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HIGH YIELD DIVIDEND NEWSLETTER

Tweaking Ideas in the High Yield Dividend Newsletter Portfolio

Changes to simulated High Yield Dividend Newsletter
Added: **5% in Phillip Morris International (PM)**
Removed: **TallGrass Energy (TGE), Iron Mountain (IRM) and Schlumberger (SLB)**
Watching: Australia ETF (EWA)

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"WE ARE MAKING SEVERAL ADJUSTMENTS TO VALUENTUM'S HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO IN THE WAKE OF CHANGING US FED POLICIES AND OTHER MAJOR EVENTS." – CALLUM TURCAN

Image Shown: *Shares of Phillip Morris International Inc (PM) have been broadly flat over the past five years, and more recently have been on an upward climb.*

Summary of newsletter portfolio changes: We are removing Tallgrass Energy (TGE), Iron Mountain (IRM) and Schlumberger (SLB). We are adding 5%+ yielding Philip Morris (PM) to the newsletter portfolio, a stock that we cover in this month's Spotlight piece. We are keeping 10% in cash as the market makes new highs and as we await new opportunities to develop in the wake of changing Fed policies.

By Callum Turcan and Brian Nelson, CFA

High yield dividend investors may have one less thing to worry about. When we launched the High Yield Dividend Newsletter, the Fed was pursuing

contractionary monetary policy, and our biggest concern was the impact that rising interest rates would have on the prices of high yield stocks. High yield stocks tend to have the characteristics of high yield bonds, so when benchmark rates rise, prices tend to fall, all else equal.

Although the performance of 2018 wasn't as strong as we would like, **we're focused on the long term and the high yield aspects of the ideas that we are highlighting in this publication.** That means, we may see volatility around share prices as the Fed takes its foot off the brake and hits the accelerator and vice-versa, but we think this space may remain in vogue for the foreseeable future. The reason is the prevalence of negative interest yielding debt around the world, and if the US economy encounters trouble, we think negative interest rate policy (NIRP) is an option in the States, too.

That means that if things get bad, we think income investors may have to continue to turn to high yield dividend vehicles to get the yield that they're thirsting for. As benchmark rates fall, so does the all-in yield on corporate debt (making newly-issued debt a less viable alternative), and what many thought was once impossible, there is even negative-yielding euro-denominated debt in the speculative-grade territory. Though we pay a lot of attention to the fundamentals of the ideas in the High Yield Dividend Newsletter portfolio, the Fed is going to arguably have the biggest impact on the total returns in this space, even if dividends/distributions advance.

High yield dividend equities are notoriously difficult to value without the complicating factor of the prospect of negative interest rate policy in our lifetimes. **As a reminder, many high yield dividend stocks are dependent on the capital markets to maintain their lofty payouts.** That means, despite what many management teams say, they need to access new capital, whether through equity or debt issuance, to keep paying the dividend at the present levels. In the event of periods of tight credit, we would expect the high yield dividend space to experience the worst performance with the greatest likelihood of dividend cuts. We're always on high alert when it comes to stocks with high yields and investors should be, too.

Let's talk about some of the changes to the High Yield Dividend Newsletter. For starters, **we're going to remove Tallgrass Energy (TGE).** The master limited partnership has been a very high-yield dividend payer since it has been in the newsletter portfolio, and it has delivered on payments without fail. The MLP also raised its quarterly dividend to $0.54 per share July 11, a 1.9% increase, not bad for such a lofty dividend payer, north of 10%. However, the bottom line is that we'd like to reduce our exposure to the MLP arena in the newsletter portfolio, and Tallgrass was the one to get the boot. We still like this idea, but not as much as we once did.

One of our favorite MLPs and holdings in the High Yield Dividend Newsletter portfolio, Enterprise Products Partners (EPD) is bumping up against multi-year highs thanks to strong pipeline volumes. **We're huge fans of Enterprise Products thanks to the transparency it provides income investors in providing both free cash flow and distributable cash flow in press releases (see image below), one of the few MLPs to do so.** The MLP trounced the market consensus estimate in its second-quarter report, released July 31, and it increased its cash distribution by 2.3% over last quarter's payout.

Second Quarter 2019 Highlights

($ in millions, except per unit amounts)	Three Months Ended June 30, 2019	2018
Operating income	$ 1,560	$ 986
Net income attributable to limited partners	$ 1,215	$ 674
Fully diluted earnings per unit	$ 0.55	$ 0.31
CFFO (1)	$ 2,023	$ 1,464
Total gross operating margin (2)	$ 2,081	$ 1,478
Adjusted EBITDA (2)	$ 2,089	$ 1,767
Free cash flow (2)	$ 947	$ 688
Distributable cash flow (2)	$ 1,722	$ 1,420

Image Source: *Enterprise Products Partners, second-quarter press release.*

Here's what the executive team at Enterprise Products had to say about the second quarter, from the quarterly report:

> *Record volumes in our fee-based businesses, contributions from new assets placed into service over the past year and the benefit of natural gas price spreads across Texas*

> *more than offset the impact of lower NGL prices on our natural gas processing activities. For the second quarter of 2019,* ***Adjusted EBITDA increased 18 percent compared to the same quarter last year to a record $2.1 billion, while cash flow from operating activities increased to a record $2.0 billion.***
>
> *Excluding proceeds from asset sales and insurance recoveries, distributable cash flow for the second quarter of 2019 increased 20 percent to a record $1.7 billion compared to the same quarter in 2018 and allowed us to retain $740 million of distributable cash flow during the quarter to reinvest in the partnership. For the first half of 2019, Enterprise retained $1.4 billion of distributable cash flow to provide us the financial flexibility to fund our growth capital projects and maintain a solid balance sheet without having to access the equity capital markets.*

Enterprise Products remains one of our favorites.

Now on to Iron Mountain (IRM), which has been an enigma of a story. We believe the company has some of the strongest competitive advantages around, but the company has been under sell-side attack for the past couple months, and that makes things very difficult for a high-yielding equity that needs good capital-market conditions to keep delivering to investors. In April, Baird cut the company's rating to Underperform, and while management had some good things to say during REITweek in early June, Bank of America cut its rating of the firm to Underperform in mid-July, too.

One can take these ratings with a grain of salt, but when the sell-side turns negative on a high-yield equity, things can unravel quickly. It's very difficult to go against the market with high-yield equities because price declines for high yield stocks are fundamental given their capital-market dependency risk. We strongly encourage readers to take a read of *Value Trap*. In it, we talk about how price declines are fundamental for high yield stocks. Many of the dividends and distributions paid are not sustainable in the event of tightened liquidity from unfavorable opinions, so the stock price is much more important to pay attention to than even under the traditional Valuentum process. We're going to part ways with Iron Mountain.

As for Schlumberger, we think it is time to move on as well. **The firm's huge debt load and deteriorating free cash flow generation relative to cash dividends paid aren't reassuring.** Net debt stood at $14.7 billion at the end of June. Free cash flow through the first six months of 2019 has been ~$617 million against dividends paid of ~$1.385 billion. Adjusted free cash flow (cash flow from operations less capital expenditures, SPM investments, and multiclient seismic data costs capitalized) was ~$176 million. We're removing it from the High Yield Dividend Newsletter portfolio, and we plan to take another look at our valuation model, too. We might be a bit too optimistic.

Here's what Valuentum's Callum Turcan had to say more recently about the firm:

> *"I'm not optimistic on the oilfield services space (OFS). Too much capacity in key parts of the industry (like pressure pumping), and new projects are only getting approved if they rake the OFS and other supplies over the coals first to bring development costs down so they can make money.*
>
> *OPEC+ holding back reduces project spend there, and US shale spending is built on the generosity of creditors/equity bagholders, at least for the smaller names out there. I'm not saying the SLB will be forced to cut its dividend anytime soon, but firms like BP (BP) are built far better to weather the doldrums of lower oil prices with room for upside than the OFS. Consolidation in the OFS industry is needed first, or raw energy resource prices need to structurally increase, before I can be confident in the longevity of dividend policies in the OFS space."*

With that said, let's talk a little about High Yield Dividend Newsletter portfolio holding BP. The company sports a dividend yield north of 6%, and the firm's second-quarter numbers, released July 30, weren't that bad. Underlying replacement cost profit advanced in the period, and so did operating cash flow, excluding the widely publicized Gulf of Mexico oil spill payments. We're paying close attention to the firm's net debt position, but many oil majors had to take on additional leverage to navigate the energy market swoon in 2015/2016. Net debt at the end of June stood at $46.5 billion, up from ~$39 billion a year ago. Upstream production volumes grew by 4% year-over-year.

BP's CEO commented:

> *At the midpoint of our five-year plan, BP is right on target. Reliable performance and disciplined growth across our businesses are delivering strong earnings, cash flow and returns to shareholders. And this is also allowing us to grow businesses that can make a significant contribution in the energy transition, helping deliver the energy the world needs with lower carbon.*

Down below is a look at BP's growing operating cash flows, when excluding payments relating to the 2010 Macondo disaster.

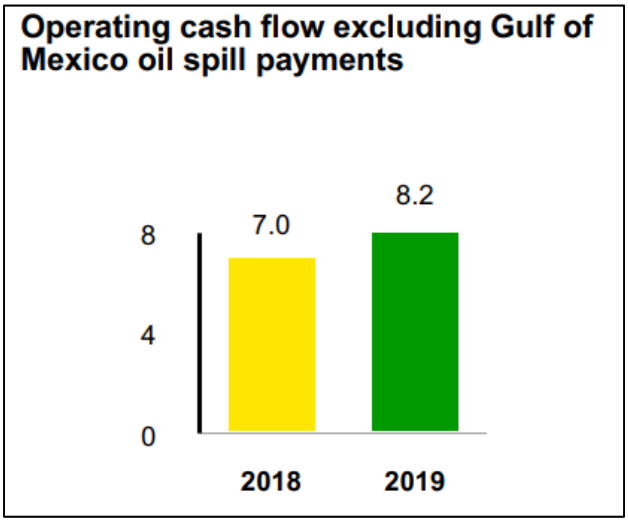

Image Source: *BP's second-quarter press release (second quarter performance, year over year).*

High Yield Dividend Newsletter portfolio holding AT&T (T) has battled back during the past few months and is now hovering around $34-$35 per share. The stock is yielding about 6%, and while fundamentals could be better, we think the executive team is focused on the right areas with an emphasis on free cash flow and deleveraging. During its second-quarter report, released July 24, cash flow from operations increased 40% on a year-over-year basis, with free cash flow coming in at $8.8 billion.

AT&T even raised its 2019 free cash flow guidance to ~$28 billion, targeting end-of-year net-debt-adjusted EBITDA in the 2.5x range. A dividend payout ratio of ~50% is targeted**. As long as free cash flow momentum is moving in the right direction and the company focuses aggressively on deleveraging, AT&T's dividend should hold.** Here's what the executive team had to say in the second-quarter press release:

> *We're halfway through the year and on track to deliver on all our 2019 priorities," said Randall Stephenson, AT&T chairman and CEO. "We continue to pay down debt and are more confident than ever that we'll meet our yearend deleveraging goal, and we'll take a look at buying back stock. Our FirstNet build is not only running ahead of schedule – it's become a driver of our wireless network leadership in speed, reliability and network performance. It also sets us up to have nationwide commercially available 5G coverage in the first half of 2020.*

Just to recap, we're removing Tallgrass Energy, Iron Mountain, and Schlumberger from the High Yield Dividend Newsletter portfolio and adding Philip Morris (our write up on PM follows in this edition). We plan to keep some dry powder in the High Yield Dividend Newsletter portfolio at 10% as the broader stock market hovers at all-time highs. Although we're optimistic in the space, we'd like to have some cash handy in case a new opportunity opens up. We hope you enjoy this edition of the High Yield Dividend Newsletter, and if you have any questions, please just let us know.

For reference, please note that the US Fed cut its target rate for federal funds by 25 basis points on July 31, which now stands at 2.00% - 2.25%.

Anglo-American plc's (NGLOY) Fundamental Transformation Has Enabled Strong Free Cash Flows and a Low Net Debt Load

By Callum Turcan

In this edition of the High Yield Dividend Newsletter, we would like to highlight a space we often don't, and that's mining. Anglo-American plc (NGLOY) – 4.5% yield -- trades OTC as an ADR with headquarters in London, UK. Anglo-American's mining operations are located all across the world and the miner is a major producer of platinum, copper, diamonds, and a handful of other useful metals in demand (like nickel and magnesium) with relatively limited exposure to the

thermal coal space. That's due to a series of 'portfolio upgrade(s)' the firm embarked on last year, which we are very supportive of.

Please note that foreign currency movements and changes in commodity prices could have a large impact on Anglo-American's semi-annual dividend payments. Historically, Anglo-American's dividend in US dollar terms has been quite volatile. All numbers cited, unless stated otherwise, are in US dollars.

Miners with exposure to copper, nickel, and magnesium are prepared for the coming shift towards the electrification of everything (electric vehicles, the internet of things, shift from gas burners to electric ones in certain regions, etc.), and while that will put upward pressure on electricity consumption, the future of power generation lies with solar, natural gas, wind, and hydro-conventional (dams), not thermal coal. **There's simply too much cheap supply of thermal coal for miners to earn an attractive return in the space, which is why Anglo-American sold out of several thermal coal assets and developments in order to pivot towards more lucrative opportunities (namely copper, diamonds, and platinum).**

Long-term, the market for thermal coal does not look promising in our view. Down below is a look at Anglo-American's diverse portfolio within the realm of mining.

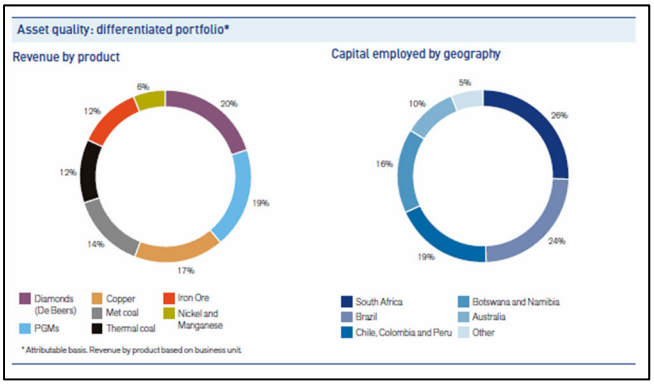

Image Shown: *The breakdown of Anglo-American's revenue by product highlights how the firm is exposed to the performance of several different metals and isn't reliant on just one commodity.*
Image Source: *Anglo-American 2018 Annual Report*

Copper is an essential part of the green energy paradigm shift as copper wires and cables are used for electrical wiring purposes. Anglo-American's exposure to copper is very appreciated. Nickel is used in the production of lithium-ion batteries, and magnesium alloy is very useful as a lightweight but durable offering for automotive, aerospace and other industrial uses (where weight and strength need to be balanced out for fuel efficiency and other performance purposes).

Platinum is primary used for catalytic converters on automobiles with internal combustion engines ("ICE"), making it exposed to the eventual structural decline in demand as automakers shift towards EVs, but ICE vehicles will still be in demand for some time. Diamonds, through its De Beers subsidiary, is a space that isn't exposed to the green paradigm shift and is more so based on the state of the global upper middle class consumer and sales of luxury goods.

Metallurgical coal (used to make coke, an essential feedstock for producing steel) and iron ore (iron ore plus coke plus fluxes, like limestone to remove impurities, produces steel) will continue to be in demand as those metals are required to make the building block of civilizations (while heavy, steel continues to be one of the best metals for infrastructure projects, major commercial and industrial buildings, and similar applications).

Here is a quick summary of Anglo-American's strategic transactions last year, from the miner's 2018 Annual Report:

> *In 2018, the Group completed a number of transactions, including the sale of our 88.2% interest in the Drayton thermal coal mine (on care and maintenance since 2016) and the Drayton South project in Australia. In South Africa, we completed the sale of the New Largo thermal coal project and the Eskom-tied domestic thermal coal operations, PGMs' 33% interest in the Bafokeng Rasimone Platinum Mine associate, as well as its 11% listed stake in Royal Bafokeng Platinum, its 85% interest in Union mine and 50.1% interest in Masa Chrome Company.*
>
> *We also completed the acquisitions of the remaining 50% interest in the Mototolo joint operation in South Africa from Glencore and Kagiso Platinum Ventures; and in Canada, the Chidliak Diamond Resource (through De Beers) through the acquisition of Peregrine Diamonds Limited."*

The miner pivoted towards platinum and diamonds and away from thermal coal through those strategic transactions, and we are big fans of the change. Looking ahead, Anglo-American's Quellaveco copper project in Peru offers additional upside. The $5.0 billion - $5.3 billion project (60% of which is net to Anglo-American, less subscription-related cash movements) will see first copper production begin in 2022. Mitsubishi (MSBHY) is Anglo-American's big partner in the venture.

Anglo-American and its partners are targeting 7.5 million metric tons of copper reserves at Quellaveco, with the mine's annual copper output expected to come in at 300,000 metric tons during the first ten years of operation. Due to the relatively low cost of extracting these resources, management is targeting an EBITDA margin north of 50%.

Financial Overview

What we really like about Anglo-American is its low net debt load and strong free cash flows. Please note that the company is exposed to swings in commodity prices, and its financial performance will depend heavily on where commodity prices end up. In 2016-2018, Anglo-American generated $4.2 billion in free cash flow on average each year.

From 2009-2015, Anglo-American's financial performance was quite volatile as the company invested heavily in its existing and future mining operations. From 2016 onwards, management kept Anglo-American's capital expenditures contained while also pivoting towards more lucrative opportunities within the mining world, allowing for material free cash flows. In 2018, Anglo-American spent $2.1 billion on its total dividend payments, which were fully covered by free cash flow.

The company's strategic shift on both the operational and financial front allowed Anglo-American to keep its balance sheet strong. At the end of June 2019, Anglo-American's net debt load stood at a little over $3.2 billion when including short-term debt ($7.1 billion in cash & cash equivalents less $9.4 billion in total debt). For a firm that's generating over $4.0 billion in free cash flow a year, a net debt load of $3.2 billion is very manageable. Its large cash balance provides a nice cushion to whatever exogenous shocks may arise.

Due to management's confidence in Anglo-American's future free cash flows, the company launched a $1.0 billion share buyback program on July 25. That program will be completed by the end of March 2020.

CONSOLIDATED CASH FLOW STATEMENT
for the year ended 31 December 2018

US$ million	Note	2018	2017
Cash flows from operating activities			
Profit before tax		6,189	5,505
Net finance costs including financing special items and remeasurements		514	586
Net income from associates and joint ventures		(728)	(567)
Non-operating special items	8	94	5
Operating profit	1	6,069	5,529
Operating special items and remeasurements	8	(838)	(287)
Cash element of special items		(3)	(102)
Depreciation and amortisation	1	2,596	2,390
Share-based payment charges		183	180
Increase/(decrease) in provisions and net retirement benefit obligations		58	(311)
Increase in inventories		(526)	(294)
(Increase)/decrease in operating receivables		(74)	23
Increase in operating payables		570	1,150
Other adjustments		(253)	97
Cash flows from operations		7,782	8,375
Dividends from associates and joint ventures	13	737	506
Dividends from financial asset investments		1	11
Income tax paid		(1,393)	(843)
Net cash inflows from operating activities		7,127	8,049
Cash flows from investing activities			
Expenditure on property, plant and equipment	12	(3,400)	(2,278)
Cash flows from derivatives related to capital expenditure	12	15	40
Proceeds from disposal of property, plant and equipment	12	162	52
Investments in associates and joint ventures	13	(99)	(86)
Purchase of financial asset investments		(3)	(6)
Net (issuance)/redemption of financial asset loans and receivables	14	(22)	168
Interest received and other investment income		204	165
Net cash outflow on acquisitions	33	(90)	–
Net cash inflow on disposals	33	193	52
Other investing activities		(58)	(54)
Net cash used in investing activities		(3,098)	(1,947)
Cash flows from financing activities			
Interest paid		(478)	(542)
Cash flows from derivatives related to financing activities	20	(250)	(419)
Dividends paid to Company shareholders	6	(1,291)	(618)
Dividends paid to non-controlling interests	25	(837)	(601)
Proceeds from issuance of bonds		647	2,998
Proceeds from other borrowings		117	35
Repayments of bonds and borrowings		(3,507)	(5,189)
Net proceeds from issue of shares to non-controlling interests		875	36
Purchase of shares by Group companies for employee share schemes		(293)	(242)
Other financing activities		40	(11)
Net cash used in financing activities		(4,977)	(4,553)
Net (decrease)/increase in cash and cash equivalents		(948)	1,549
Cash and cash equivalents at start of year	20	7,792	6,044
Cash movements in the year		(948)	1,549
Effects of changes in foreign exchange rates		(296)	199
Cash and cash equivalents at end of year	20	6,548	7,792

Image Shown: *Anglo-American was firmly free cash flow positive in 2018, allowing for free cash flow to fully cover its total dividend payments with plenty of cash left over.* ***Image Source:*** *Anglo-American – 2018 Annual Report with additions from the author.*

Again, we caution that changes in commodity prices will play an outsized role in determining the miner's financial performance, but the structural changes in its operational focus are really panning out in its favor. **Anglo-American's credit rating is investment grade (BBB/Baa2, stable outlooks) and furthermore, the company received credit rating upgrades from both Moody's Corporation (MCO) and S&P Ratings earlier this year.** Stronger free cash flows, a relatively low net debt load, and credit rating upgrades all point towards the strength of Anglo-American's future financial performance.

Management sees Anglo-American's long-term sustaining capital expenditures coming in at $2.8 billion - $3.1 billion. In the graphic on the next page, management highlights Anglo-American's expected

capital expenditures over the coming years, keeping in mind growth-related capital expenditures will push total capital investment up over the next few years before moving back down.

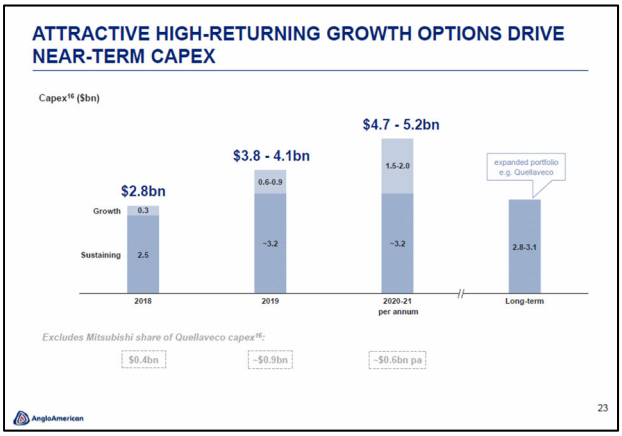

Image Shown: *A look at Anglo-American's capital expenditures and sustaining long-term capital expenditure guidance.* ***Image Source:*** *Anglo-American – IR Presentation*

Concluding Thoughts

While miners will always be at the mercy of swings in the prices of metals, Anglo-American is focusing on the right things. The strategic changes in its asset base combined with the opening of the Quellaveco copper mine in 2022 point towards stronger net operating cash flows in the future than in the past. Future free cash flows will be made possible by Anglo-American investing in only high-quality projects that produce metals that are in demand, allowing for its long-term capital expenditures to move and stay lower.

Management expects Anglo-American's sustaining capital expenditures will decline from an estimated $3.2 billion during the 2019 – 2021 period to $2.8 billion - $3.1 billion over the long-term due to asset highgrading and economies of scale.

Anglo-American's low net debt load, strategic operational changes, and recent credit rating upgrades allows for better dividend coverage and growth prospects going forward.

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

High Yield Dividend Spotlight on Next Page >>

High Yield Spotlight: Adding Phillip Morris International Inc (PM) to High Yield Dividend Newsletter

Over a decade ago, Phillip Morris split into Phillips Morris International Inc (PM) and Altria Group Inc (MO), with the former the focus of this Spotlight and the newest addition to Valuentum's simulated High Yield Dividend Newsletter portfolio. While the Phillip Morris International --5.4% yield-- was built on iconic brands such as Marlboro, the top-selling cigarette by volume in the world, the Phillip Morris International of the future will be one built on heated tobacco products. On April 30, 2019, the US FDA approved the sale of Phillip Morris International's IQOS heated tobacco device. The product was already selling in dozens of markets all around the world and now can be marketed to customers in the US.

> *"At the heart of IQOS are sophisticated electronics that heat specially designed heated tobacco units. IQOS heats the tobacco just enough to release a flavorful nicotine-containing tobacco vapor but without burning the tobacco. Here's the key point: the tobacco in a cigarette burns at temperatures in excess of 600°C, generating smoke that contains high levels of harmful chemicals. But IQOS heats tobacco to much lower temperatures, up to 350°C, without combustion, fire, ash, or smoke. The lower temperature heating releases the true taste of heated tobacco. Because the tobacco is heated and not burned, the levels of harmful chemicals are significantly reduced compared to cigarette smoke." – Phillip Morris International, IQOS Website*

Phillip Morris International noted in April 2019 that its IQOS device had exceed 10 million users worldwide. During its second quarter 2019 earnings report, the company noted that it estimates "approximately 8.0 million adult smokers around the world have already stopped smoking and switched to PMI's heat-not-burn product," which indicates that's the size of what Phillip Morris International sees as its core IOQS consumer base. The company's heated tobacco unit shipments were up 29% year-over-year during the first half of 2019, while its cigarette volumes were down 2% in the same period. **Growth will come from the company launching the IQOS product in new markets, expanding its core customer base (including winning over customers than have already tried IQOS), and through greater usage from its existing customers.**

From 2016 to 2018, Phillip Morris International's net sales (excluding excise taxes) climbed from $26.7 billion to $29.6 billion but its GAAP gross margin slipped by over 110 basis points during this period. Launching new products and contending with declining traditional cigarette volumes weighed on its gross margins, which was offset by the firm's impressive pricing power. **Excluding currency headwinds, which we caution have been a major headwind for the company, Phillip Morris International is targeting a revenue growth rate of 5%+ CAGR during the 2019 – 2021 period. Heated tobacco and pricing power form the foundation of this growth trajectory.**

In the graphic on the next page, management lays out the future of Phillips Morris International. From 2018 to 2025, the company expects its traditional cigarettes volumes will fall from 767 billion units to less than 550 billion when assuming constant market share. Market share gains could offset that to some degree. However, the traditional tobacco market is still in decline, and pricing power is Phillip Morris International's main way of maintaining its free-cash-flow cow status. We like management's eye towards the future as the heated, smokeless, and vape space of the tobacco market is growing in popularity worldwide. Beyond the IQOS offering, Phillip Morris International also has its TEEPS product.

Business Transformation for a Smoke-Free Future

	Actual 2018	Aspiration[a] 2025
Reduced-Risk Product Volume[b] (billion units)	41 Over 5% of PMI total volume	>250 >30% of PMI total volume
Combustible Tobacco Product Volume[c] (billion units)	767	<550
Reduced-Risk Product Net Revenues	$4.1 billion Nearly 14% of PMI total net revenues	$17-$19 billion[d] Approx. 38% - 42%[d] of PMI total net revenues

(a) Assumes constant PMI market share outside China and the U.S. We do not set aspirational targets for R&D and commercial expenditure but we expect both ratios to continue increasing to enable the stated outcome in terms of shipment volume
(b) For 2018, reduced-risk product volume includes HTUs only. Total RRP volume, including e-vapor products, was 42 billion units equivalent in 2018
(c) Includes cigarettes (740.3 billion units) and other combustible tobacco products
(d) Reflects pricing and excise tax assumptions as of May 15, 2018
Note: **Aspirational targets do not constitute financial projections**
Source: PMI Financials or estimates, and PMI Communication on Progress 2017 United Nations Global Compact

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Image Shown: *The future of Phillip Morris International is one built on rising "reduced-risk product(s)" and less so on traditional cigarette volumes.* ***Image Source:*** *Phillip Morris International – IR Presentation*

In 2019, the company expects to grow its constant currency revenue by 6% annually, up from 5% previously as management raised Phillip Morris International's full-year guidance during its second quarter 2019 earnings report. Total cigarette and heated tobacco unit volume sales are expected to drop by just 1.0% this year on an annual basis, versus previous guidance calling for a 1.5% - 2.0% decline in 2019.

Net Revenue Growth Target (2019-2021)

≥5%
CAGR
ex-Currency

- Driven by:
  - Continued combustible strong pricing
  - Higher volume for *IQOS* devices and HTUs
  - Partly offset by lower cigarette volume, reflecting:
    - Switching to RRPs
    - Impact of lower cigarette consumption, net of market share gains
- Strong pricing outlook supported by the broadly rational excise tax environment globally and our leading brand portfolio
- Leading product innovation capabilities position PMI to remain at the forefront of the growing RRP category

Source: PMI Financials or estimates (PMI Investor Day, September 27, 2018)

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Image Shown: *Phillip Morris International is targeting a revenue growth rate of 5%+ CAGR over the next three years.*
Image Source: *Phillip Morris International – IR Presentation*

Management aims to keep Phillip Morris International's gross margins stable during the 2019 – 2021 period, while targeting $1.0 billion in cost savings from zero-based cost initiatives, productivity gains, and asset base optimization. Some of those savings will be reinvested in growing net sales, likely including investments in technology to roll out new heated tobacco offerings. Marketing, administration, and research costs jumped by 17% from 2016 to 2018, partially due to Phillip Morris International's strategic shift.

That shift is expected to grow the company's 'reduced-risk product' segment's net sales from $4.1 billion in 2018 to $17.0 billion - $19.0 billion by 2025, aided by unit sales jumping from 41 billion units to 250 billion units over this period. Additionally, Phillip Morris International expects these new products will represent 40% of its net sales by 2025, up from 14% in 2018. **Combined with potential market share gains and likely price increases, Phillip Morris International's medium- and long-term outlook are more promising than first appearances would suggest.**

In July 2019, Phillip Morris International opened its first flagship store in Africa. The new location in Johannesburg, South Africa, is targeted towards tourists and businesspeople but its offerings could also appeal to local smokers as well. Phillip Morris International first started selling the affordable version of the IQOS in South Africa in 2017, before later launching more expensive IQOS offerings.

If successful, Phillip Morris International could use its South African operations to provide a framework for how to set up a stronger presence in other African markets. Having a product to sell is one thing, but supply chains, distribution systems, marketing programs, and ultimately brand power and consumer awareness are also required to be successful. As the heated tobacco space is a more recent additional to the world of smoking, more effort needs to be put towards marketing and ensuring consumers are aware of IQOS in the first place.

During the 2019 – 2021 period, the company forecasts its EPS will grow by 8%+ CAGR when excluding the impact of foreign currency movements. The company raised its full-year GAAP EPS guidance modestly during its second quarter 2019 earnings report. More importantly, management is targeting 9% year-over-year growth in Phillip Morris International's non-GAAP adjusted EPS in 2019, which is expected to hit $5.28 when excluding factors like foreign currency movements (which are expected to reduce GAAP EPS by $0.14/share this year).

Over the past three fiscal years, Phillip Morris International's free cash flows averaged $7.4 billion while dividend payouts averaged $6.6 billion, providing for decent coverage. We give the company a 0.8x Dividend Cushion ratio due to its large net debt load ($25.9 billion at the end of the second quarter of 2019, inclusive of short-term debt), but rate its dividend coverage as Good considering the stability of its free cash flows. Moody's Corporation (MCO) rates Phillip Morris International's credit rating as an investment grade A2 with a stable outlook.

Phillip Morris International's net operating cash flows expanded by 17% to $9.5 billion from 2016 to 2018. Management forecasts net operating cash flow will stay flat in 2019 versus 2018 levels while capital expenditures are expected at $1.1 billion, allowing for $8.4 billion in forecasted free cash flow this year (up from $8.0 billion in 2018). During the 2019 – 2021 period, the company is targeting $1.2 billion - $1.3 billion in capital expenditures per year which should allow for material free cash flows over the medium-term. **Management expects Phillip Morris International's net operating cash flow will grow roughly in-line with earnings from 2019 – 2021, which when combined with spending discipline, could allow for the company's dividend coverage to improve over time.**

Image Shown: *Phillip Morris International is guiding for relatively modest capital expenditures and net operating cash flow growth, which should allow for material free cash flows.* ***Image Source:*** *Phillip Morris International – IR Presentation*

We like Phillip Morris International as our newest addition to Valuentum's simulated High Yield Dividend Newsletter portfolio because it's a free cash flow cow, comes with a promising medium-term and long-term outlook, and shares of PM yield 5.4% as of this writing. Per share dividend payouts should grow alongside expected free cash flow growth as Phillip Morris International keeps capital expenditures contained and considering the firm does not have a share repurchasing program and didn't repurchase shares in 2018. Dividend increases are just competing with net debt when it comes to deciding what to do with rising free cash flow streams. Due to its large net debt position and exposure to foreign currency movements, a cycle of interest rate cuts from the US Fed (which have already begun) would be a very welcome tailwind for Phillip Morris International.

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

Bank Earnings Roundup and Fair Value Changes

By Matthew Warren

With the big 6 banks having reported second-quarter earnings, a few key trends have emerged. First and foremost, the strong consumer--with low unemployment and higher-than-inflation wage gains--has led to good earnings growth in consumer banking with very benign credit costs at this stage in the cycle. The drag on earnings for the big six banks came from lower investment banking and securities trading revenues for most segments at most big banks. While market levels have been around all-time highs, activity levels have been lower than last year's high levels. If current trends persist, this headwind will start to fade with the upcoming fourth-quarter results, as we lap a downturn in investment banking and securities trading that took place with the market swoon last year.

The other major ongoing trend is hefty return of capital to big bank shareholders. Not only are dividend yields fairly high with some of these banks, but enormous share buybacks have been taking place at the same time, driving down shares outstanding and driving up earnings per share above and beyond more measured earnings growth at most of the banks. These high levels of capital return will likely continue as long as the economic cycle keeps chugging along after these many years thus far. And if the cycle continues, expect earnings growth to increase beginning in the fourth quarter.

Lowering Our Fair Value Estimate of Morgan Stanley

We are lowering our Fair Value Estimate of Morgan Stanley to $45 from $50 to update our view of what mid-cycle results might look like.

Morgan Stanley (MS) posted second-quarter 2019 results July 18 with net revenue down 3% from last year to $10.2 billion and diluted earnings per share down 5% to $1.23, better than the Wall Street consensus of $1.16 per share. The Institutional Securities segment, with net income applicable to Morgan Stanley down 23% versus last year, was the major drag on overall results, while the much smaller Investment Management unit provided some ballast with net income applicable to Morgan Stanley up 23%. Weakness in Institutional Securities was very broad-based compared to last year (a strong year) as you can see in the below graphic:

Morgan Stanley

Institutional Securities

Income Statement Information, Financial Metrics and Ratios

(unaudited, dollars in millions)

	Quarter Ended			Percentage Change From:		Six Months Ended		Percentage
	Jun 30, 2019	Mar 31, 2019	Jun 30, 2018	Mar 31, 2019	Jun 30, 2018	Jun 30, 2019	Jun 30, 2018	Change
Revenues:								
Advisory	$ 506	$ 406	$ 618	25%	(18%)	$ 912	$ 1,192	(23%)
Equity	546	339	541	61%	1%	885	962	(8%)
Fixed income	420	406	540	3%	(22%)	826	1,058	(22%)
Underwriting	966	745	1,081	30%	(11%)	1,711	2,020	(15%)
Investment Banking	1,472	1,151	1,699	28%	(13%)	2,623	3,212	(18%)
Equity	2,130	2,015	2,470	6%	(14%)	4,145	5,028	(18%)
Fixed Income	1,133	1,710	1,389	(34%)	(18%)	2,843	3,262	(13%)
Other	41	17	(101)	141%	*	58	(130)	*
Sales & Trading	3,304	3,742	3,758	(12%)	(12%)	7,046	8,160	(14%)
Investments	194	81	89	140%	118%	275	138	99%
Other	143	222	168	(36%)	(15%)	365	304	20%
Net revenues	5,113	5,196	5,714	(2%)	(11%)	10,309	11,814	(13%)
Compensation and benefits	1,789	1,819	1,993	(2%)	(10%)	3,608	4,153	(13%)
Non-compensation expenses	1,861	1,782	1,909	4%	(3%)	3,643	3,737	(3%)
Total non-interest expenses	3,650	3,601	3,902	1%	(6%)	7,251	7,890	(8%)
Income (loss) before taxes	1,463	1,595	1,812	(8%)	(19%)	3,058	3,924	(22%)
Net income (loss) applicable to Morgan Stanley [1]	$ 1,121	$ 1,371	$ 1,457	(18%)	(23%)	$ 2,492	$ 3,084	(19%)
Pre-tax profit margin	29%	31%	32%			30%	33%	
Compensation and benefits as a % of net revenues	35%	35%	35%			35%	35%	
Non-compensation expenses as a % of net revenues	36%	34%	33%			35%	32%	
Return on Average Common Equity	10%	13%	13%			11%	14%	
Return on Average Tangible Common Equity [2]	10%	13%	13%			11%	14%	
Trading VaR (Average Daily 95% / One-Day VaR)	$ 46	$ 46	$ 44					

Image Source: *Morgan Stanley 2Q2019 Earnings Presentation*

While it might not be fair to parse any one quarter as compared to the prior year's quarter, Morgan Stanley did post bigger revenue declines than its large US peers this time around. We wouldn't read too much into this unless the trend persisted over a longer timeframe.

Aside from its largest segment by revenue and profit coming under such pressure, we were also struck by the cautious tone from management. We are ten years into a bull market with many securities markets at all time highs, and yet Morgan Stanley management mentioned quite prominently in the earnings call that clients don't seem to have much conviction, as evidenced by a lack of more bullish portfolio re-positioning and a lack of financial leverage applied to portfolios as compared to other bull markets. **It does make one wonder if the markets are susceptible to a significant downdraft like what happened in late 2018.**

Aside from that pondering, we continue with our view that investment banking and securities businesses are not particularly attractive, as evidenced by Morgan Stanley's 10% return on average tangible common equity for its Institutional Securities segment in the quarter. This from one of the premier US firms in this space. On the other hand, we do like Wealth Management and Investment Management segments, which posted 36% and 33% returns on average tangible common equity, respectively. These businesses are thriving at this point in the cycle, given current market levels. **We are lowering our Fair Value Estimate to $45 from $50 to update our view of what mid-cycle results might look like.**

Pounding the Table on Bank of America

Bank of America can be bought for a valuation that reflects the bank as if it were to stand still, even though it is steadily going after the competition and improving its own efficiency and return on capital metrics.

Powered ahead by its Consumer Banking segment, but held back by Global Banking and Global Markets, Bank of America (BAC) reported decent second-quarter results July 17. Total revenue was up only 2%, but ongoing tremendous cost control helped translate this into 8% net income growth, and ongoing sizable share buybacks meant diluted earnings per share were up a whopping 17%.

Summary Income Statement ($B, except per share data)	2Q19	2Q18	% Inc / (Dec)
Total revenue, net of interest expense	**$23.1**	$22.5	2 %
Noninterest expense	**13.3**	13.2	0
Provision for credit losses	**0.9**	0.8	4
Pretax income	**9.0**	8.5	5
Income tax expense	**1.6**	1.7	(6)
Net income	**$7.3**	$6.8	8
Diluted earnings per share	**$0.74**	$0.63	17
Average diluted common shares (in millions)	**9,560**	10,309	(7)
Return Metrics and Efficiency			
Return on average assets	**1.23 %**	1.17 %	
Return on average common shareholders' equity	**11.6**	10.8	
Return on average tangible common shareholders' equity [1]	**16.2**	15.2	
Efficiency ratio	**57**	59	

Image Source: *Bank of America 2Q19 Earnings Presentation*

Quite simply, if market related revenues weren't moving backwards from last year's high levels, this would have been a monster quarter for Bank of America. But you simply can't run a universal bank without offering corporate and commercial customers investment banking and trading services. **Compared to peers, Bank of America appears to have gained share at its investment bank and securities operations.**

In fact, it appears the large US universal banks in general are gaining share at the expense of their European competitors. This will only serve to exacerbate the problems those institutions, which are faced with weaker local economies and negative rates on key on-balance-sheet securities everywhere they look. Bank of America has now delivered positive operating leverage for an astonishing 18 quarters in a row, as you can see below:

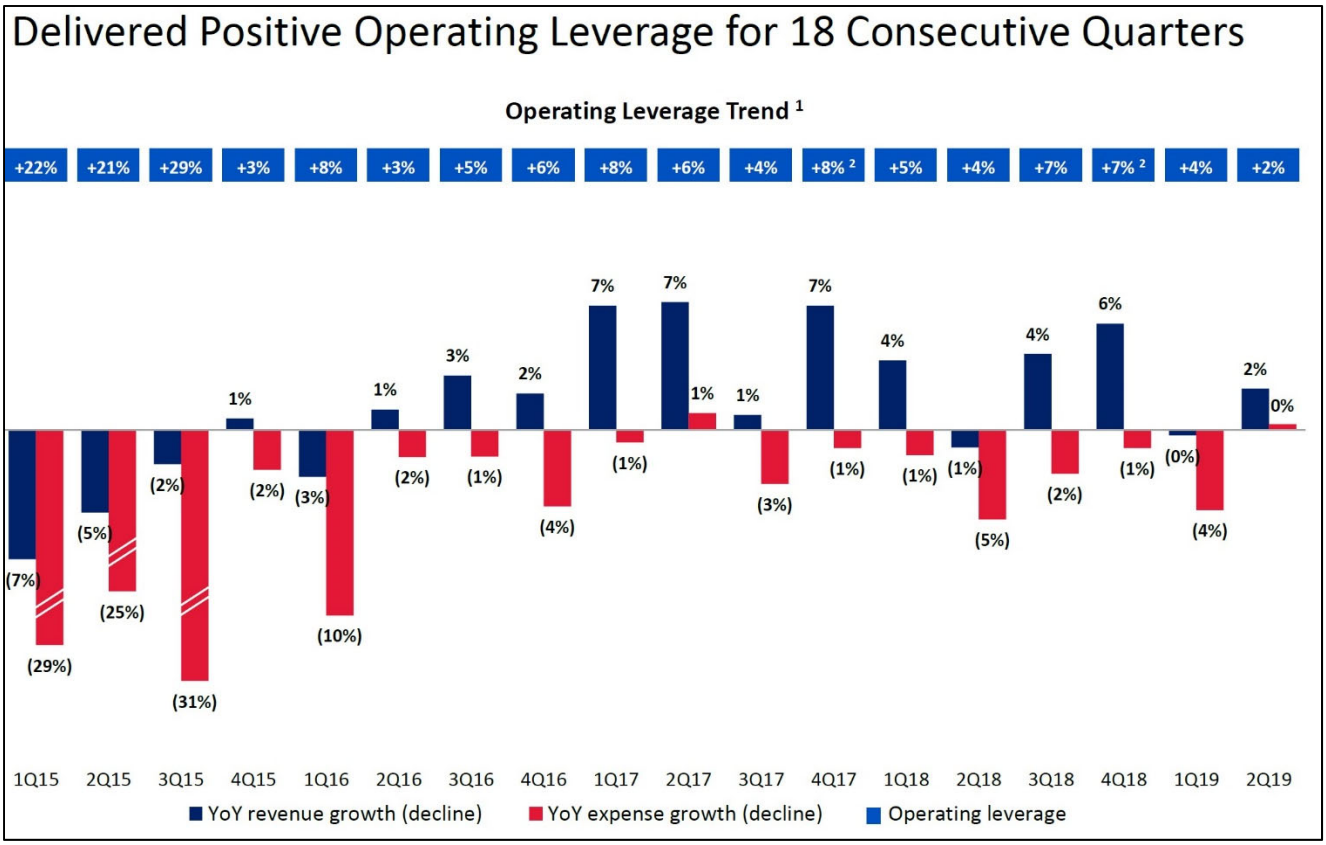

Image Source: *Bank of America 2Q19 Earnings Presentation*

While the early work was the result of getting rid of bloat compared to more-efficient peers, the more-recent progress reflects an institution that is nipping at JPMorgan's (JPM) heels to be considered the best-in-class global universal bank. Bank of America's management has been investing in improving the franchise and taking market share in areas like deposits, all this while that it has also been focused on improving its efficiency ratio.

Bank of America is on the cutting edge of digitalization efforts which allows millennials ("MILN") and other like-minded folks to do business the way they want (at the click of a button on a mobile app), while also streamlining the back office and overall cost structure. The branch footprint has been and continues to be streamlined, with a lot of selling activity replacing simple transactions like depositing a check. Corporate clients are also doing routine transactions on mobile phones, as management highlighted in this quarter's presentation deck.

All in all, Bank of America can be bought for a valuation that reflects the bank as if it were to stand still, even though it is steadily going after the competition and improving its own efficiency and return on capital

metrics. While a recession could dent results for a spell, we like the idea of betting on this management team and this bank. We may look to add Bank of America to the newsletter portfolios.

Goldman Sachs May Continue to Suffer

We don't find Goldman to be very attractive trading above its tangible book value when its return on capital barely clears its cost of capital in the 10th year of a bull market.

Goldman Sachs (GS) reported second-quarter 2019 results July 16, with net revenues down 2% to $9.46 billion and diluted earnings per share down 3% to $5.81, which was well ahead of Wall Street consensus for $5.03. As you can see in the below graphic, the Investing & Lending segment was the star in the quarter with revenue up 16% versus last year. This is because the quarter included approximately $500 million of net gains from investments that went public during the quarter.

We would also note that the Institutional Client Services business with revenue down only 3% seems to have held up better than some peers in a tougher environment as compared to the bright environment this time last year. The outperformance especially came in equities and with "low-touch" customers. Goldman seems to be taking share with this sub-group of clients.

Financial Results

$ in millions, except per share amounts	2Q19	vs. 1Q19	vs. 2Q18	2Q19 YTD	vs. 2Q18 YTD
Investment Banking	$ 1,863	3%	-9%	$ 3,673	-4%
Institutional Client Services	3,476	-4%	-3%	7,081	-11%
Investing & Lending	2,530	38%	16%	4,367	1%
Investment Management	1,592	2%	-14%	3,147	-13%
Net revenues	$ 9,461	7%	-2%	$ 18,268	-7%
Provision for credit losses	214	-4%	-9%	438	58%
Operating expenses	6,120	4%	-%	11,984	-6%
Pre-tax earnings	3,127	15%	-5%	5,846	-13%
Provision for taxes	706	51%	-1%	1,174	-10%
Net earnings	2,421	8%	-6%	4,672	-13%
Net earnings to common	$ 2,198	1%	-6%	$ 4,380	-14%
Diluted EPS	$ 5.81	2%	-3%	$ 11.52	-11%
ROE[1]	11.1%	— pp	-1.7pp	11.1%	-3.0pp
ROTE[1]	11.7%	— pp	-1.8pp	11.7%	-3.2pp

2Q19 YTD Net Revenue Mix by Segment

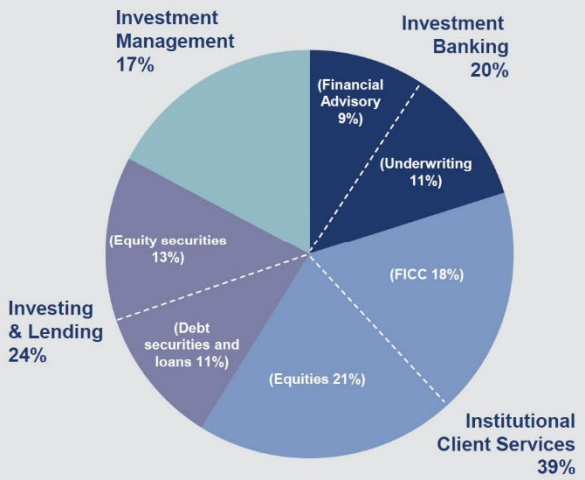

Image Source: *Goldman Sachs 2Q2019 Earnings Presentation*

While management called out that current investments in platforms such as Marcus and the upcoming Apple (AAPL) card launch dragged ROE by about 60 basis points in the quarter, the return on tangible equity of only 11.7% still speaks volumes. Goldman is one of the strongest investment banks and securities dealers on the street, but the firm is barely able to earn above the cost of capital. It is cold comfort that some (especially European) competitors are losing money or earning substantially below the cost of capital.

The truth is that the global investment banking and securities trading markets are oversaturated with competition. Unless and until there is a rationalization of competition in these spaces--which provide a disproportionate share of earnings--Goldman will continue to suffer from volatile and middling return earnings streams. We don't find Goldman to be very attractive trading above its tangible book value when its return on capital barely clears its cost of capital in the 10th year of a bull market.

Wells Fargo Showing Damage from Scandals

Our Fair Value Estimate for Wells Fargo remains unchanged for now while the bank grapples with the fallout from scandals.

Wells Fargo (WFC) reported second-quarter 2019 earnings July 16, with revenue flat at $21.6 billion and diluted EPS of $1.30 as compared to $1.16 Wall Street consensus and $0.98 earned in the same period last year. Cost control improved marginally with noninterest expense down $533 million to $13.4B in the quarter, but at an improved 62.3% (versus 64.9% last year) the bank's efficiency ratio is still meaningfully worse than peers. **Since the beginning of 2018, Wells has reduced 18,000 full time employees via cost cutting efforts, but then had to add back the same amount in risk, compliance, and audit, meaning the savings were lost to keep the bank out of trouble with regulators and to keep up on the technology front.**

Credit quality remains benign as it has at the other banks which have reported, with a strong consumer given the low unemployment rate and some degree of real wage inflation. The bank's return on average common equity rose to 15.78% from 12.62% last year. Wells returned $6.1 billion to shareholders in the quarter via dividends and share buybacks. The bank plans to raise its quarterly dividend to $0.51 per share, which would mean a 4.5% dividend yield. The bank is well capitalized with a common equity Tier 1 ratio of 12.0%. Management indicates they plan to move towards a target of 10.25%-10.5% over the next two years, which would mean increased leverage and higher returns on capital if they are able to follow through.

Aside from bloated expenses (management is no longer sure they will be able to cut expenses in 2020), the other cloud on the horizon was that the bank's net interest margin fell to 2.82% from 2.91% last quarter and 2.93% in the same quarter last year. This will only get worse with outside pressure from expected Federal Reserve rate cuts. In fact, management indicated if the current rate environment persists and we get one to two rate cuts, they expect to come in at the low end of last quarter's guidance for net interest income shrinking 2-5% for the year.

Internally, average deposits were down $2.4 billion from last year to $1.27 trillion despite the bank paying more for deposits sequentially. "The average deposit cost for the second quarter 2019 was 70 basis points, up 5 basis points from the prior quarter and 30 basis points from a year ago quarter." The bank also cited its "increased promotional activity" as it relates to deposit costs. **It seems like Wells might be leaking core deposits as compared to peers and paying up for interest earning deposits. In my view, this reflects an ongoing branch closure program as well as the ongoing damage the franchise has incurred as a result of recent scandals.** Wells' board is still searching for a permanent CEO. Our Fair Value Estimate is unchanged.

Disclosure: *Matthew Warren does not own shares in any of the securities mentioned above.*

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

Value Trap Wins Awards!

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THE SIMULATED HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO

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

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

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

We know there's a lot of competition in this area, but we're laser focused on identifying high yielding stocks that have sustainable yields, and if the income stream becomes threatened, we won't hesitate to say goodbye to a name. The simulated High Yield Dividend Newsletter portfolio is presented each month in similar fashion (list and weightings) as that of the first edition.

If you have any questions, comments, or concerns, please be sure to let us know at info@valuentum.com.

Idea	Symbol	Weighting	Est Div Yield
CORE			
Alerian MLP ETF	AMLP	5.0%	7.99%
Global X SuperDividend ETF	SDIV	5.0%	9.43%
Global X SuperIncome Preferred ETF	SPFF	10.0%	6.71%
iShares International Select Dividend ETF	IDV	5.0%	6.05%
iShares MSCI Australia ETF	EWA	5.0%	5.28%
iShares U.S. Preferred Stock ETF	PFF	5.0%	5.78%
PowerShares Senior Loan Portfolio	BKLN	5.0%	4.87%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	6.24%
Vanguard Real Estate ETF	VNQ	10.0%	3.47%
EQUITY			
AT&T	T	5.0%	5.99%
BP PLC	BP	5.0%	6.19%
Digital Realty Trust	DLR	5.0%	3.78%
Enterprise Products Partners	EPD	5.0%	5.85%
Magellan Midstream Partners	MMP	5.0%	6.12%
Philip Morris ***NEW***	PM	5.0%	5.45%
Public Storage	PSA	5.0%	3.30%
Cash*	-	10.0%	2.25%
		100.0%	**5.36%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 8/1/2019. Est. Div. Yield retrieved from YahooFinance.

** Reflects high end of federal funds rate*

SCREEN OF THE MONTH – THE FINANCIALLY-HEALTHIEST DIVIDEND PAYERS YIELDING OVER 2%

The following is a list of stocks that have the highest multiplicative combination of their dividend yield and Dividend Cushion ratio, per our estimates. 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!

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. This screen was included in the June edition of the Dividend Growth Newsletter.*

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)**, 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.

DIVIDEND REPORT PAGE 2 – PFIZER INC (PFE)

Valuentum's Stock Dividend Research | Visit us at www.valuentum.com | Ratings as of 30-Mar-2019 | Data as of 25-Mar-2019

Pfizer PFE FAIRLY VALUED

Buying Index™ 7 Value Rating

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$36.00 - $54.00	RISKY	GOOD / 1.8	GOOD	3.39%

Assessment of Company Dividend Strategy

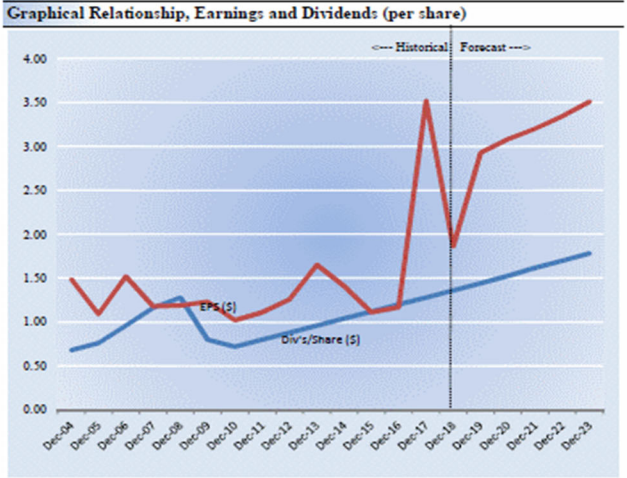
Key Strengths

Pfizer is a leader in a number of treatment areas within pharmaceutical markets around the world, but emerging markets continue to offer the company meaningful opportunities for growth. Management is high on its potential growth trajectory in oncology, which is expected to be driven by IBRANCE and XTANDI. Though free cash flow generation has waned in recent years, it has still been well in excess of annual run rate cash dividend obligations. The firm does hold a sizeable debt load on the books, but its free cash flow generation should be sufficient in handling it. Management has been quite shareholder friendly of late, and it returned nearly $20.2 billion in capital to shareholders in 2018, ~$8 billion of which came via dividends.

Potential Weaknesses

Some income investors may never forgive Pfizer for its dividend cut when it scooped up Wyeth way back in 2009. When it comes to counting on that dividend check, income investors can't afford an executive team that puts wheeling and dealing first. We think Pfizer has learned from this mistake even if big deals are still its "thing" – the company's quarterly dividend has now reached levels prior to the Wyeth deal in any case. We'll be monitoring potential M&A activity after it lost out on its Allergan (it recently bought Anacor Pharma), but we're not expecting anything drastic that will hurt the payout. Share buybacks continue to eat up capital, and the company's large debt load should not be ignored, should its free cash flow waver meaningfully.

Graphical Relationship, Earnings and Dividends (per share)

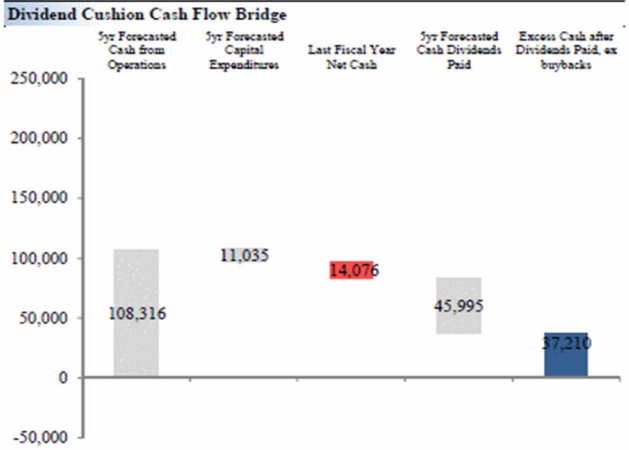


The graph above shows the relationship between a firm's earnings per share and its dividends per share.

Dividend Cushion Cash Flow Bridge Evaluation

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

Dividend Cushion Cash Flow Bridge

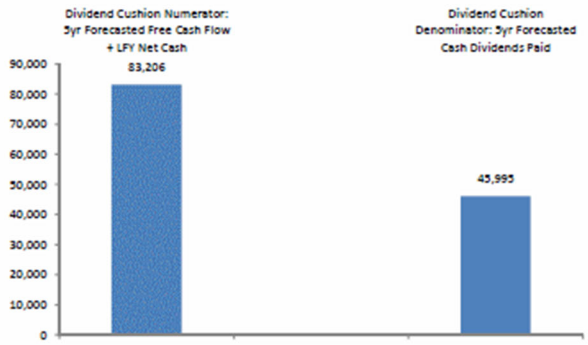


Source: Company Filings, Valuentum Projections

Dividend Cushion Ratio Evaluation

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

Dividend Cushion Ratio Deconstruction



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DEFINITIONS

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

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

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

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