	EFX	1.4%	7	EXCELLENT	GOOD	1.8
Manpower	MAN	2.4%	7	EXCELLENT	EXCELLENT	3.1
Robert Half	RHI	1.9%	7	EXCELLENT	EXCELLENT	3.5

At any time, our favorite dividend growth ideas are included in the Dividend Growth portfolio, page 5.

The Financially-Healthiest Dividend Payers Yielding Over 2%

By Valuentum Analysts

There are a number of ways to evaluate the health of a company's dividend. We think a minimum threshold for a company's yield is par for the course in any income-oriented screen, and we peg the dividend yield hurdle rate for this screen at 2%. For firms that make this cut, we want to find those that generate free cash flow at a pace that is far larger than the cash paid out as dividends and have a strong balance sheet to boot, or companies that have high Dividend Cushion ratios.

Enter stocks that have the highest multiplicative combination of their dividend yield and Dividend Cushion ratio. We exclude the business models of master limited partnerships and real estate investment trusts in this screen and focus exclusively on corporates. We also make a few other tweaks with respect to business model risk considerations. Income investors have a lot to choose from, and this screen is one of our favorites -- it focuses on identifying the financially-healthiest dividend-payers with yields over 2%. We've overlaid the screen with an Economic Castle assessment to consider business-model risk, too!

Company Name	Symbol	Div Cushion	Economic Castle	Multiplier
General Motors	GM	3.4	Attractive	14.90
Chico's FAS	CHS	2.3	Attractive	13.74
Honda	HMC	3.7	Neutral	12.98
Gilead Sciences	GILD	3.1	Very Attractive	12.17
Fluor	FLR	4.1	Attractive	11.79
Chicago Rivet	CVR	3.9	Neutral	11.78
Guess	GES	3.9	Attractive	10.48
Automatic Data Processing	ADP	5.0	Very Attractive	10.36
Abercrombie & Fitch	ANF	3.3	Attractive	10.17
Cooper Tire & Rubber	CTB	8.1	Neutral	9.96
Methode Electronics	MEI	6.0	Attractive	9.75
Hewlett-Packard	HPQ	3.1	Attractive	9.74
Bristol-Myers Squibb	BMY	2.7	Very Attractive	9.29
Western Union	WU	2.1	Neutral	9.22
American Eagle	AEO	3.5	Attractive	9.19
Gap	GPS	2.3	Attractive	8.46
Caterpillar	CAT	2.8	Very Attractive	8.41
Gentex	GNTX	4.4	Attractive	8.37
Total	TOT	1.6	Neutral	8.27
Huntsman	HUN	3.0	Attractive	8.25
Ralph Lauren	RL	4.3	Attractive	8.19
Omnicom	OMC	2.3	Unattractive	8.01
Dick's Sporting	DKS	2.6	Attractive	7.96
Cummins	CMI	2.6	Attractive	7.94
Tapestry	TPR	1.9	Attractive	7.93
Foot Locker	FL	3.3	Attractive	7.74
QUALCOMM	QCOM	2.1	Very Attractive	7.71
Apple	AAPL	5.5	Very Attractive	7.69
H&R Block	HRB	2.1	Very Attractive	7.67
Archer-Daniels-Midland	ADM	2.3	Attractive	7.66
Walgreens Boots Alliance	WBA	2.3	Attractive	7.64
Newmont Mining	NEM	5.3	Neutral	7.59
AVX Corp	AVX	2.9	Attractive	7.50
Manpower	MAN	3.1	Attractive	7.47
Lear Corp	LEA	4.1	Attractive	7.45
Amgen	AMGN	2.4	Very Attractive	7.37
Ethan Allen	ETH	1.8	Unattractive	7.31
Rio Tinto	RIO	1.6	Neutral	7.19
Cisco	CSCO	2.8	Very Attractive	7.17
MKS Instruments	MKSI	8.9	Attractive	7.15
McKesson	MCK	5.9	Very Attractive	7.07
Southwest	LUV	5.6	Attractive	7.02
Applied Materials	AMAT	3.6	Very Attractive	7.01
Cardinal Health	CAH	1.7	Attractive	6.95
Oracle	ORCL	4.5	Very Attractive	6.93
Novartis	NVS	2.3	Attractive	6.93
AmerisourceBergen	ABC	3.5	Very Attractive	6.92
Paychex	PAYX	2.4	Very Attractive	6.92
Cheesecake Factory	CAKE	2.5	Attractive	6.86
Johnson & Johnson	JNJ	2.4	Attractive	6.73

Note: The 'Multiple' in this list considers a company's dividend yield and Dividend Cushion ratio as a multiplicative combination. Though it is a robust and largely objective measure, there could be exogenous or secular dynamics that could impact the business, where a dividend may not be as strong as the financials indicate.

For example, there may be stocks such as **GameStop (GME),** for example, which is dealing with a secular shift toward digital gaming, or **Abercrombie & Fitch (ANF) and Guess (GES)**, which are navigating changing consumer preferences as millennials seek 'experiences' not 'things' (e.g. fashion). The Dividend Cushion is only one factor that we use in assessing the overall health of a company's dividend.

Yields to Consider Avoiding

By Valuentum Analysts

As many investors know, firms can often become cheap for good reasons. That is, they are not trading cheaply because of Mr. Market's irrational behavior, but instead are trading at depressed levels due to deteriorating underlying fundamental characteristics that actually justify their current share price, even if traditional valuation techniques suggest the company's shares are inexpensive. On a similar note, companies that boast high dividend yields may do so because the market has little confidence in the sustainability of its dividend and believes a cut may be just around the corner.

Though we fall short of saying the following list of companies will slash their respective dividends anytime soon, our dividend-cut predictive indicator--the Valuentum Dividend Cushion™--indicates that the firms below are at significant risk for a dividend cut in coming years. We think the more conservative dividend-growth investor may want to consider steering clear of the following firms' shares:

Company Name	Symbol	Industry	Est Div Yield	Div Safety	Div Cushion
Ensco	ESV	Energy Svcs - Offshore Drilling	1.0%	VERY POOR	-49.4
R.R. Donnelley	RRD	Commercial Services	2.2%	VERY POOR	-27.5
Superior	SUP	Auto Parts Suppliers	7.1%	VERY POOR	-12.5
Ryder System	R	Rental and Leasing	3.9%	VERY POOR	-11.3
Yamana Gold	AUY	Miscellaneous	0.8%	VERY POOR	-9.2
General Electric	GE	Conglomerates	0.4%	VERY POOR	-6.6
NiSource	NI	Utilities	3.0%	VERY POOR	-6.3
Pitney Bowes	PBI	Commercial Services	2.8%	VERY POOR	-5.7
Intl Game Technology	IGT	Leisure	5.7%	VERY POOR	-5.7
Teekay	TGP	Shipping	3.7%	VERY POOR	-5.7
HCA Healthcare	HCA	Health Care Services	1.3%	VERY POOR	-4.3
H.B. Fuller	FUL	Chemicals - broad	1.3%	VERY POOR	-4.1
Centurylink	CTL	Telecom Services - diversified	8.2%	VERY POOR	-3.9
Spire	SR	Utilities	3.0%	VERY POOR	-3.6
ConAgra Brands	CAG	Food Products - Large	3.7%	VERY POOR	-3.0
Entergy	ETR	Utilities	4.1%	VERY POOR	-2.9
Alliant Energy Corp	LNT	Utilities	3.2%	VERY POOR	-2.5
CMS Energy	CMS	Utilities	2.9%	VERY POOR	-2.4
Silgan	SLGN	Containers & Packaging	1.5%	VERY POOR	-2.4
American Electric	AEP	Utilities	3.4%	VERY POOR	-2.1
SITE Centers	SITC	REIT - Retail	6.4%	VERY POOR	-2.0
Kraft Heinz	KHC	Food Products - Large	4.8%	VERY POOR	-2.0
Casey's General	CASY	Food Retailers	0.9%	VERY POOR	-1.9
Duke Energy	DUK	Utilities	4.2%	VERY POOR	-1.8
PPL	PPL	Utilities	5.4%	VERY POOR	-1.8
Eversource Energy	ES	Utilities	2.9%	VERY POOR	-1.7
Dine Brands Global	DIN	Restaurants - Fast Cas & Full Svc	3.0%	VERY POOR	-1.7
Pinnacle West	PNW	Utilities	3.4%	VERY POOR	-1.5
Southern Co	SO	Utilities	4.9%	VERY POOR	-1.5
DTE Energy	DTE	Utilities	3.2%	VERY POOR	-1.5
Olin Corp	OLN	Chemicals - mid/small	3.5%	VERY POOR	-1.5
Public Service	PEG	Utilities	3.3%	VERY POOR	-1.5
Kroger	KR	Food Retailers	2.2%	VERY POOR	-1.4
South Jersey	SJI	Utilities	3.8%	VERY POOR	-1.4
Edison Intl	EIX	Utilities	4.3%	VERY POOR	-1.4
Big 5	BGFV	Retail - Sporting Goods	6.1%	VERY POOR	-1.4
CVS Health	CVS	Food Retailers	3.7%	POOR	-1.4
Xcel Energy	XEL	Utilities	2.9%	VERY POOR	-1.3
Wendy's Co	WEN	Restaurants - Fast Food & Coffee	2.1%	VERY POOR	-1.2
Newell Brands	NWL	Household Durables	5.8%	VERY POOR	-1.2
Meredith	MDP	Media - advertising	4.0%	VERY POOR	-1.2
Sempra Energy	SRE	Utilities	3.1%	VERY POOR	-1.2
Comcast	CMCSA	Media - CATV	2.1%	POOR	-1.1
Exelon	EXC	Utilities	2.9%	VERY POOR	-1.1
Consolidated Edison	ED	Utilities	3.8%	VERY POOR	-1.1
Compass Minerals	CMP	Chemicals - agriculture	5.1%	POOR	-1.1
Brinker	EAT	Restaurants - Fast Cas & Full Svc	3.5%	VERY POOR	-1.0
Sealed Air	SEE	Containers & Packaging	1.5%	VERY POOR	-1.0

The Valuentum Dividend Cushion™ has an excellent track record of predicting dividend cuts. For more information, please select the following link (login required):

http://www.valuentum.com/articles/20130528

*Kinder Morgan…*from page 9

The company's adjusted operational sales from its consumer division climbed over 2% last quarter year-over-year, assisted by solid demand for its beauty products like Neutrogena (includes skin care, hair care, and cosmetic offerings) and over-the-counter medicine like Zyrtec (for allergy relief). Medical device revenue rose by over 3% year-over-year on an adjusted operational sales basis (excludes the impact from its ASP divestment), aided by its electrophysiology products selling well (which can be used to treat arrhythmia, irregular heartbeats).

Another Guidance Raise

Management was confident enough in Johnson & Johnson's performance to reiterate their forecast calling for $8.53 - $8.63 in adjusted EPS this year on a diluted basis, good for ~5% annual growth at the midpoint. **Even better, Johnson & Johnson now sees its adjusted operational sales climbing by 3.2% - 3.7% this year, up from 2.5% - 3.0% growth previously.** Its forecasted GAAP sales were revised up as well, with the company now expecting its 2019 revenue to either come in flat or post a marginal decline versus 2018 levels (instead of forecasting a modest decline in sales).

Please keep in mind that Johnson & Johnson had already revised both its earnings and sales guidance for 2019 upwards when it reported first quarter 2019 earnings. We covered that positive revision back in April 2019.

We caution that the company's positive sales revision was offset by expectations for a slight decline in its adjusted pre-tax operating margin, which previously was expected to expand slightly, resulting in its adjusted EPS estimates for 2019 staying the same. That's largely due to increased R&D investments, which we will cover in a moment. Foreign currency headwinds are expected to shave 200 basis points off Johnson & Johnson's GAAP revenue growth rate this year.

2019 Guidance

	July	April	Comments
Adjusted Operational Sales[1,2]	3.2% - 3.7%	2.5% - 3.5%	Net Impact Acq./Div.: ~2.0% at the midpoint
Operational Sales[2]	$82.4 - $83.2B 1.0% - 2.0%	$82.0B - $82.8B 0.5% - 1.5%	Increase of 50 bps
Estimated Reported Sales[3]	$80.8B - $81.6B (1.0%) – 0.0%	$80.4B - $81.2B (1.5%) - (0.5%)	FX ($1.6B) or (2.0%) impact
Adjusted Pre-Tax Operating Margin[4,5]	Slight decline	Slight improvement	Increasing investments in innovation
Net Interest Expense	$0 - $100 million	$100 - $200 million	Positive effect of net investment hedging arrangements and certain cross currency swaps
Net Other Income[4]	$2.65 - $2.85 billion	$2.4 - $2.7 billion	Completed the divestiture of ASP in Q2
Effective Tax Rate[4]	17.5% - 18.5%	17.0% - 18.0%	Includes the updated impact associated with the ASP gain
Adjusted EPS (Operational)[2,4]	$8.73 - $8.83 6.7% - 7.9%	$8.73 - $8.83 6.7% - 7.9%	
Adjusted EPS (Reported)[3,4]	$8.53 - $8.63 4.3% - 5.5%	$8.53 - $8.63 4.3% - 5.5%	FX ($0.20) or (2.4%) impact

Johnson & Johnson

[1] Non-GAAP measure; excludes acquisitions and divestitures
[2] Non-GAAP measure; excludes the impact of translational currency
[3] Euro Average Rate: July = $1.12 April = $1.12
[4] Non-GAAP measure; excludes intangible amortization expense and special items
[5] Sales less: COGS, SM&A and R&D expenses

17

Image Shown: *Johnson & Johnson revised its expected sales growth rate for 2019 upwards, however, pressures on its operating margin forced management to keep adjusted EPS forecasts the same.* ***Image Source:*** *Johnson & Johnson – IR Presentation*

Please see *Kinder Morgan…*on next page

*Kinder Morgan…*from previous page

While Johnson & Johnson is facing some major headwinds as it relates to foreign currency movements and ongoing legal troubles (stemming from its alleged role in the opioid crisis to the asbestos lawsuits relating to its talc powder offerings), we appreciate its positive sales guidance revision. We see Johnson & Johnson's legal liabilities as being manageable, but various legal challenges do pose a distraction from the company's longer term goals.

Investing in the Future

Another space the company is performing well in relates to controlling its selling, marketing and administration expenses. As a percent of revenue, that line item fell by 50 basis points year-over-year last quarter, enabling Johnson & Johnson to allocate more towards R&D (which rose by 30 basis points as a percent of revenue) to better fund its drug pipeline and other potential future offerings. That includes pushing for greater use of Erleada to treat prostate cancer, which was approved by the US FDA back in February 2018.

Expanding on that, Johnson & Johnson's Phase 3 TITAN study found that a combination of Erleada and androgen deprivation therapy (hormone therapy) was effective at treating metastatic castration-sensitive prostate cancer ("mCSPC"). That study's results were announced in a May 31 press release, the same day the company presented the data to the American Society for Clinical Oncology. Now the company is seeking approval to use Erleada to treat patients with mCSPC from the FDA.

In order to fund these kinds of studies, Johnson & Johnson needs to invest heavily in R&D, and that's just what the company is doing. **We are very supportive of Johnson & Johnson's focus on healthcare and pharmaceutical investments.** R&D expenses were equal to 13% of the firm's revenue during the second quarter of 2019.

What We Think

Here is a concise summary of our thoughts on Johnson & Johnson from our 16-page Stock Report (with minor adjustments);

> *"J&J has built one of the most comprehensive health care businesses, generating approximately 70% of revenue from top positions in its respective markets. The firm is focused on innovation while broadening its geographic presence. Consumer product sales are roughly 17% of its operations. The company was founded in 1885 and is headquartered in New Brunswick, New Jersey. J&J has 26 platforms/products that boast $1+ billion in annual sales as of the end of 2018. It plows ~10% of annual sales into R&D (that figure has more recently been closer to ~13%), a focus we like, but litigation risk continues to cast a shadow over shares. Management has been productive in reducing net debt of late.*
>
> *J&J's pharma portfolio is impressive. REMICADE has ~90% share of the US market for IV immunology products by volume, but the therapy's US exclusivity expired in 2018. STELARA (exclusivity through 2023 in US) and SIMPONI (exclusivity through 2024 in US) are also key profit drivers. Biosimilars competition is accelerating, but J&J's Oncology division is growing at a tremendous pace. Top-line growth at Johnson & Johnson will be driven by its impressive pharma portfolio pipeline, which will be supported by its steady consumer product business. The firm has at least 10 new molecular entities it believes have $1+ billion in individual annual sales potential that it expects to launch or file for approval from 2017-2021…"*

Please see *Kinder Morgan…*on next page

*Kinder Morgan…*from previous page

Furthermore;

> *"**J&J's has raised its dividend for 56 years consecutive years as of 2018**. That streak continued in April 2019 as the company approved a 5.6% per share increase in its quarterly dividend. Its annual payout has advanced from just $0.43/share in 1997 to its current robust payout of $3.80/share on an annualized basis. J&J is a holding in both simulated newsletter portfolios, and we expect future dividend growth to be driven by robust free cash flow generation."*

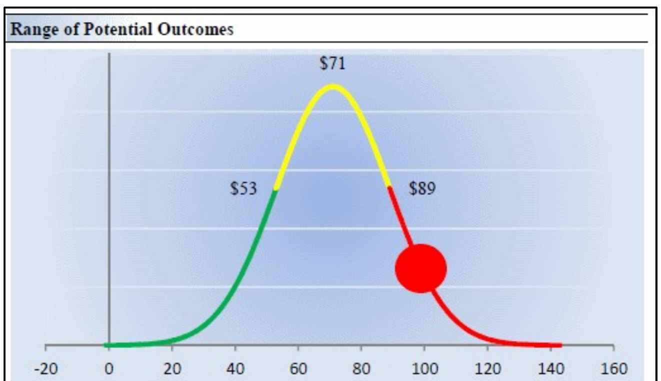
We would like to highlight that Johnson & Johnson generated $18.5 billion in free cash flow last year, which easily covered $9.5 billion in dividend payments. Share buybacks totaled $5.9 billion in 2018.

Concluding Thoughts

Shares of JNJ yield 2.9% and remain at the lower end of our $121-$181 fair value estimate range for Johnson & Johnson. We see its legal troubles as representing the greatest hurdle to capital appreciation in the short term (again, we see those liabilities as manageable) but appreciate the apparently strong underlying demand for its products.

***Disclosure:** Callum Turcan does not own any of the securities mentioned in the article above.*

We Just Can't Justify Starbucks' Lofty Valuation, Even After Its Great Quarter



Our discounted cash flow process values each firm on the basis of the present value of all future free cash flows. Although we estimate the firm's fair value at about $71 per share, every company has a range of probable fair values that's created by the uncertainty of key valuation drivers (like future revenue or earnings, for example). After all, if the future were known with certainty, we wouldn't see much volatility in the markets as stocks would trade precisely at their known fair values. Our ValueRisk™ rating sets the margin of safety or the fair value range we assign to each stock. In the graph above, we show this probable range of fair values for Starbucks. We think the firm is attractive below $53 per share (the green line), but quite expensive above $89 per share (the red line). The prices that fall along the yellow line, which includes our fair value estimate, represent a reasonable valuation for the firm, in our opinion.

***Image Shown:** The red dot signifies where shares of SBUX are trading at as of midday trading on July 26. Shares of Starbucks are trading well above the top end of our Fair Value Range. We just can't see a way to justify its current lofty valuation other than, to quote Alan Greenspan, irrational exuberance.*

By Callum Turcan

Starbucks (SBUX) posted a great fiscal third quarter 2019 earnings report on July 25, sending shares higher the next day as investors took in its 6% year-over-year growth in comparable store sales and full fiscal year guidance raise.

Please see *We Just Can't…*on next page

*We Just Can't…*from previous page

Management now forecasts Starbucks will post $2.80-$2.82 in non-GAAP EPS in fiscal 2019, up from $2.42 in fiscal 2018 and ahead of previous guidance calling for $2.75 - $2.79 in non-GAAP EPS. That's good for 16% annual growth at the midpoint, aided by Starbucks' share buyback program. Starbucks' guidance calls for 4% comparable store sales growth worldwide (up from 3%-4%) and 7% GAAP revenue growth (up from 5% - 7%) for fiscal 2019 on an annual basis. Please note that Starbucks' fiscal year ends in September, and that shares of SBUX yield 1.5% as of this writing.

While Starbucks has a promising growth trajectory ahead of it, we see its valuation as stretched after updating our model. The top end of our fair value estimate range stands at $89/share, well below where SBUX is trading at as of this writing.

Stellar Performance in China

The coffee chain plans to open 2,000 net stores this fiscal year, down from its 2,100 target previously, including 600 in China. While the global economy is slowing down and China's economy has been feeling the heat from US tariffs, Starbucks still reported 6% year-over-year comparable sales growth in the country. Management noted that investments in digital programs such as customer loyalty programs and delivery services were key to driving its strong performance. Additionally, the company has been offering more novel beverages at its stores (just like in the US) to much success. Starbucks' CEO Kevin Johnson mentioned this during the company's latest quarterly conference call (emphasis added);

> *"China also delivered a very strong quarter, and we remain bullish on the long-term market opportunity as we deploy capital to build new stores and expand our presence…* ***We introduced exciting new beverages, including the launch of Modern Mixology, a unique range of cold beverages that originated at our Shanghai Rose Street with local taste preferences in mind****."*

Furthermore, Starbucks made sure to highlight the positive impact its relationship with Alibaba Group Holding Limited (BABA) has had on its performance in the Middle Kingdom. That agreement was reached back in August 2018 and already appears to be panning out favorably with room for an enormous amount of upside ahead. From Starbucks' quarterly conference call (emphasis added):

> *"****The China Digital partnership with Alibaba has enabled us to expand Starbucks delivers to approximately 2,900 stores across nearly 80 cities by the end of Q3****. This puts us on track to exceed 3,000 stores or roughly 75% of our total store base by the end of this fiscal year. We continue to see strong performance in key cities, including a meaningful, incremental transaction lift, increased ticket and strong operational performance."*

During the third quarter, deliveries represented 6% of Starbucks' total sales volume in China and played a key role in driving comparable sales growth. As a relatively new segment of Starbucks' Chinese operations, there is plenty of potential upside ahead.

Starbucks' China store count grew by 16% year-over-year in the third quarter, hitting 3,900 by the end of the period. Going forward, Starbucks plans to have its new store locations built with delivery in mind, integrating its in-store and delivery operations to make this digitally enabled strategy scalable. The company launched a mobile order and pay option in Beijing and Shanghai in May 2019 and has since expanded that offering to ~1,300 stores in four major cities in China. This is just the beginning, as management expects to continue investing in and expanding Starbucks' digital, delivery and mobile strategy in China over the coming years.

Trade talks between the US and China have started up once again, with plans for "high-level" talks to be held in the US this September. No deal is within sight, but it's clear both parties are at least trying to come to an agreeable arrangement. How the upcoming 2020 elections in the US impacts China's calculus, and that of President Trump's, remains to be seen.

Please see *We Just Can't…*on next page

*We Just Can't…*from previous page

Another Great Quarterly Performance in the US

Starbucks' US comparable sales growth hit 7% in the fiscal third quarter on a year-over-year basis due to the popularity of its new Nitro Cold Brew offerings. Cold beverages are driving traffic to Starbucks' stores in the afternoon, which helped drive 3% year-over-year growth in comparable transactions. Management plans to keep the ball rolling by making advertising investments highlighting its new offerings as Starbucks rolls out Nitro Cold Brew to all its stores nationwide by the end of its 2019 fiscal year.

This kind of innovation, specifically as it relates to launching new products, is why Starbucks stays ahead of the pack when it comes to coffee shops. It maintains Starbucks' brand power as the cold beverage is still in the "affordable luxury" segment if you will and provides a new avenue for growth by winning over customers during different times of the day. We see Starbucks continuing to generate a ROIC ex-goodwill that's far and away above its estimated WACC over the next few years, earning the firm a Very Attractive Economic Castle rating from Valuentum.

Loyalty programs are a great way to maintain brand power and Starbucks mentioned that it had modified its U.S. loyalty program ('Starbucks Rewards') during the third quarter to make it easier for customers to redeem points. Initial results have been very favorable as the company reported 14% year-over-year growth in its 90-day active rewards members last quarter, reaching over 17 million active members. Here's what management had to say about this during the firm's quarterly conference call;

> *"Loyalty members accounted for 42% of U.S. tender, and we are seeing evidence of improved engagement across our Starbucks Rewards member base. More specifically, the growth of active rewards members, the enhancements to the Starbucks Rewards Program, adoption of mobile order and pay, and the personalized marketing efforts contributed nearly 2% of comp sales growth in the U.S. for the quarter, an improvement from recent quarters."*

Delivery services and digital investments to support those operations are being expanded across the US. While Starbucks hasn't seen its US delivery business, in partnership with Uber Technologies (UBER) Uber Eats, contribute meaningful to its financials yet, management still sees this as a long-term growth opportunity. These services are available from 2,700 stores in roughly a dozen markets, and Starbucks plans to further expand its relationship with Uber across the US in early-2020.

Concluding Thoughts

Starbucks has been on a roll and we appreciate that, but we want to caution readers that we see the valuation of SBUX as stretched. The company's GAAP top-line and GAAP operating income both grew by 8% year-over-year in the third quarter, which is great, and the firm is firing on all cylinders in its key markets like China, the US, and elsewhere.

However, after updating our fair value estimate to $71/share on July 26, up from $61/share previously, with the top end of our fair value estimate range standing at $89/share. As of this writing, shares of Starbucks are trading north of $97/share. Under reasonable assumptions, we can't justify where SBUX is trading at currently.

Exogenous pressures could stymie Starbucks ability to grow in the medium term, with an eye towards a global synchronized slowdown in economic growth beginning to emerge. That could put a tremendous amount of pressure on Starbucks' share price in the future. Consumer spending in the US and China has held up well in the face of numerous headwinds and ongoing tit-for-tat trade war tariffs, but many organizations, including the IMF, see a synchronized slowdown in economic growth as increasingly likely as we enter a new decade. The US economy is strong now, but once the tailwind from fiscal stimulus begins to fade, growth in economic activity will likely move lower with no relief coming from overseas demand.

Please see *We Just Can't…*on next page

*We Just Can't…*from previous page

Valuation Assumptions

In Millions of USD (except for per share items)	5-year Projections	
Revenue CAGR %	7.1%	
Avg. EBIT Margin %	20.0%	
Avg. Cash Tax Rate %	21.0%	
Earnings Before Interest CAGR %	17.1%	
Earnings Per Share CAGR %	8.9%	
Free Cash Flow to the Firm CAGR %	29.0%	
Earnings before interest = Net operating profits less adjusted taxes	Long-term Projections	
Phase II --> III FCFF CAGR %	4% (II)	3% (III)
Cost of Equity %	9.2%	
After-tax Cost of Debt %	5.0%	
Discount Rate (WACC) %	8.9%	
Synthetic credit spread = 2%	Results	
Phase I Present Value	17,623	
Phase II Present Value	45,746	
Phase III Present Value	36,350	
Total Firm Value	99,719	
Net Balance Sheet Impact	-502	
Total Equity Value	99,217	
Diluted Shares Outstanding	1,394.6	
Fair Value per Share	$71.00	

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Starbucks and the break down to the firm's total equity value, which we estimate to be about 99.22USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $71 per share fair value estimate.

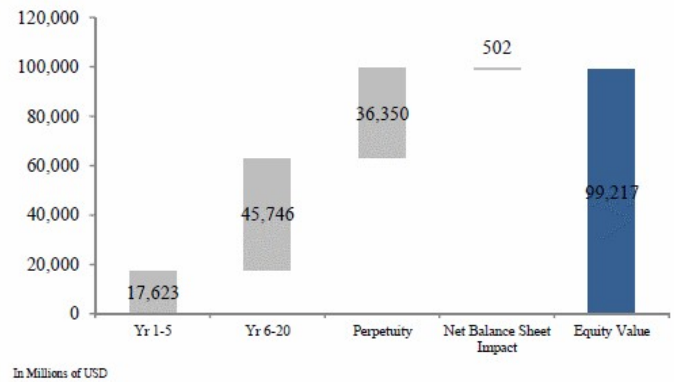


Image Shown: *We just can't find a way to justify Starbucks' very lofty valuation under reasonable assumptions.*

Disclosure: *Callum Turcan does not own any of the securities mentioned in the article above.*

McDonald's Not on the Value Menu

We can't get anywhere close to McDonald's share price with our discounted cash-flow valuation process. That doesn't mean that shares are destined to fall, but it may indicate that the stock has pulled forward future returns. In any case, investors in McDonald's should be cautious.

By Brian Nelson, CFA

McDonald's (MCD) has done a wonderful job in years past, pursuing all-day breakfast and transitioning (even) more to a franchise business model, but these changes are now behind the fast-food restaurant. Our fair value estimate for McDonald's is in the mid-$150s (its shares are trading over $200), and frankly, we're having a very difficult time coming anywhere close to how high the market is valuing shares.

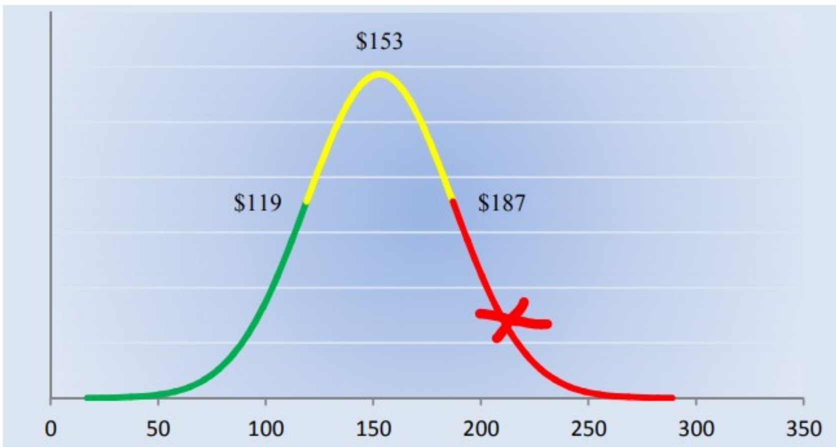
The fast-food giant released its second-quarter results on July 26, a period which saw McDonald's global comparable store sales advanced 6.5%, a nice pace. But that's not the whole story, in our view. The restaurant is trading at roughly 24 times expected 2020 earnings and holds more than $30 billion on the balance sheet in net debt. The reported consolidated numbers are what we're focusing on, and they weren't that great at all for a company with these back-of-the-envelope valuation metrics.

During the second quarter, consolidated revenues were flat with the prior year, while consolidated operating income advanced 1%. We're not saying shares of McDonald's are going to collapse, but we do think that investors should be exercising some caution at these levels. The company's Dividend Cushion ratio stands at 0.4, so dividend health is something to keep in mind, too. We don't think McDonald's is the best idea in the restaurant space by a long shot.

Please see *McDonald's Not…*on next page

*McDonald's Not…*from previous page

Range of Potential Outcomes



Our discounted cash flow process values each firm on the basis of the present value of all future free cash flows. Although we estimate the firm's fair value at about $153 per share, every company has a range of probable fair values that's created by the uncertainty of key valuation drivers (like future revenue or earnings, for example). After all, if the future were known with certainty, we wouldn't see much volatility in the markets as stocks would trade precisely at their known fair values. Our ValueRisk™ rating sets the margin of safety or the fair value range we assign to each stock. In the graph above, we show this probable range of fair values for McDonald's. We think the firm is attractive below $119 per share (the green line), but quite expensive above $187 per share (the red line). The prices that fall along the yellow line, which includes our fair value estimate, represent a reasonable valuation for the firm, in our opinion.

Image Source*: Valuentum's 16-page Report of McDonald's.*

Down below is a concise summary of how we view the restaurant industry, specifically as it relates to fast food and coffee offerings, from McDonald's 16-page Stock Report;

> *"The restaurant industry has benefited from a long-term trend toward eating out, but the space has become increasingly more competitive as new concepts are introduced and successful chains expand. Not only are there pricing pressures and trade-down threats, but rising costs for commodities and labor have pressured profits. Barriers to entry are low, and many constituents have a difficult time differentiating themselves. We tend to like larger chains that benefit from scale advantages and international expansion opportunities, though niche franchises can be appealing. We're neutral on the structure of the group."*

With that said, we wanted to mention a few things about the restaurant space more recently. According to a July 29 post by Seeking Alpha, the best-performing restaurant stocks this year through July 26 are Chipotle (CMG), up 81%, and Wingstop (WING), up 51%. These two stood head and shoulders above the rest, while Fiesta Restaurant Group (FRGI) was on the list of the worst-performing restaurant stocks so far this year.

Though we maybe should have kept a few of these ideas open a bit longer, we're doing an awesome job getting the right names in front of readers, and that's what's most important. Chipotle, for example, was a former Best Ideas Newsletter portfolio idea, Wingstop a former Exclusive capital appreciation idea, and Fiesta Restaurant Group, a former Exclusive short-idea consideration. All three were closed as winners!

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

*Please note that this article originally appeared on our website on July 12, 2018. **This metric has been included in the screener since October 2018.***

If The Dividend Is Secure, What Does That Imply With Respect to Financial Leverage?

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

As more and more investors rely on company dividends for income, dividends, in our view, have become more debt-like commitments in nature, especially from the perspective of dividend-growth or income-oriented shareholders. We plan to roll out a new measure of financial leverage that considers both the company's debt and the present value of its future expected cash dividend obligations, which, in the eyes of die-hard dividend-growth or income-oriented shareholders, may be implicitly assumed to be debt-like commitments in substance. We think this leverage ratio can be used in conjunction with the Dividend Cushion ratio to gain additional insight into the dividend-paying financial health of an entity.

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

Please see *A New Measure...*on next page

*A New Measure…*from previous page

By Brian Nelson, CFA

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

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

The ratio RCF/net debt is a rare credit metric, in our view, that may be applicable to that of the dividend growth or income investor. Where a bond holder may implicitly assume that dividends can be cut/reduced in order to shore up cash flow to service debt repayment, from the perspective of the equity investor (one that is counting on that dividend for income), the view is quite different.

Please note that in the eyes of many die-hard dividend growth or income investors, for example, the dividend payment is often viewed, in great substance, as the equivalent of a debt-like cash commitment. RCF/net debt provides some context in how much cash flow is left over after paying dividends or distributions to service the debt, but it may not be a pure measure of dividend-adjusted leverage, as in the traditional sense (where EBITDA may be in the denominator, for example, as in net debt-to-adjusted EBITDA).

In any case, what we like about the RCF/net debt ratio is that it does not assume that dividends are *not* going to be paid, as in the case of other traditional credit metrics that effectively ignore the dividend or distribution as an important cash outflow (and an implicit reduction to credit quality). The RCF/net debt ratio assumes that the dividend is a debt-like cash commitment reducing funds from operations, something we believe is very relevant to the dividend growth or income-oriented shareholder that is depending heavily on that dividend or distribution payment.

What RCF/net debt also considers is that the same money distributed to shareholders or unitholders is not also used twice as same money that can be used to service the debt (double counting). In our view, it should be generally assumed that such capital can only be used once; if it's paid out as a dividend/distribution, it generally should not be assumed that it is also capital that can be used for debt repayment.

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

Please see *A New Measure…*on next page

***A New Measure...*from previous page**

Here's what we said back in 2015;

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

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

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

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

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

Coca-Cola's Valuation Is Stretched

By Callum Turcan

Coca-Cola Company (KO) posted a great second quarter report for 2019 on July 23, sending shares up 6% on the day. Management surprised the market by upgrading their forecast for Coca-Cola's full-year performance with guidance for organic revenue, constant currency operating income, net operating cash flow, and capital expenditures for 2019 all getting a boost. **We still think shares of KO are overvalued as the market has gotten ahead of itself.** Consumer staples companies trading at premium valuations late in the business cycle are prime examples of how irrational exuberance can seep into every corner of the market.

Furthermore, the IMF just downgraded global GDP growth projections for both 2019 and 2020, and while the US economy continues to chug along, the US Fed is fearful enough of a global synchronized downturn that chances of a series of "insurance" rate cuts are growing. We value shares of Coca-Cola at $48 per share at the top end of our fair value estimate range, well below where shares are trading at as of this writing. Shares of KO yield 3.0%, and please note that Coca-Cola's second quarter ended on June 28, 2019.

Guidance Upgrades

Let's dig into Coca-Cola's guidance upgrades (for reference, these are annual growth figures). Non-GAAP organic revenue growth was revised up to 5% in 2019 (from 4% previously), while non-GAAP constant currency net revenues was revised down to 12% (from 12% -13% previously) due to Coca-Cola increasing its expected foreign currency movement headwind to 4% (from 3% -4% previously) and due to its tailwind from net A&D and other activities shrinking to 7% (previously estimated at 8% - 9%).

While there is a ton of noise and adjustments in these figures, the most important thing Coca-Cola's management team wanted to communicate to the market was that there is strong underlying demand for its products. Foreign currency headwinds remain a major obstacle in light of the strong US dollar.

When it comes to operating income, Coca-Cola now sees its non-GAAP constant currency operating income for 2019 growing by 11%-12% this year (up from 10%-11%), with net A&D activity providing a "low single-digit tailwind." The headwinds from foreign currency movements was upgraded to 7%-8% (from 6%-7% previously), meaning that foreign currency movements are expected to consume a large portion of the guidance increase (if not, all of it).

Perhaps the most important part of these guidance revisions was the upward movement in Coca-Cola's cash from operations forecast for 2019. Now management is targeting $8.5 billion in cash from operations, up from $8.0 billion previously, while capital expenditures are expected to come in at $2.4 billion, up from $2.0 billion previously. **That implies forecasted free cash flows are expected to come in slightly stronger than previously expected.**

While underlying demand for Coca-Cola's offerings remains strong, foreign currency headwinds have eaten into most of those gains. The valuations of consumer staples companies are stretched as the market bids up equities in the face of potential US Fed rate cuts and other factors.

Cash Flow and Dividend Commentary

During the first six months of 2019, Coca-Cola generated $4.5 billion in net operating cash flow while allocating $2.9 billion towards capital expenditures, enabling $1.6 billion in free cash flows. **Those free cash flows covered the majority, but not all, of its $1.7 billion in dividend payments this period.**Share buybacks totaled $0.7 billion, while share issuances totaled $0.6 billion, making that largely a wash as it relates to cash outlays and inlays.

Please see *Coca-Cola's…*on next page

*Coca-Cola's…*from previous page

Coca-Cola ended June 28, 2019, with $9.3 billion in cash and cash equivalents on top of $4.1 billion in marketable securities, which includes Coca-Cola's stake in Monster Beverage Corporation (MNST). Excluding its marketable securities as those are strategic assets, Coca-Cola's net debt load sits at $26.5 billion as its $35.8 billion in total debt (short-term debt, loans payable, and long-term debt) looms large. Coca-Cola's Dividend Cushion ratio stands at 1.2x, which is alright but not great due to its hefty net debt burden.

Reviewing Coca-Cola's Financials

As reported on a GAAP basis, Coca-Cola's revenue rose 5% to $18.7 billion year-over-year during the first six months of 2019 while its GAAP gross margin contracted by ~160 basis points. Management noted that the expansion into new product categories (such as hot beverages and coffee drinks) would put some downward pressure on gross margins, but was adamant that productivity gains would more than offset that during Coca-Cola's quarterly conference call (emphasis added):

> *"**Will expansion of new categories cause the compression of the gross profit margin, we had previously said yes, it might be a little, but it will be offset by productivity. What you've seen in the first half is it's a wash.** We've been able to drive the Coke franchise and the innovation and manage the portfolio such that the net impact on gross margin is a wash, which is a great result. And then obviously, we're getting some flow-through of our ongoing productivity efforts. **Just because we haven't announced the new program, we are still focused on using resources effectively in the SG&A on the back -- in the back office and investing wisely with the marketing such that this operating leverage is flowing through into the margin.** So, I think the game plan is intact and we're continuing to drive against it."*

Coca-Cola's GAAP operating income climbed by 15% year-over-year to $5.4 billion during the first half of 2019 versus the same period last year as its GAAP operating margin jumped by ~240 basis points. **Management is doing their best to manage Coca-Cola's operating expenses to offset pressure on gross margins, which we appreciate.** However, we caution that a large part of this boost came from a precipitous drop in other operating charges, aided by SG&A expenses rising by only 2% year-over-year during the first half of 2019.

The push into new beverages and new markets, seen through its purchase of CHI (which sells iced teas, juices, and dairy-based drinks in West Africa) and Costa (which sells hot beverages and coffee products on a global level), will help support Coca-Cola's long-term growth trajectory. On the other hand, this strategy does come with risks including pressure on gross margins and potential foreign currency headwinds.

Concluding Thoughts

While the market clearly liked Coca-Cola's earnings report, we believe investors are getting ahead of themselves. **We aren't interested in shares of KO at these levels, and we caution readers on the stretched valuation of consumer staples companies in general.** Coca-Cola's free cash flows during the first half of 2019 didn't fully cover its dividend payments, while a large net debt load will make growing that payout much harder in the future.

Disclosure: *Callum Turcan does not own any of the securities mentioned in the article above.*

About the Valuentum Dividend Cushion™ Ratio

By Valuentum Analysts

History has revealed that the best performing stocks during the previous decades have been those that shelled out ever-increasing cash to shareholders in the form of dividends. In a recent study by Ned Davis Research, S&P 500 stocks that initiated dividends or grew them over time registered roughly a 9.6% annualized return since 1972 (through 2010), while stocks that did not pay out dividends or cut them performed poorly over the same time period.

Such analysis is difficult to ignore, and we believe investors may be well-rewarded in future periods by finding the best dividend-growth stocks out there. As such, we've developed a rigorous dividend investment methodology that uncovers firms that not only have the strongest dividends but also ones that are poised to grow them long into the future.

How did we do this? Well, first of all, we scoured our stock universe for firms that have cut their dividends in the past to uncover the major drivers behind the dividend cut. This is what we found out: The major reasons why firms cut their dividend had to do with preserving cash in the midst of a secular or cyclical downturn in demand for their products/services or when faced with excessive leverage (how much debt they held on their respective balance sheets) during tightening credit markets.

The Importance of Forward-Looking Dividend Analysis

Informed with this knowledge, we developed the forward-looking Valuentum Dividend Cushion™, which is a ratio that gauges the safety of a dividend over time.

Most dividend analysis that we've seen out there is backward-looking – meaning it rests on what the firm has done in the past. Although analyzing historical trends is important, we think assessing what may happen in the future is even more important. The S&P 500 Dividend Aristocrat list, or a grouping of firms that have raised their dividends for the past 25 years, is a great example of why backward-looking analysis can be painful. One only has to look over the past few years to see the removal of well-known names from the Dividend Aristocrat List (including General Electric and Pfizer) to understand that backward-looking analysis is only part of the story. After all, you're investing for the future, so the future is what you should care about more.

We want to find stocks that will increase their dividends for 25 years into the future, not use a rear-view mirror to build a portfolio of names that may already be past their prime dividend growth years. The Valuentum Dividend Cushion™ ratio measures just how safe the dividend is in the future. It considers the firm's net cash on its balance sheet (cash and cash equivalents less debt) and adds that to its forecasted future free cash flows (cash from operations less capital expenditures) and divides that sum by the firm's future expected dividend payments. At its core, it tells investors whether the firm has enough cash to pay out its dividends in the future, while considering its debt load. If a firm has a Valuentum Dividend Cushion™ above 1, it can cover its dividend on the basis of our estimates, but if it falls below 1, trouble may be on the horizon.

In the study, the Valuentum Dividend Cushion™ process caught every dividend cut made by a non-financial, operating firm that we have in our database, except for one (Marriott). But interestingly, the Valuentum Dividend Cushion™ indicated that Marriott should have never cut its dividend, and sure enough, two years after the firm did so, it raised it to levels that were higher than before the cut.

Please see *About the Valuentum Dividend Cushion…*on next page

*About the Valuentum Dividend Cushion…*from previous page

Here are the results of the study (a Valuentum Dividend Cushion™ below 1 indicates the dividend may be in trouble). The Valuentum Dividend Cushion™ ratio shown in the table below is the measure in the year before the firm cut its dividend, so it represents a predictive indicator. The measure continues to do well by members in walk-forward analysis (beyond the limitations of a backtested academic study).

The following link, for example, provides more information of the Dividend Cushion ratio tested in a robust out-of-sample walk-forward study across our coverage universe from its inception in 2012 through 2017:

Our Dividend Growth Methodology Is Rocking! ***http://www.valuentum.com/articles/20130528***

The Valuentum Dividend Cushion Caught These Dividend Cuts in Advance

A Valuentum Dividend Cushion Score Below 1 Indicates a Firm's Dividend is At Risk in the Years Ahead

Dividend Cutter	Cut Date	Dividend Cushion (Before Cut)	Reason for Dividend Cut
Avery Dennison (AVY)	31-Jul-09	0.66	Reduced dividend to support debt-reduction efforts.
ConAgra Foords (CAG)	16-Mar-06	-0.59 (1)	Restructuring, divestitures.
Constellation (CEG)	18-Feb-09	-4.36	Refocus on core business of generating and selling power.
DR Horton (DHI)	6-May-08	-0.03	Housing turmoil.
Gannett Co. (GCI)	25-Feb-09	-0.06	Excessive debt; preserve cash amid downturn of newspaper industry.
La-Z-Boy (LZB)	17-Feb-09	0.89	Suspended dividend to preserve cash amid downturn in home furnishings.
Marriott Intl (MAR)	1-May-09	2.18 (2)	Suspended dividend in the wake of weak business travel, but dividend achieved record highs again, May 6, 2011.
Masco Corp (MAS)	11-Feb-09	-0.74	Cut dividend to ensure ability to fund operations and service debt coming due.
New York Times (NYT)	20-Nov-08	0.04	Effort to preserve cash. Downturn in newspaper industry. Loss of investment-grade credit rating.
Pfizer (PFE)	26-Jan-09	0.54	Bought Wyeth to diversify revenue base. Raised $22 billion+ in debt.
Sara Lee Corp (SLE)	8-Aug-06	0.70	Streamlining operations, business unit divestitures to raise cash.
Sunoco Inc. (SUN)	6-Oct-09	-0.85 (3)	Poor margins, overseas competition.
SuperValu (SVU)	20-Oct-09	-5.78	Rising unemployment, competition from Wal-Mart, etc.
Valero Energy (VLO)	27-Jan-10	0.15	Lower demand for gas and diesel.
Vulcan Materials (VMC)	14-Oct-11	-1.42	Free up much-needed cash amid downturn in aggregate demand.

(1) Forecast period for ConAgra, 2007 through 2011.

(2) Marriott is an instance where management prematurely cut its dividend, in our opinion. The Cushion reflected little risk at the time of cut, and sure enough Marriott restored its payout to record high

(3) Forecasts adjusted to reflect Sunoco's poor free cash flow trends beyond last reported year.

Backtesting Methodology: Net balance sheet (year prior to dividend cut). Free cash flow for years beginning in year of dividend cut through reported years. If reported years do not total five, last reported year is extrapolated for remainder of forecast period. Dividends paid reflects what the dividends would be ex dividend cut.

Please see *About the Valuentum Dividend Cushion…*on next page

*About the Valuentum Dividend Cushion…*from previous page

At the very least, using the Valuentum Dividend Cushion™ can help you avoid firms that are at risk of cutting their dividends in the future. And we are the only firm out there that does this type of in-depth analysis for you. We provide the Valuentum Dividend Cushion™ ratio in the dividend reports and monthly Dividend Growth Newsletter, and we also scale the safety of a firm's dividend based on this measure in simple terms: Excellent, Good, Poor, Very Poor.

Here's a glimpse of the Valuentum Dividend Cushion™ ratio (as of November 2017) for a sample set of firms in our coverage universe. Please note that the current score on these and hundreds more are available with a membership to our website:

Company Name	Symbol	Sector	Div Cushion
Coca-Cola	KO	Consumer Staples	1.4
PepsiCo	PEP	Consumer Staples	1.2
Air Products & Chemicals	APD	Materials	1.3
Ecolab	ECL	Materials	1.2
PPG Industries	PPG	Materials	2.5
Cintas Corp	CTAS	Industrials	2.7
3M	MMM	Industrials	1.6
W.W. Grainger	GWW	Industrials	1.4
Emerson Electric	EMR	Industrials	2.1
Hormel Foods	HRL	Consumer Staples	2.2
McCormick	MKC	Consumer Staples	1.7
Archer-Daniels-Midland	ADM	Consumer Staples	2.1
Sysco	SYY	Consumer Staples	1.4
Target	TGT	Consumer Staples	1.4
Walgreens Boots Alliance	WBA	Consumer Staples	2.0
Wal-Mart	WMT	Consumer Staples	1.6
Leggett & Platt	LEG	Consumer Discretionary	1.3
Clorox	CLX	Consumer Staples	1.2
Colgate-Palmolive	CL	Consumer Staples	1.8
Johnson & Johnson	JNJ	Consumer Staples	2.2
Kimberly-Clark	KMB	Consumer Staples	1.2
Procter & Gamble	PG	Consumer Staples	1.8
VF Corp	VFC	Consumer Discretionary	1.6
Dover	DOV	Industrials	1.2
Illinois Tool Works	ITW	Industrials	1.6

Understanding Dividend Growth

It takes time to accumulate wealth through dividends, so dividend growth investing requires a long-term perspective. We assess the long-term future growth potential of a firm's dividend, and we don't take management's word for it. Instead, we dive into the financial statements and make our own forecasts of the future to see if what management is saying is actually achievable. We use the Valuentum Dividend Cushion™ as a way to judge the capacity for management to raise its dividend – how much cushion it has – and we couple that assessment with the firm's dividend track record, or management's willingness to raise the dividend.

Please see *About the Valuentum Dividend Cushion…*on next page

*About the Valuentum Dividend Cushion…*from previous page

In many cases, we may have a different view of a firm's dividend growth potential than what may be widely held in the investment community. That's fine by us, as our dividend-growth investment horizon is often longer than others'. We want to make sure that the firm has the capacity and willingness to increase the dividend years into the future and will not be weighed down by an excessive debt load or cyclical or secular problems in fundamental demand for their products/services. We scale our dividend-growth assessment in an easily-interpreted fashion: Excellent, Good, Poor, Very Poor.

What Are the Dividend Ideas We Seek to Deliver to You in Our Newsletter?

First of all, we're looking for stocks with dividend yields that are greater than the average of the S&P 500, or about 2% (but preferably north of 3%). This excludes many names, but we think such a cutoff eliminates firms whose dividend streams aren't yet large enough to generate sufficient income. Second, we're looking for firms that register an 'EXCELLENT' or 'GOOD' rating on our scale for both safety and future potential growth. And third, we're looking for firms that have a relatively lower risk of capital loss, as measured by our estimate of the company's fair value.

The Dividend Cushion Ratio Helps Income Investors

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

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

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

The Valuentum Dividend Cushion™ ratio has an excellent track record of predicting dividend cuts. For more information, please select the following link (login required):

http://www.valuentum.com/articles/20130528

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Fair Value Range. The fair value range represents an upper bound and lower bound, between which we would consider the firm to be fairly valued. The range considers our estimate of the firm's fair value and the margin of safety suggested by the volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow (the determinants behind our ValueRisk™ rating).

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

Dividend Track Record. We assess each firm's dividend track record based on whether the fundamentals of the firm have ever forced it to cut its dividend. If the firm has ever cut its dividend (within the last 10 years), we view its track record as RISKY. If the firm has maintained and/or raised its dividend each year (over the past 10 years), we view its track record as HEALTHY.

Dividend Safety. We measure the safety of a firm's dividend by adding its net cash to our forecast of its future cash flows and divide that sum by our forecast of its future dividend payments. This process results in a ratio called the Dividend Cushion™. Scale: Above 2.75 = EXCELLENT; Between 1.25 and 2.75 = GOOD; Between 0.5 and 1.25 = POOR; Below 0.5 = VERY POOR.

Valuentum Dividend Cushion™. This is a proprietary Valuentum measure that drives our assessment of the firm's Dividend Safety rating. The forward-looking measure assesses dividend coverage via the cash characteristics of the business.

Dividend Growth Potential. We blend our analysis of a firm's Dividend Safety with its historical Track Record, while also considering historical dividend growth trends. We believe such a combination captures a firm's capacity (cash flow) and willingness (track record) to raise its dividend in the future. Scale: EXCELLENT, GOOD, POOR, VERY POOR.

Risk of Capital Loss. We think capital preservation is key for the dividend investor. As such, we evalute the risk of capital loss by assessing the intrinsic value of each firm based on our discounted cash-flow process. If a firm is significantly OVERVALUED, we think the risk of capital loss is HIGH. If a firm is FAIRLY VALUED, we think the risk of capital loss is MEDIUM, and if a firm is UNDERVALUED, we think the risk of capital loss is LOW.

Dividend Strength. Our assessment of the firm's dividend strength is expressed in a matrix. If the safety of a firm's dividend is EXCELLENT and its growth prospects are also EXCELLENT, it scores high on our matrix (top right). If the firm's dividend safety and the potential future growth are VERY POOR, it scores lower on our scale (bottom left).