THE EXCLUSIVE

Confidential*

October 2019

THE VALUENTUM TEAM

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Revisiting Two Open Exclusive Ideas, Closed March 2019 Income Idea

By Callum Turcan and Brian Nelson, CFA

We closed **March 2019** income idea **Canadian Natural Resources (CNQ)** on September 24. Email link:

http://campaign.r20.constantcontact.com/render?preview=true&m=1110817109903&ca=1f1c432a-4a40-4219-b8a2-dd42ca9764e4&id=preview

Dear Exclusive members,

From heightened political uncertainty--now with the Democrats launching a formal impeachment inquiry against President Trump--to ongoing worries about the implications of an inverted yield curve, to some $15 trillion in negative-yielding debt around the globe, to growing concerns about an over-inflated commercial real estate market, to general overvaluations of equities as a result of ultra-low yields around the globe, the number of obstacles thrown at the stock market continues to increase. **Still, despite all of this, the S&P 500 is but a stone's throw from all-time highs, at 2,952.01 on Friday October 4.**

There's more at work than meets the eye, of course. Despite the mainstream media's best efforts to assure the investing public that all is well when it comes to buying anything at any price, as in index funds, and the denial of financial professionals regarding the severe conflicts of interest on advice that come with recommending index funds in lieu of individual security due-diligence, it is my belief, like that of famed "The Big Short" investor Michael Burry, that the market is in an index fund bubble. Don't expect to hear this from index or ETF providers, however, or even from much of the industry that charges to hold indexed assets. Over 5,000 ETFs and more than 70 times as many indexes as stocks is enough to convince me something's not right.

But really, it comes down to the widespread belief that stocks, as an investment class, will always go up. This, of course, isn't set in stone, and while we all want this to be the case, especially during our lifetimes, there's no guarantee. There are two types of investors: 1) Those investors that index, making the implicit bet that stock values will continue to advance regardless of current valuations (that valuations simply don't matter), and 2) those that aren't indexing, making the implicit bet that the future is uncertain and embracing the belief that paying attention to intrinsic values and performing due diligence will eventually matter (and pay off), if not today, than some time in the future.

The latter type of investor is the Valuentum investor, or one that cares about the price that they pay for the assets they hold, and they understand that bull markets don't last forever. They believe that stocks have intrinsic values, backed by key variables such as interest rates and future expectations of free cash flow. These types of investors know that, while intrinsic values should advance over time due to the time value of money as companies collect cash flows, there are variables that could cause long-term declines in intrinsic values (and prices), too. Read more about this in *Value Trap*.

Link: https://www.amazon.com/Value-Trap-Theory-Universal-Valuation/dp/0998038490

Index investors, on the other hand, just aren't thinking this way. They are plugging in return numbers into their retirement models and hoping, or rather praying, that things work out. In this light, can you tell why I think it's pretty much a sin to charge 1% on indexed assets? Many say that individuals would do far worse than an index fund that trails the market 1% each year because of an advisory fee (or a total of 17 percentage points over a 20-year period ending June 2017, by my estimates), but I'm not so sure. Even if an individual randomly selected a diversified group of stocks, would they really have trailed the index by 17 percentage points during the past 20 years?

Many advisors are doing a fabulous job serving their clients and putting their clients' best interest first (and index funds can make sense in this context), but there are sub-segments of the advisory market that are scaling indexed vehicles in such a way where it seems they are only putting their business models first, and the goals and risk tolerances of the client may not matter as much. This is the hidden reason for the index fund bubble, in my view. Ill-marketing against active funds coupled with severe conflicts of interest in advisory business models. I think we all know it, but where are the warnings from regulators?

Instead, it seems like more attention is given to "closet indexers" that charge less than 1% of assets, than actual real indexers that charge 1% on assets. To the end investor, that 1% is the same fee. Large fees on index funds are large fees on index funds. Jack Bogle surely didn't intend index funds to be expensive! **We hope to have a solution for our dear financial advisor clients in the coming months, and we encourage you to respond to a survey that we plan to release in November. We're excited about the potential!**

Just a reminder: **we closed March 2019 income idea Canadian Natural Resources (CNQ) on September 24** as the firm benefited from the short-term spike in crude oil prices recently, a bounce that is now largely wearing off. We closed the idea at $27.14 per share. We continue to like our most recently-highlighted ideas the most, and we hope that members continue to be pleased with not only the success rates of ideas in the Exclusive publication, but also by the magnitude of some of the moves, particularly with respect to capital-appreciation and short-idea considerations. On that note, let's talk two previously highlighted ideas.

May 2019 income idea **National Health Investors Inc (NHI)** has continued to move higher with shares of NHI closing at $83.27 per share on Friday October 4, up from our highlight price of $76.43 per share. The healthcare REIT yields ~5% on a forward-looking basis, and we view National Health Investor's payout growth trajectory quite favorably given powerful demographic trends in the US supporting growing demand for assisted living facilities. Shares of National Health Investors came under pressure earlier this year due to problems with some of the operators at a handful of its facilities, but as the REIT has since transitioned many of those embattled properties to better operators, investors are starting to pile back into the name. According to its property portfolio website, National Health Investors has economic interests in ~240 senior housing facilities, skilled nursing facilities, hospitals, and medical offices across the US.

While May 2019 short idea consideration **Match Group Inc (MTCH)** has gotten away from us initially, shares of MTCH are beginning to pullback as social media giant **Facebook Inc (FB)** entered the online dating scene by launching Facebook Dating back on September 5. That was followed up the US Federal Trade Commission announcing it was suing Match Group on September 25 as the agency alleges "that the company used fake love interest advertisements to trick hundreds of thousands of consumers into purchasing paid subscriptions on Match.com" on top of other alleged charges including fraud and engaging in deceptive & unfair practices. Additionally, Match Group is now being investigated by the US Department of Justice and the DOJ just recently subpoenaed the company for certain marketing-related documents. A combination of paradigm altering legal events and new competitive pressures reinforces the thesis behind why we still like Match Group as a short idea consideration.

More to come, of course, so stay tuned. We hope you enjoy this edition of the Exclusive!

Disclosure: *Callum Turcan owns shares of Facebook Inc (FB).*

Commentary: Apple $225+, Brokers Tumble, Auto Sales Look Tired

There has been plenty of news in the markets this week, with the Dow Jones Industrial Average (DIA) experiencing significant declines only to bounce back a bit. From where we stand, the markets look vulnerable technically, but that doesn't mean we're looking to change anything in the newsletter portfolios. We have some dry powder in the form of a ~10% cash weighting in the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio.

The disappointing September ADP jobs report added to lower-than-expected ISM (Institute for Supply Management) manufacturing data, adding to recession fears and driving increased market volatility during the week ending October 4. Let's talk to the Valuentum team about the latest economic developments, starting on a positive note. One of the highest-weighted ideas in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio, Apple (AAPL), moved above $225 per share earlier this week before closing just above $227 per share on Friday October 4.

Image Shown: We increased the weighting in Apple two times recently: 1) in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio December 2018 and 2) in the Best Ideas Newsletter again in April 2019. Our fair value estimate for Apple stands north of $220.

Brian Nelson: Apple is one of the highest-weighted ideas in both newsletter portfolios, and we continue to like shares. The company is now trading roughly in-line with our fair value estimate, but we're not making any changes to its weighting, as this fantastic idea continues to run higher. Consistent with the Valuentum methodology, we won't truncate returns as shares approach intrinsic value, as some value strategies do. We let our winners run higher and try to capture the entire pricing cycle from undervalued and "going up" to overvalued and "going down." Being patient remains a core part of the Valuentum process.

Brian: This week, building on to its flat $30 per-month fee for financial planning, Charles Schwab (SCHW) announced that it will cut online trading commissions to zero. We maintain our view that stock selection will continue to be the way advisors and planners will be paid to add the most value to clients in the future. This is an area we're laser-focused on when it comes to serving individual investors and our advisor clients. We continue to travel around the country, explaining to individual investors the many changes that have been occurring in the financial industry. We'll be in Los Angeles November 16.

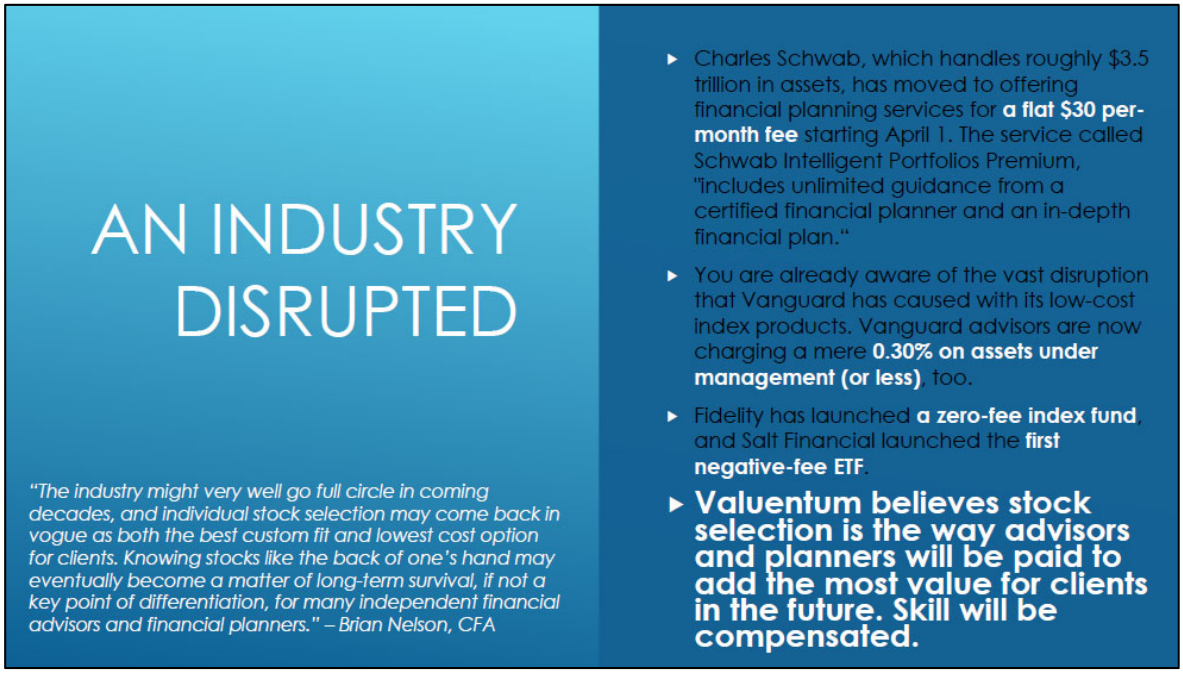


Image Shown: Valuentum's presentation of its new book, *Value Trap: Theory of Universal Valuation.*

Callum Turcan: I suspect all brokers will be forced to do this at some point. Robinhood (funded by sweep accounts and its "Gold" offering) fundamentally shattered the industry's old business model.

Matthew Warren: Have they hit the zero-bound, or do they start offering rebates like the banks do to open an account? Yikes those stocks had big downdrafts on the news!

Image Shown: *Shares of TD Ameritrade Holdings have been punished as online trading commissions go to zero.*

Brian: Interactive Brokers (IBKR) may have been the one to have started this latest commission war announcing late last month, IBKR Lite, "a new offering that will provide commission-free, unlimited trades on US exchange-listed stocks and exchange traded funds." TD Ameritrade (AMTD) followed Charles Schwab's lead, cutting commissions to zero. E*Trade (ETFC), Ally Financial (ALLY), and TradeStation have now eliminated commissions, too. LPL Financial (LPL) might start to feel the pinch, but one beneficiary could be Virtu Financial (VIRT) as it may benefit from higher trading volumes. Callum, what do you think about some of the key economic data this week?

Callum: I suspect this week's big market moves are largely due to expectations the US will slap the EU with tariffs very soon and thus create another hot trade war, ostensibly over the Airbus (EADSY)-WTO ruling but in reality the Trump Administration has been gearing up for a trade war with Europe for some time now. The weaker-than-expected ADP payroll report is troublesome given the weakening macroeconomic outlook, and the lackluster industrial readings across the developed world earlier this week. Furthermore, additional US tariffs on China (FXI, MCHI, KWEB) are set to come into effect in the middle of October. Market participants are waking up and realizing that favorably monetary policy movements are a direct result of negative trade war headlines.

If the US were to levy significant tariffs on auto imports from the EU, that would really hurt Germany (EWG) which could prompt a stimulus bill to pass the Bundestag in order to offset exogenous shocks to an economy already slipping into (or according to some, already in) recession. Powerful positive forces--monetary policy stimulus that has already been approved or communicated to the market, along with the chance for fiscal stimulus which hasn't largely come into play yet in key markets like Germany, the UK (EWU), and France (EWQ)-- are meeting head on with very powerful negative forces (supply chain inefficiencies, tariffs boosting input prices, and unconventional retaliatory practices i.e. cutting off US investment in Chinese equities). Equity markets are whipsawing as a result.

Matthew: Auto sales seem tired, or at least not a source of growth, despite quite low rates and the "robust" consumer. Home sales (ITB) while getting a boost from the tick down in mortgage rates, also seems late cycle to me. Affordability is a major issue in so many hot markets around the country. Are the lower rates just temporarily pulling some fence sitters along? Will this be a blip or something more sustainable? I suspect the former. If job growth slows down, then the whole strong consumer story starts to unravel. It is a lagging indicator to watch. I think the more important one to watch is ISM Services. Will it follow the ISM Manufacturing lower?

Callum: To your point on auto sales Matt, the average selling price of a new automobile in the US has marched towards $40,000 as of 2019, up sharply from just over $30,000 back in 2009. A large part of this has been made possible by WTI/Brent (USO, OIL) crashing down from $80-110 per barrel in 2010-2014 to $50-65 per barrel of late, which sharply reduced domestic gasoline and diesel prices. Light duty trucks and crossovers/SUVs now represent the majority of US auto sales by volume (a change that happened earlier this decade) and rising domestic demand for more expensive, larger automobiles played a key role in supporting US manufacturing output this past decade (and output in North America at-large given interconnected supply chains).

Callum: However, the "average" middle class US consumer can only afford a new vehicle priced at ~$18,400 according to Bankrate.com. In order to bridge this gap, US consumers have turned to debt and longer loan periods. US auto debt stood at $1.3 trillion at the end of June 2019, up from ~$0.75 trillion a decade earlier, and the popularity of 7-year auto loans (versus the old standard of ~4 year auto loans) has exploded over the past decade allowing for more US households to afford relatively expensive new vehicles. This paradigm isn't sustainable and US auto sales peaked, in terms of unit volume, back in 2017. Should US consumer confidence weaken significantly, that could reduce demand for these auto loans, ultimately resulting in a sharp reduction in new U.S. automobile sales and weaker industrial output.

Matthew: Good point on price point and value of car sales as opposed to just volumes, Callum. It does feel like we are late in that cycle with increased use of 7-year financing and the like, though. Even if we cycle lower, it will ultimately bounce back of course. The technology content and interface of cars is changing so rapidly; I can see many folks wanting to keep up.

Callum: One important note about the lackluster ISM Services reading for September 2019. While the reading was over 50, weaker U.S. services performance will find it significantly harder to offset weak industrial data when it comes to supporting GDP growth and ultimately employment levels. Chances of another US rate cut this year just grew substantially, in my opinion.

Matthew: You're right that a lot of the high secular growth companies caught a bid later this week, after a lot of recent pressure. I reckon your attribution is right, too. If the service economy ultimately turns down, that would augur recession. The ISM U.S. services reading points in that direction.

Brian: The news out Friday showed the unemployment rate ticking down to 3.5% versus 3.7% consensus and prior. The markets seem to be experiencing what best might be described as a tug-of-war, as bulls and bears continue to go back and forth whether a recession might be imminent, or that the signs we are witnessing recently is rather "pre-recession" type tendencies. The economic recovery/expansion have been about as robust and long as any in this country's history, so the risks, in my view, remain heavily to the downside. This is why we're seeing so much technical churning at current pricing levels, an indication that investors are anticipating a change in the trend, behavior that may actually cause the change in trend, itself. Though all signs point to increased volatility, we maintain our view that we're well-positioned in the newsletter portfolios and the ideas highlighted in the Exclusive publication consider the backdrop economic conditions we closely monitor.

Join the conversation at Valuentum.com by clicking on the link below:

Latest Economic Commentary: https://www.valuentum.com/articles/20191004

Valuentum has now highlighted over 100 ideas in the Exclusive publication with fantastic success rates! If you would like for us to comment on previously-highlighted ideas, please just email us at info@valuentum.com, and we will include our updated thoughts in the subsequent edition. Thank you!

Disclosure: *Callum Turcan owns shares of Apple Inc (AAPL).*

Tracking Exclusive Idea Simulated Performance

INCOME IDEAS

Highlight Date	Company (symbol)	Highlight Price	Annual Divs per Share at Highlight	Current Fwrd Dividends per Share	Current Fwrd Exp Dividend Yield	Time Horizon
Income Ideas						
Jul, 16	Universal Corp (UVV)	57.74	2.12	3.04	5.6%	Closed - 2/12/2017
Aug, 16	B&G Foods (BGS)	51.54	1.68	1.90	10.2%	Closed - 7/17/2017
Sep, 16	Maxim Integrated (MXIM)	41.12	1.32	1.92	3.4%	Closed - 2/12/2017
Oct, 16	Douglas Dynamics (PLOW)	31.94	0.94	1.09	2.5%	Closed - 2/12/2017
Nov, 16	Ennis Inc. (EBF)	14.60	0.70	0.90	4.5%	Closed -- 11/12/2016
Dec, 16	Watsco, Inc. (WSO)	150.57	4.20	6.40	3.8%	Closed - 2/12/2017
Jan, 17	Star Gas Partners (SGU)	11.21	0.41	0.5	5.2%	0-5 yrs
Feb, 17	Moelis & Co (MC)	35.00	1.28	2.00	6.5%	Closed - 6/22/2017
Mar, 17	Park National (PRK)	108.59	3.76	4.04	4.1%	0-20 yrs
Apr, 17	American Software (AMSWA)	10.44	0.44	0.44	3.0%	Closed - 6/22,23/2017
May, 17	NW Natural (NWN)	59.20	1.88	1.90	2.7%	Closed - 10/25/2018
Jun, 17	Japan Tobacco (JAPAY)	19.03	0.60	0.68	6.2%	0-20 yrs
Jul, 17	Vectren Corp (VVC)	58.21	1.68	Acquired	Acquired	Closed 8/30/2017
Aug, 17	National Retail Properties (NNN)	40.50	1.90	2.06	3.7%	Closed - 10/25/2018
Sep, 17	STORE Capital (STOR)	25.72	1.16	1.4	3.8%	Closed - 10/25/2018
Oct, 17	Fortis (FTS)	36.14	1.27	1.45	3.5%	Closed - 4/18/2019
Nov, 17	Black Hills (BKH)	61.23	1.78	2.02	2.7%	Closed - 10/25/2018
Dec, 17	Four Corners Propety Trust (FCPT)	26.03	0.97	1.15	4.1%	Closed - 10/25/2018

Many members have said that they prefer to focus on the long-term income-oriented dynamics of the income ideas, and we think this makes sense. The formatting of the table reflects a greater focus on the trajectory of the dividend as well as the current forward expected annualized dividend yield. We hope that you find this layout more helpful as you sort through the prior income ideas.

INCOME IDEAS

Highlight Date	Company (symbol)	Highlight Price	Annual Divs per Share at Highlight	Current Fwrd Dividends per Share	Current Fwrd Exp Dividend Yield	Time Horizon
Jan, 18	TransCanada Corp (TRP)	49.47	1.98	2.28	4.6%	0-20 yrs
Feb, 18	Siemens (SIEGY)	71.13	2.18	2.17	4.2%	0-20 yrs
Mar, 18	Philips 66 Partners (PSXP)	49.63	2.71	3.42	6.1%	Closed - 10/25/2018
Apr, 18	PS Business Parks (PSB)	113.68	3.40	4.20	2.3%	Closed - 10/25/2018
May, 18	Hubbell (HUBB)	103.97	3.08	3.36	2.5%	Closed - 2/11/2019
Jun, 18	Park Hotels & Resorts (PK)	32.43	1.72	1.80	7.5%	Closed - 5/3/2019
Jul, 18	Healthcare Trust of America (HTA)	27.36	1.22	1.26	4.3%	Closed - 2/11/2019
Aug, 18	QTS Realty Trust (QTS)	44.01	1.64	1.76	3.6%	Closed - 4/18/2019
Sep, 18	Atmos Energy (ATO)	93.62	1.94	2.10	1.9%	Closed - 10/25/2018
Oct, 18	Veolia Environment (VEOEY)	19.70	0.99	1.03	4.2%	Closed 4/18/2019
Nov, 18	Roche Holding (RHHBY)	29.82	1.08	1.07	3.0%	Closed - 2/11/2019
Dec, 18	OGE Energy (OGE)	40.46	1.46	1.55	3.4%	Closed - 2/11/2019
Jan, 19	BAE Systems (BAESY)	24.32	0.92	1.33	4.9%	Closed - 2/11/2019
Feb, 19	EastGroup Properties (EGP)	107.58	2.88	3.00	2.4%	0-20 yrs
Mar, 19	Canadian Natural Resources (CNQ)	26.76	1.01	1.13	4.5%	Closed - 9/24/2019
Apr, 19	Evergy (EVRG)	57.32	1.90	1.90	2.9%	0-20 yrs
May, 19	National Health (NHI)	76.43	4.20	4.20	5.1%	0-20 yrs
Jun-19	Corporate Office Properties Trust (OFC)	28.94	1.10	1.10	3.7%	0-20 yrs
Jul-19	Nuveen Real Estate Income Fund (JRS)	10.63	0.76	0.76	6.9%	0-20 yrs
Aug-19	South32 Limited (SOUHY)	10.01	0.28	0.28	3.2%	0-20 yrs
Sep-19	Bank of America Preferred Stock (ISIN: US0605052291)	26.87	1.50	1.50	5.5%	0-20 yrs

The information provided in the tables is offered for the convenience of the reader, for illustrative purposes only, and no actual trading is taking place. Actual results may differ from the simulated information being presented. Valuentum is a publisher of financial information, not a money manager, broker, or financial advisor.

CAPITAL APPRECIATION IDEAS

Highlight Date	Company (symbol)	Highlight Price	Current or "Close" Price	Div's Received	'Hypothetical' 'Closed'Gain %	Time Horizon
Capital Appreciation Ideas						
Jul, 16	Bloomin Brands (BLMN)	17.87	19.28	0.07	8.3%	Closed -- 11/12/2016
Aug, 16	Healthcare Srvs Group (HCSG)	38.91	41.02	0.369	6.4%	Closed - 2/12/2017
Sep, 16	Grupo Aeroportuario (ASR)	157.87	181.61	-	15.0%	Closed - 4/5/2017
Oct, 16	Swedish Match (SWMA.ST)	314.80SEK	417.40SEK	17.7	38.2%	Closed - 6/1/2018
Nov, 16	Symrise AG (SYIEY)	16.25	16.34	-	0.6%	Closed - 4/5/2017
Dec, 16	Tootsie Roll (TR)	37.80	38.96	0.90	5.4%	Closed 4/18/2019
Jan, 17	Texas Capital Bancshares (TCBI)	78.05	85.10	-	9.0%	Closed - 2/12/2017
Feb, 17	Arconic (ARNC)	25.90	29.62	-	14.4%	Closed - 2/12/2017
Mar, 17	Tesaro (TSRO)	180.84	122.62	-	-32.2%	Closed - 7/17/2017
Apr, 17	Yum China (YUMC)	31.15	37.67	-	20.9%	Closed - 5/23/2017
May, 17	Galapagos (GLPG)	87.67	76.13	-	-13.2%	Closed - 7/17/2017
Jun, 17	Huntington Ingalls (HII)	193.79	206.39	-	6.5%	Closed 8/18/2017
Jul, 17	Orbital ATK (OA)	102.33	104.65	-	2.3%	Closed 8/18/2017
Aug, 17	Wingstop (WING)	32.28	66.17	3.61	116.2%	Closed - 10/25/2018
Sep, 17	Qualys (QLYS)	51.10	75.44	-	47.6%	Closed - 10/25/2018
Oct, 17	Guidewire Software (GWRE)	78.24	87.50	-	11.8%	Closed - 10/25/2018
Nov, 17	Ferrari N.V. (RACE)	117.43	123.26	0.71	5.6%	Closed - 2/11/2019
Dec, 17	Square (SQ)	38.22	72.61	-	90.0%	Closed - 10/25/2018
Jan, 18	Planet Fitness (PLNT)	33.70	46.41	-	37.7%	Closed - 10/25/2018

Many capital appreciation ideas are based on a long-term thesis. However, rapid price-to-fair value convergence may mean we close the ideas relatively quickly, or sooner than expected. Our decision to close an idea may or may not be relevant to you given varying goals and risk tolerances.

CAPITAL APPRECIATION IDEAS

Highlight Date	Company (symbol)	Highlight Price	Current or "Close" Price	Div's Received	'Hypothetical' 'Closed'Gain %	Time Horizon
Capital Appreciation Ideas						
Feb, 18	Insulet Corp (PODD)	75.84	82.69	-	9.0%	Closed - 10/25/2018
Mar, 18	Preferred Bank (PFBC)	64.01	52.75	1.62	-	0-20 yrs
Apr, 18	Esperion Therapeutics (ESPR)	66.43	40.94	-	-38.4%	Closed - 4/18/2019
May, 18	Heidrick & Struggles (HSII)	37.65	40.77	0.41	9.4%	Closed - 3/9/2019
Jun, 18	Green Dot Corp (GDOT)	72.86	23.75	-	-	0-20 yrs
Jul, 18	Wix.com (WIX)	105.30	111.93	-	6.3%	Closed - 2/11/2019
Aug, 18	Tactile Systems Technology (TCMD)	50.84	63.52	-	24.9%	Closed - 10/25/2018
Sep, 18	Invitae (NVTA)	13.95	20.84	-	49.4%	Closed - 3/9/2019
Oct, 18	Cigna (CI)	215.72	149.00	0.04	-30.9%	Closed 4/18/2019
Nov, 18	Yeti Holdings (YETI)	16.50	17.99	-	9.0%	Closed - 2/11/2019
Dec, 18	Spotify (SPOT)	135.31	139.65	-	3.2%	Closed - 4/18/2019
Jan, 19	Suncor Energy (SU)	29.32	32.05	-	9.3%	Closed - 2/11/2019
Feb, 19	Delek Holdings (DK)	32.12	37.31	0.27	17.0%	Closed - 4/18/2019
Mar, 19	Physicians Realty Trust (DOC)	17.82	17.57	0.69	-	0-20 yrs
Apr, 19	Everbridge (EVBG)	72.75	98.43	-	35.3%	Closed 7/24/2019
May, 19	Teladoc Health (TDOC)	60.93	68.09	-	11.8%	Closed 7/24/2019
Jun-19	Alteryx (AYX)	95.15	119.29	-	25.4%	Closed 7/24/2019
Jul-19	CrowdStrike (CRWD)	67.21	86.42	-	28.6%	Closed 7/24/2019
Aug-19	Inovalon Holdings (INOV)	17.12	14.95	-	-	0-20 yrs
Sep-19	Avalara (AVLR)	81.10	70.17	-	-	0-20 yrs

Success rate: The percentage of ideas highlighted in the Exclusive that have moved in the direction of our thesis (i.e. up for capital appreciation ideas and down for short idea considerations) through the current price or closed price, with consideration of cash and stock dividends. Success rates do not consider trading costs or tax implications.

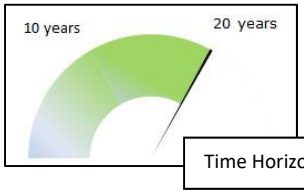
SHORT IDEA CONSIDERATIONS

Highlight Date	Company (symbol)	Highlight Price	Current or "Close" Price	Div's Received	'Hypothetical' 'Closed'Gain %	Time Horizon
Short Idea Considerations						
Jul, 16	Lands' End (LE)	16.76	16.10	NA	3.9%	Closed -- 12/2/2016
Aug, 16	Vivint Solar (VSLR)	2.94	2.85	NA	3.1%	Closed -- 12/2/2016
Sep, 16	Lloyds Banking (LYG)	3.31	2.78	NA	16.0%	Closed -- 11/4/2016
Oct, 16	GoPro (GPRO)	16.68	11.16	NA	33.1%	Closed -- 11/4/2016
Nov, 16	Seritage Growth Properties (SRG)	44.31	42.13	0.25	4.4%	Closed -- 1/6/2017
Dec, 16	Royal Bank of Scotland (RBS)	4.91	4.86	0.39	-	0-5 yrs
Jan, 17	Sequential Brands Group (SQBG)	4.62	4.18	-	9.5%	Closed - 2/12/2017
Feb, 17	Sportman's Warehouse (SPWH)	6.85	6.11	-	10.8%	Closed - 2/12/2017
Mar, 17	Fitbit (FIT)	6.07	5.71	-	5.9%	Closed - 4/5/2017
Apr, 17	Santander Consumer (SC)	12.51	11.65	-	6.9%	Closed - 5/23/2017
May, 17	Snap, Inc (SNAP)	23.19	17.19	-	25.9%	Closed - 5/10/2017
Jun, 17	Mallinckrodt (MNK)	42.65	36.41	-	14.6%	Closed - 8/18/2017
Jul, 17	Deutsche Lufthansa AG (DLAKY)	23.38	21.42	0.94	4.4%	Closed - 10/25/2018
Aug, 17	Del Frisco's (DFRG)	14.35	11.93	-	16.9%	Closed - 10/16/17
Sep, 17	Fiesta Restaurant Group (FRGI)	15.90	14.36	-	9.7%	Closed - 2/11/2019
Oct, 17	Ingles Markets (IMKTA)	26.50	24.20	-	8.7%	Closed - 10/16/17
Nov, 17	Fogo de Chao (FOGO)	10.85	15.62	-	-44.0%	Closed - 3/3/2018
Dec, 17	TrueCar (TRUE)	12.07	10.97	-	9.1%	Closed - 12/28/17

The tables above are provided for the sole purpose of transparency, to allow readers to measure Exclusive ideas in a way they feel is most appropriate. Ideas within the Exclusive are not constructed as a portfolio, nor should they be viewed as a portfolio, and performance information is hypothetical and "trading" is simulated. "Hypothetical annualized returns," now labeled "Capital Efficiency," cannot be achieved and are provided for the sole purpose of rightsizing each idea to a common measurement period (one year), to compare ideas 'closed' within one year to ones 'open' longer than one year, taking into account capital efficiency. A reader, for example, may view a 20% hypothetical return over a period of five weeks as much better than a 20% hypothetical return over a period of five years. Whereas both represent 20% hypothetical returns, hypothetical annualized performance is much different under each case. Readers may have different views and time horizons. To retain independence, neither Valuentum nor Brian Nelson own any shares, nor do they plan to own any shares, of any companies highlighted in the Exclusive. Importantly, shorting stocks involves a number of abnormal risks, including theoretically the infinite loss of capital, and is not for everyone. Valuentum is a financial publisher not a financial advisor. Please contact your personal financial advisor to determine if any idea in the Exclusive may be appropriate for you.

SHORT IDEA CONSIDERATIONS

Highlight Date	Company (symbol)	Highlight Price	Current or "Close" Price	Div's Received	'Hypothetical' 'Closed'Gain %	Time Horizon
Short Idea Considerations						
Jan, 18	Shake Shack (SHAK)	44.17	94.66	-	-	0-2 yrs
Feb, 18	iShares Core US Aggregate Bond ETF (AGG)	107.20	104.63	1.93	0.6%	Closed - 10/25/2018
Mar, 18	iShares iBoxx $ High Yield Corporate Bond ETF (HYG)	85.75	86.68	4.936	-6.8%	Closed - 4/18/2019
Apr, 18	Houghton Mifflin Harcourt (HMHC)	7.25	6.70	-	7.6%	Closed - 6/1/18
May, 18	Noodles & Company (NDLS)	7.25	7.04	-	2.9%	Closed - 2/11/2019
Jun, 18	iShares International High Yield Bond ETF (HYXU)	52.40	50.94	-	2.8%	Closed - 10/25/2018
Jul, 18	Installed Building Products (IBP)	56.15	40.10	-	28.6%	Closed - 9/28/2018
Aug, 18	Veritiv Corp (VRTV)	38.80	36.35	-	6.3%	Closed - 9/28/2018
Sep, 18	Box (BOX)	24.55	24.30	-	1.0%	Closed - 9/28/2018
Oct, 18	Modine Manufacturing (MOD)	14.73	12.00	-	18.5%	Closed - 10/25/2018
Nov, 18	Beazer Homes USA (BZH)	9.01	15.32	-		0-2 yrs
Dec, 18	Vera Bradley (VRA)	10.22	9.95	-	2.6%	Closed - 8/23/2019
Jan, 19	RH (RH)	117.84	106.99	-	9.2%	Closed - 4/4/2019
Feb, 19	QuinStreet (QNST)	14.77	12.79	-	13.4%	Closed - 3/9/2019
Mar, 19	Dycom Industries (DY)	47.20	41.74	-	11.6%	Closed - 8/23/2019
Apr, 19	Diplomat Pharmacy (DPLO)	5.69	5.29		7.0%	Closed - 5/16/2019
May, 19	Match Group (MTCH)	61.91	74.43			0-2 yrs
Jun-19	Tailored Brands (TLRD)	5.56	4.94	0.18	11.2%	Closed - 7/24/2019
Jul-19	Realogy Holdings (RLGY)	6.55	5.60		14.5%	Closed - 7/24/2019
Aug-19	Party City Holdco (PRTY)	6.04	4.50		25.5%	Closed - 8/8/2019
Sep-19	LendingTree (TREE)	309.02	314.10	-	-	0-2 yrs



Time Horizon: Long-term

Life Storage (LSI)

"Our acquisition pipeline remains strong with the inclusion of stores under contract in new strategic markets with attractive demographics. Second quarter results were solid operationally, having achieved the high end of our adjusted FFO guidance range, and we remain diligent in continuing to drive revenue growth and control costs as our markets absorb new supply." – CEO Joe Saffire, 2Q 2019 press release

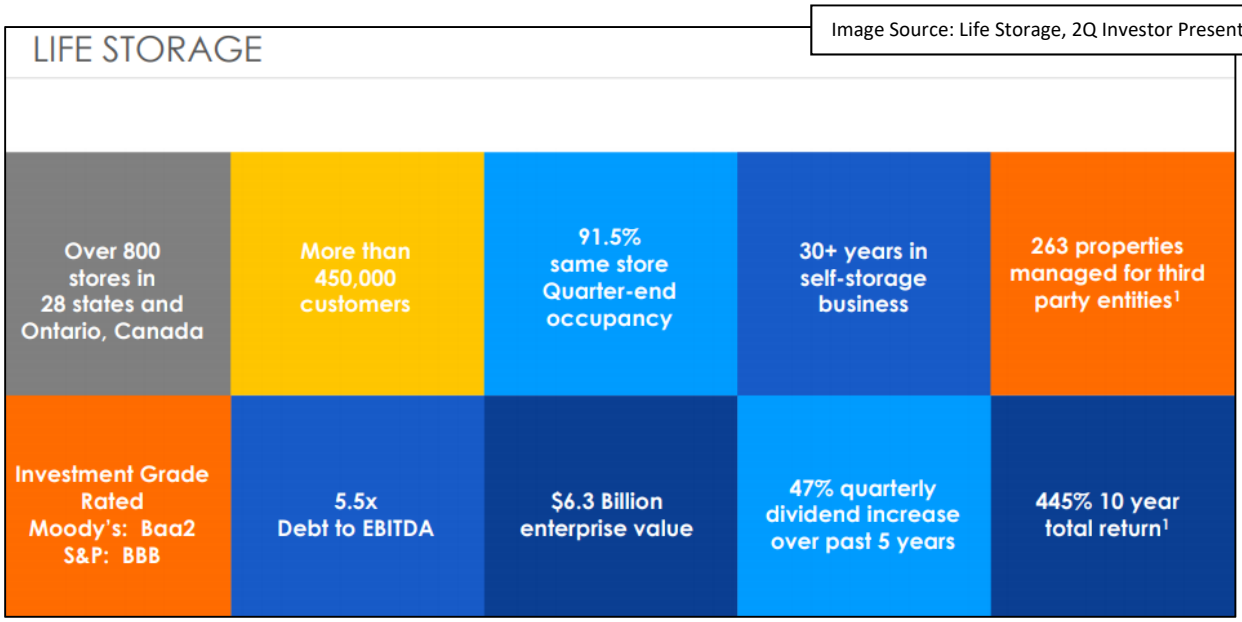
Thesis

The income idea for this month's Exclusive publication is one of our favorite real estate investment trusts (REITs), Life Storage (LSI), **which yields ~3.8% at the time of this writing.** In an environment where interest rates around the globe are zero-bound, if not negative (with some $15 trillion in negative-yielding debt around the world), higher-yielding and stronger REITs may continue to be in high demand. We continue to like REITs a lot, but healthy ones, which brings us to the next point.

Corporate Profile

Life Storage is a REIT that owns and managers self-storage properties. The entity started operations in June 1995, and it now has ownership interest or manages 800+ self-storage properties in 28 states under the banner, Life Storage. Texas and Florida account for ~21% ~13% of storage revenue, respectively. It recently expanded into Canada under the Bluebird Self Storage name. The REIT's principle offices are located in Williamsville, New York.

Image Source: Life Storage, 2Q Investor Presentation



What we like most about Life Storage as an income idea is its ability to generate strong traditional free cash flow, as measured by cash flow from operations less all capital spending, or in this REIT's case, net cash provided by operating activities less 'improvements, equipment additions, and construction in progress.' During the past three years, traditional free cash flow has averaged about ~$170 million, roughly in line with its cash dividends paid annual run rate over this time (~$175 million).

Importantly, its traditional free cash flow generation during fiscal 2018 was ~$195 million, by our tally, in excess of its cash dividends paid during the year of $185.8 million. What we're trying to say is that Life Storage's financials suggest that the dividend is relatively solid, as if it were a corporate**; it being a REIT, however, the financials put it near the upper echelon of credit and dividend health, in our view.** Let's now talk a little more about the simplicity of Life Storage as an investment idea.

Life Storage generates revenue primarily from rental income pursuant to month-to-month leases for storage space. Since 2016, total operating revenues have expanded to $550.9 million from $462.6 million, showcasing solid top-line growth. Though Texas (~21%) and Florida (~13%) represent some geographic concentration, the REIT is fairly diversified across the U.S. As of the end of 2018, occupancy ranges were north of 86%, revealing the opportunity for continued leverage and higher levels of profitability as storage space fills up within existing locations. **Same store revenue grew 2% during the second quarter of 2019, in-line with its target for the year.**

Image Source: Life Storage 10-K.

	Number of Stores at December 31, 2018	Square Feet	Number of Spaces	Percentage of Store Revenue
Alabama	21	1,579,228	12,116	2.24%
Arizona	27	1,929,797	17,395	4.10%
California	30	2,694,054	23,729	6.50%
Colorado	11	767,545	6,775	1.69%
Connecticut	11	835,512	8,706	2.17%
Florida	97	6,590,557	65,234	13.14%
Georgia	36	2,493,052	21,484	4.49%
Illinois	42	3,121,709	30,911	6.58%
Kentucky	2	142,764	1,322	0.27%
Louisiana	46	3,794,446	31,048	2.05%
Maine	5	245,824	2,447	0.63%
Maryland	3	138,709	1,618	0.35%
Massachusetts	15	787,499	8,085	2.00%
Mississippi	15	1,118,473	8,464	1.50%
Missouri	16	1,108,897	9,907	1.87%
Nevada	22	1,630,593	13,695	3.29%
New Hampshire	11	781,065	7,040	1.35%
New Jersey	31	2,244,922	23,207	5.82%
New York	51	3,077,462	31,618	7.09%
North Carolina	24	1,491,139	14,053	1.99%
Ohio	25	1,727,913	14,747	2.74%
Pennsylvania	14	895,236	7,994	1.68%
Rhode Island	4	205,871	1,922	0.51%
South Carolina	14	889,799	7,900	1.64%
Tennessee	7	510,283	4,236	0.95%
Texas	172	12,837,725	106,854	20.87%
Virginia	20	1,481,794	13,435	2.27%
Wisconsin	2	167,893	1,631	0.22%
Total	774	55,289,761	497,573	100.00%

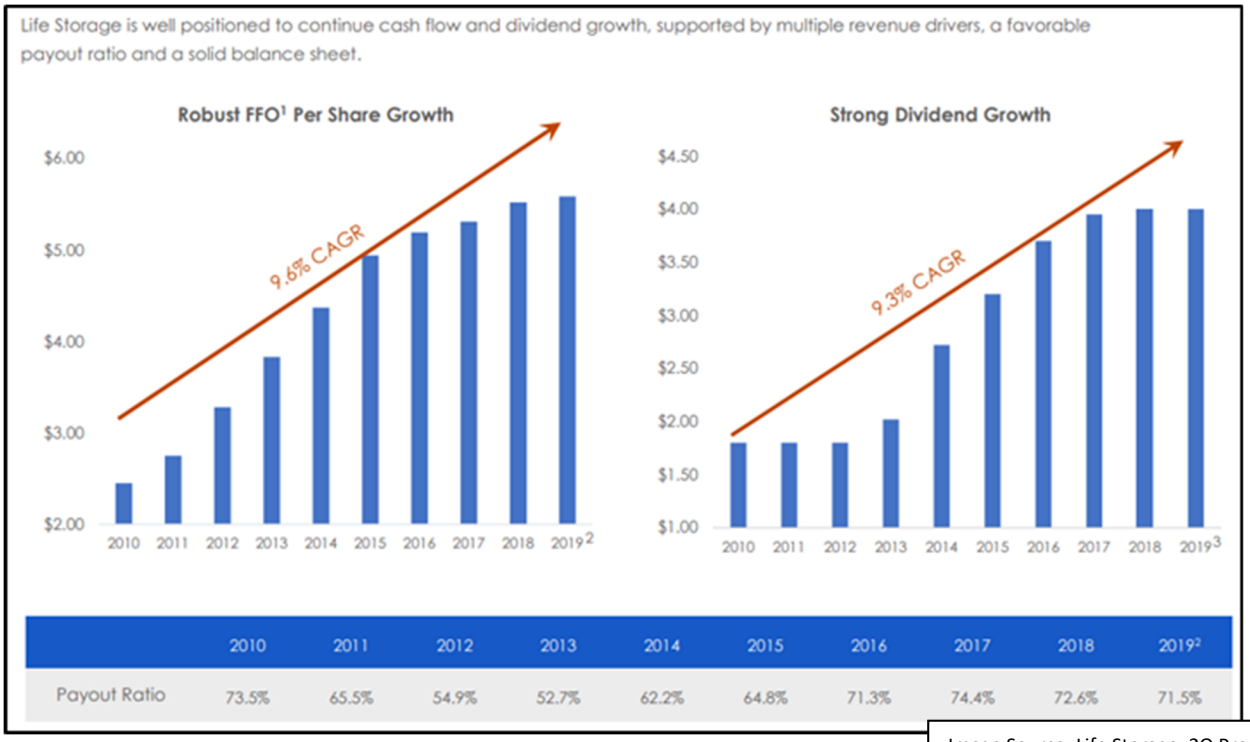
Growth prospects remain strong, too. According to the Self-Storage Almanac, roughly 19% of self-storage facilities are managed by the top 10 operators, so the industry remains ripe for consolidation as smaller providers are rolled up. Barriers to entry aren't that high, but competitive advantages can be garnered through efficient scale means, where a self-storage provider can look to dominate a particular locale by rolling up smaller providers. **We expect Life Storage to benefit from organic and acquisitive growth, both of which should augment its bottom line as efficiencies are captured.**

Image Source: Life Storage, 2Q Presentation

Let's cover a few risk factors before we get into the REIT's solid FFO (funds from operations) and dividend growth track record. For starters, in any highly fragmented industry, there is a risk of irrational pricing, but we view the fragmentation as more of an opportunity for the largest storage providers. They can always take out an irrational rival that's pricing at below-market levels, and in doing so, drive combined efficiencies across back-office, maintenance, and other expense line items. That said, in pursuing acquisitions, Life Storage must maintain discipline, and we have no reason to believe that it won't.

As with many REITs and high-yielding equities, there is often a lot of debt attached to the business model, and Life Storage is no exception. The REIT holds roughly $1.61 billion in term notes and the end of 2018 against a minimal cash balance. Though we much would prefer a large net cash position, the very idea of REITs paying out a large dividend almost negates this proposition, by definition and from a practical standpoint. **Moody's and Standard & Poor's rate Life Storage's debt Baa2 and BBB, respectively; these ratings are well into investment-grade territory, so we're not worried much, if at all.**

Life Storage's debt maturity schedule is extended, too, with the most meaningful maturities coming due in 2026 (~$600 million). It does have some debt coming due in 2020 and 2023/2024, but we would expect the REIT to have little difficulty rolling this over, given free-cash-flow generation trends of late. Debt/EBITDA stands at about 5.5x, so a little on the high side, but not terribly outlandish given the REIT's ability to cover dividends with free cash flow. **Life Storage's FFO and dividend growth track record are quite impressive, the latter clocking in at a 9.3% CAGR from 2010 through 2019 (see image on next page).**



	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019[2]
Payout Ratio	73.5%	65.5%	54.9%	52.7%	62.2%	64.8%	71.3%	74.4%	72.6%	71.5%

Image Source: Life Storage, 2Q Presentation

As we wrap up with this month's income idea, let's talk valuation. With interest rates so low and falling, it does mean that higher-yielding REITs may garner higher valuations, but it also reveals that in the event interest rates rapidly reverse course higher, valuations may reset lower, too – so there is risk. That said, as we look at where Life Storage stands today against some peers, **the company's FFO multiple, EBITDA multiple, and implied cap rate look mighty attractive, relatively speaking.**

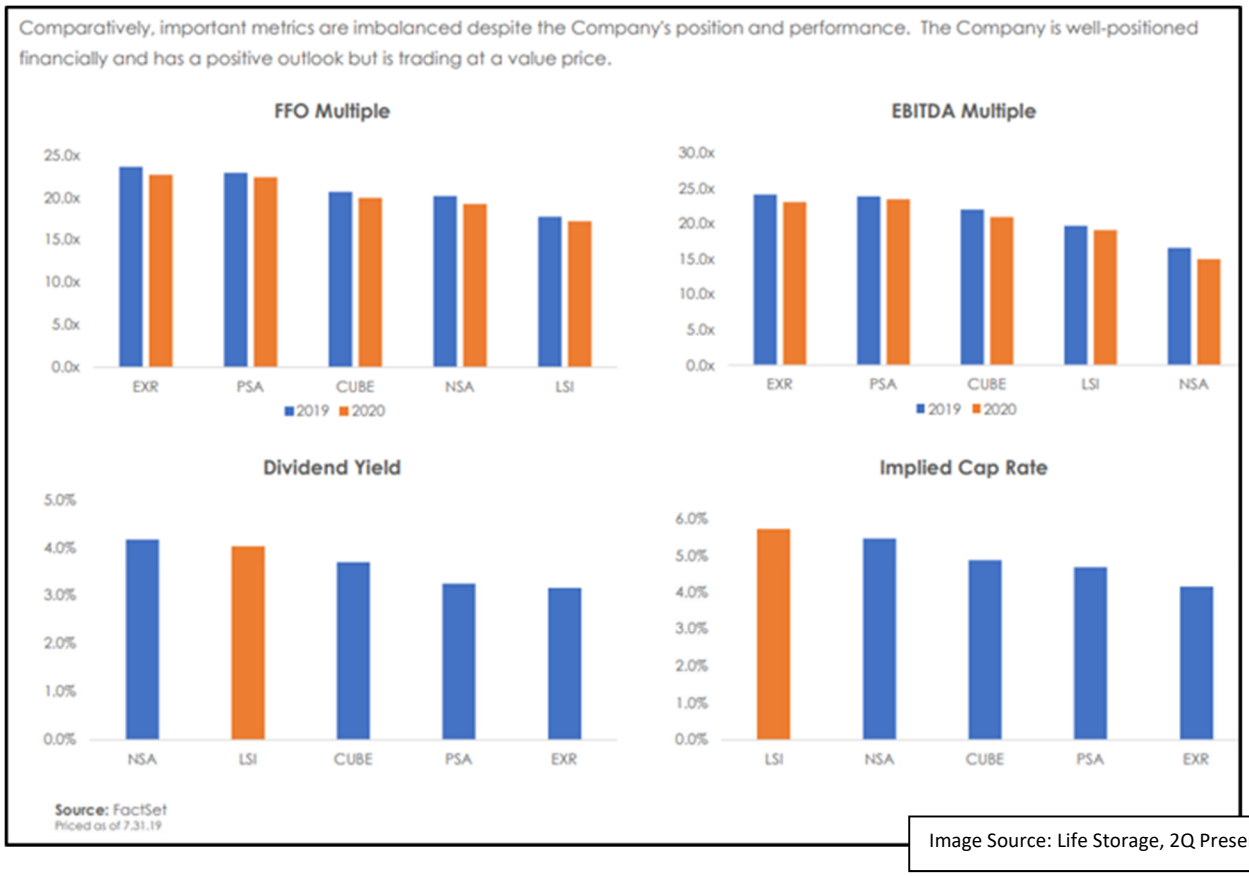


Image Source: Life Storage, 2Q Presentation

With strong traditional free cash flow generation, solid investment-grade credit marks, a nice dividend growth track record, organic and acquisitive growth opportunities, and a reasonable equity valuation, Life Storage makes the cut for this month's income idea for the Exclusive. Though we may want management to have a little more "skin in the game" (no one director or executive officer owns more than 1% of the company, as shown below), frankly, we're not seeing much to dislike. **Life Storage has a bright future, in our view, and its juicy yield looks enticing.**

Image Source: Life Storage, 2Q Presentation

Stock Ownership by Directors and Executive Officers

The following table sets forth information concerning beneficial ownership of Common Stock as of April 2, 2019 for each current director, each of our named executive officers and for all current directors and Executive Officers as a group. Unless otherwise noted, to the best of the Company's knowledge, each person has sole voting and investment power with respect to the shares listed.

Name	Shares of Common Stock Beneficially Owned at April 2, 2019 (1)(2)(3)	Percent of Common Stock Owned
Kenneth F. Myszka	174,021	*
Charles E. Lannon	139,079	*
Stephen R. Rusmisel	15,774	*
Arthur L. Havener, Jr.	10,826	*
Mark G. Barberio	10,027	*
Carol Hansell	912	*
Dana Hamilton	684	*
Edward J. Pettinella	684	*
David L. Rogers	110,000	*
Andrew J. Gregoire	55,224	*
Edward F. Killeen	28,498	*
Joseph V. Saffire	11,206	*
Directors and Executive Officers As a Group (11 persons)(4)	382,914	0.8%

Image Source: Life Storage, 2Q Presentation

Security Ownership of Certain Beneficial Owners

The following table sets forth information as to all persons or groups known to the Company to be beneficial owners of more than five percent of the outstanding Common Stock of the Company as of April 2, 2019.

Title of Class	Name and Address of Beneficial Owners	Amount of Common Stock Beneficially Owned as of April 2, 2019	Percent of Common Stock Owned
Common	The Vanguard Group, Inc. (1) 100 Vanguard Boulevard Malvern, PA 19355	7,304,313	15.7%
Common	Cohen & Steers, Inc. (2) 280 Park Avenue 10th Floor New York, NY 10017	6,857,416	14.7%
Common	BlackRock, Inc. (3) 55 East 52nd Street New York, NY 10055	5,657,678	12.1%
Common	Massachusetts Financial Services Company (4) 111 Huntington Avenue Boston, MA 02199	3,155,646	6.8%

BrianNelson published on TradingView.com, October 05, 2019 19:11:44 UTC
BATS:LSI, D 106.42 ▼ −0.39 (−0.37%) O:106.77 H:107.20 L:105.65 C:106.42
LIFE STORAGE INC, D, Cboe BZX
108.00
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100.00
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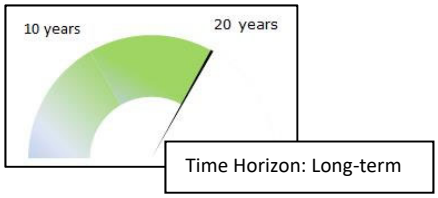


CLOUDFLARE

Cloudflare Inc (NET)

"Our business model is designed for efficiency. Our network and product flywheels create a virtuous cycle that has driven down our unit costs over time while we increase the diversity and quality of our products. We believe that our serverless platform's flexibility, as well as our aligned interests with our ISP partners, allows us to continue to become more efficient as we expand our network. At the same time, this architecture allows us to add new products and features across our platform without significant additional operating costs." – Cloudflare S-1/A Filing

Thesis

Our Exclusive Capital Appreciation idea for October 2019 is SaaS provider Cloudflare Inc (NET) which went public in September 2019. Cloudflare provides web security and web infrastructure services, with its cloud-based platform acting as an intermediary between the hosting server and the website visitor. Cloudflare offers a combination of web security, reliability, and performance enhancing services by optimizing web traffic and load balancing efforts while maintaining a buffer between user and host. **These services are required when conducting enterprise-level operations, with ~10% of the Fortune 1,000 now paying customers of Cloudflare's.** The vast majority of Cloudflare's revenue is generated through subscription-based revenue streams.

[Please note Cloudflare does not pay a common dividend and is unlikely to do so for the foreseeable future as it seeks to grow to gain the level of scale needed to become profitable. The firm isn't free cash flow positive and needs to retain cash to fund its growth story.]

Corporate Profile

Cloudflare Inc (NET) is a software-as-a-service ("SaaS") company that provides a broad range of network services to customers across the globe. Its cloud platform offers services that involve web security (virtual private networks, cyber-attack detection and prevention, internal and external firewalls, and more) and web infrastructure (application delivery controls, content delivery networks, and domain name systems). Cloudflare's platform acts as an intermediary between the hosting server and a website visitor, providing a level of security along with traffic optimization and load balancing services. Cloudflare was founded in 2009 and is based on San Francisco, CA.

Key Statistics	
Cloudflare (NET)	
Last Close	$17.27
52 Week Range	$15.51 - $22.08
Market Cap	$5.1B
Revenue (LFY)	$193M
GAAP Gross Margin (LFY)	77.40%

Cloudflare cites data provided by third-party market researcher IDC when noting that the market for its services stood at $31.6 billion in 2018, which is forecasted to rise to $47.1 billion in 2022. That's good for a 10.5% compound annual growth rate in a very lucrative industry with room to keep running higher. That growth is being driven by the shift from on-premise IT infrastructure (supported by prepackaged hardware), offerings that are very limited in their ability to scale and adapt to the ever changing demands of the 21st Century, to cloud-based IT offerings that are extremely scalable and far more intuitive than 'traditional' IT offerings. **Cloud-based offerings are better able to use real time analytics to identify cyber-security threats, balance web traffic and server loads, and identify efficiency improvements across the entire IT**

In order to gauge how well SaaS operates are performing, the dollar-based net retention rate is essential. This measure compares the annualized revenue generated from existing customers in the last month of the current period versus the annualized revenue of those customers during the prior twelve months and is a measure of how well Cloudflare is retaining customers and upselling existing customers on additional services or simply higher fees. **As of June 2019, Cloudflare's dollar-based net retention rate was solidly above 100% during the trailing eight quarter periods leading up to the end of the first half of this year.** During that eight quarter period, Cloudflare's dollar-based net retention rate averaged ~113.1% and came in at 111.7% during the quarter ended June 2019, which we like as that indicates Cloudflare is both retaining existing customers and generating more revenue on an annualized basis per existing customer. Below is a look at the trend of Cloudflare's dollar-based net retention rate.

Quarter Ended	30-Sep-17	31-Dec-17	31-Mar-18	30-Jun-18	30-Sep-18	31-Dec-18	31-Mar-19	30-Jun-19
Dollar-Based Net Retention Rate	111.3%	115.6%	110.5%	114.4%	113.6%	114.4%	113.1%	111.7%

Image Source: Cloudflare S-1/A Filing - Table created by the author

In the graphic below, Cloudflare highlights its customer cohorts by date (when the customer first became a paying customer) and annualized billings. **As you can see, growth really began picking up in 2014-2015 with each customer cohort after that adding substantially more to Cloudflare's reoccurring revenue streams than its early customers.**

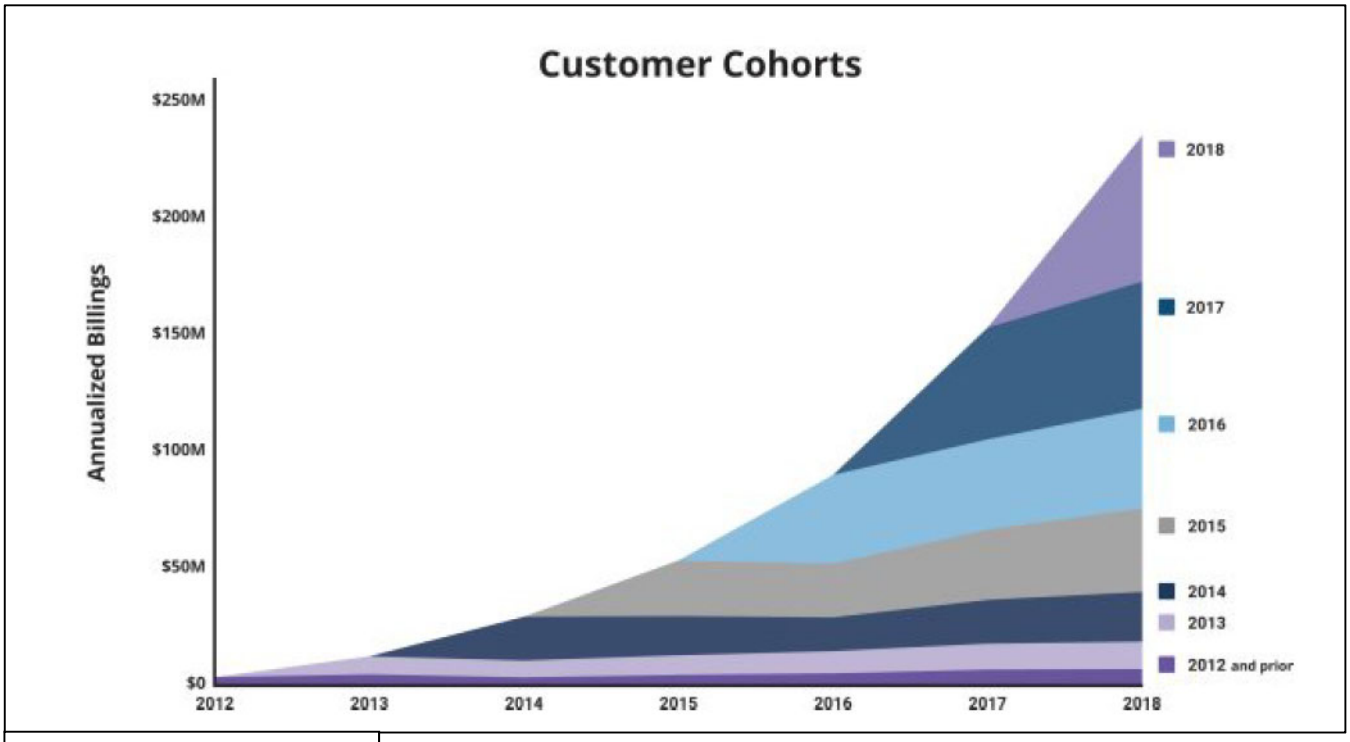


Image Source: Cloudflare S-1/A Filing

Beyond growing its reoccurring revenue streams, Cloudflare needs to prove that its business model is both profitable and scalable. As you can see in the table at the top of the next page, Cloudflare has seen its GAAP revenue climb from $85 million in 2016 to $193 million by 2018, up over 227% in two years. **During that period, Cloudflare's GAAP gross margin climbed from 71.7% to 77.4%, which we really like.** Cloudflare maintained 77.4% GAAP gross margins during the first six months of 2019 as its revenue grew by 48% year-over-year.

Results of Operations

The following tables set forth our consolidated results of operations for the periods presented in dollars and as a percentage of our revenue for those periods:

	Year Ended December 31,			Six Months Ended June 30,	
	2016	2017	2018	2018	2019
	(dollars in thousands)				
Revenue	$ 84,791	$134,915	$192,674	$ 87,105	$129,151
Cost of revenue(1)	23,962	28,788	43,537	19,372	29,192
Gross profit	60,829	106,127	149,137	67,733	99,959
Operating expenses:					
Sales and marketing(1)	40,122	61,899	94,394	41,744	66,653
Research and development(1)	23,663	33,650	54,463	24,286	36,517
General and administrative(1)	14,073	20,308	85,179	33,041	33,707
Total operating expenses	77,858	115,857	234,036	99,071	136,877
Loss from operations	(17,029)	(9,730)	(84,899)	(31,338)	(36,918)
Non-operating income (expense):					
Interest income	626	762	1,895	460	1,743
Interest expense	(654)	(862)	(992)	(475)	(563)
Other income (expense), net	(208)	115	(2,091)	(663)	(379)
Total non-operating income (expense), net	(236)	15	(1,188)	(678)	801
Loss before income taxes	(17,265)	(9,715)	(86,087)	(32,016)	(36,117)
Provision for income taxes	69	1,033	1,077	472	703
Net loss	$(17,334)	$ (10,748)	$ (87,164)	$(32,488)	$ (36,820)

(1) Includes stock-based compensation expense as follows:

Image Source: Cloudflare S-1/A Filing

While Cloudflare continued to post net operating losses during this period, that is to be expected for a growing SaaS company. **Sharp increases in operating expenses were realized across the board as Cloudflare rolled out its presence worldwide, and on a GAAP basis, those expenses grew by 38% during the first half of 2019 on a year-over-year basis.** These investments have yielded meaningful results and new customer additions as mentioned above. At the end of 2016, Cloudflare had roughly 35,000 paying customers with 95 of those customers paying more than $100,000 per year in annualized billings. By the end of June 2019, Cloudflare had almost 75,000 paying customers with 408 of those customers paying over $100,000 per year in annualized billings.

Note advertising expenses rose from $2 million in 2016 to $10 million in 2018, hitting an annualized $17 million during the first half of 2019. Advertising expenses represented less than 8% of Cloudflare's operating expenses in 2018. Cloudflare offers free services with limited offerings, utilizing spare capacity on its network infrastructure to provide those services at a very low cost, to win new customers over. That strategy has proven to be quite effective.

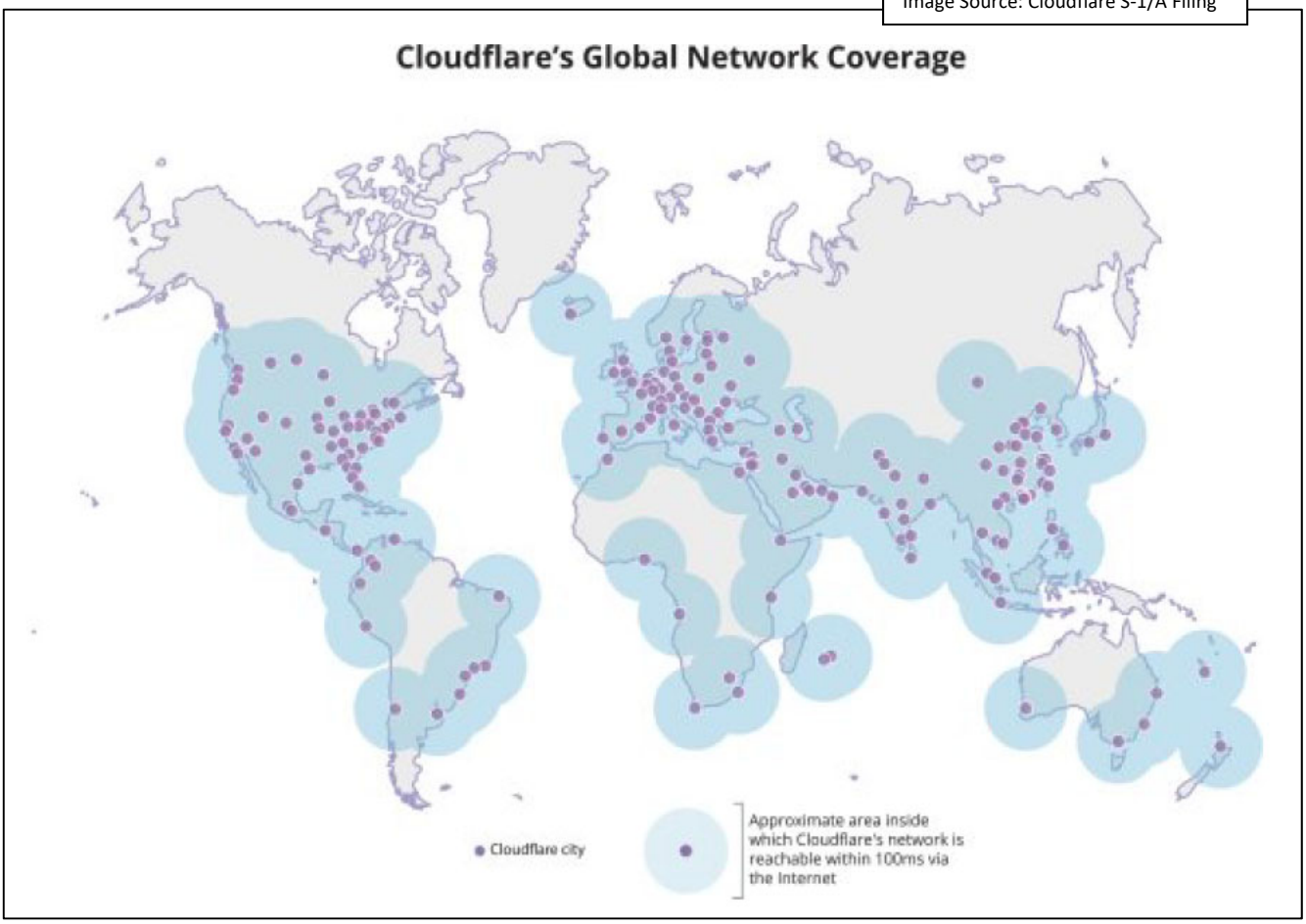
To fund its growth story, Cloudflare pursued an IPO and went public at $15 per share. The company planned to issue 35 million shares with its underwriters retaining the option to purchase an additional 5.25 million shares. **If fully exercised, that would raise ~$0.6 billion in cash. At the end of June 2019, Cloudflare had a negligible amount of debt (less than $1 million) and $125 million in cash, cash equivalents, and marketable securities on hand.** Combined with its most recent cash infusion, Cloudflare should have the funds it needs to reach profitability without necessarily needing to tap capital markets for the foreseeable future. During the first half of 2019, Cloudflare's annualized free cash flows came in at -$63 million (negative $63 million). **The SaaS provider appears to have enough cash on hand to cover current annualized negative free cash flows for more than a decade.**

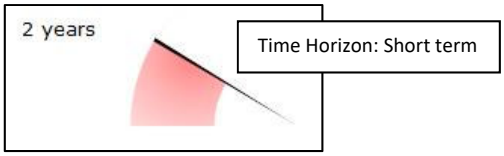
Cloudflare's Athenian Project represents a prime example of how the firm leverages free offerings to drum up interest in its products and services. The company offers free enterprise-level web security and web infrastructure services to local and state election websites in the US, including those operating in the City of San Francisco and the states of Alabama, Hawaii, North Carolina, and Rhode Island according to Cloudflare's website touting the project. While offering these free services incurs marginal incremental operating expenses, we see this as an effective way to highlight the power of its web security services at a time when competition in the cybersecurity market is really heating up. **The transition from on-premise prepackaged hardware to off-premise dynamic SaaS offerings for web security creates opportunities for smaller firms, but those firms need to get their brand out in front of key potential enterprise-level customers.**

We see a lot to like about Cloudflare, and in light of shares of NET trading near where it went public as of this writing, we think current market turbulence opens up a prime opportunity in another high-quality SaaS name. **Cloudflare has a nice net cash position, improving GAAP gross margins, strong dollar-based net retention rates, great top line growth, and operates in a growing market with room for enormous upside.** Cloudflare's business model is relatively light on capital expenditures but requires meaningful investments in talent and R&D to stay ahead of its competitors (both the old guard and new market entrants). **Once a meaningful level of scale is realized, Cloudflare should be in a position to be very free cash flow positive.**

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

Image Source: Cloudflare S-1/A Filing





Peloton Interactive Inc (PTON)

"Peloton was founded by John Foley in 2012. Along with his four co-founders, John set out to create the most convenient and immersive indoor cycling experience in the world. Our founders believed deeply that creating a Members-first experience would require Peloton to be as vertically integrated as possible, so we built teams that span software development, product design, fitness instruction, content production, marketing, music, logistics, retail, and apparel. We believe that no other company is at the intersection of all these disciplines, which means that every day we are doing something that no other company has done before. This, along with the positive impact we have on our Members' physical and mental well-being, fuels our passion for continuous innovation and progress." – Commentary from Peloton Interactive Inc's management team – S-1 SEC filing

Thesis

This should be an interesting exercise, because we are essentially going to make the case the Peloton Interactive Inc (PTON) is a very unique, interesting, and even inspiring company as it relates to health and wellness, **but that the shares are significantly overvalued and therefore PTON would make a sensible short consideration.** [Please note Peloton just went public back in late-September 2019 and that the firm does not currently pay out a dividend.]

Let's start with the boldness of the company's vision. Peloton has created a company that designs and markets bikes and treadmills (hardware) made by third parties in Taiwan, interactive software that facilitates real time and on demand distributed "boutique" fitness classes led by top notch instructors operating out of studios in New York and London. The firm sells products directly to consumers, most through its own website, but also through showrooms as well.

Peloton has both their own and outsourced "last mile" logistics teams to set up the hardware and software for clients to easily start using. The firm also designs and sells apparel for hardcore members and to both bolster its top line while facilitating word of mouth advertising. **While it's impressive how many things they do internally, I find the company and the CEO's communication regarding this topic bordering on hyping Peloton up to be a tech-led, everything company.**

Corporate Profile

Peloton Interactive, Inc. (PTON) is the largest interactive fitness platform in the world with a loyal community of over 1.4 million members, which they define as any individual who has a Peloton account. The Company pioneered connected, technology-enabled fitness and the streaming of immersive, instructor-led boutique classes to its Members anytime, anywhere. The Company markets and sells its interactive fitness products ("Connected Fitness Products") directly through its retail showrooms and its website.

The Company was founded in 2012 and incorporated in the State of Delaware in 2015. As of June 30, 2019, the Company had established wholly owned subsidiaries in the United States, the United Kingdom, Canada, and Germany and its corporate headquarters is in New York, New York. The Company organizes its business into the following three reportable segments: Connected Fitness Products, Subscription, and Other.

Key Statistics	
Peloton Interactive (PTON)	
Last Close	$23.01
52 Week Range	$21.14 - $27.98
Market Cap	$6.4B
Revenue (LFY)	$719M
GAAP Gross Profit (LFY)	$384M

This is clearly exemplified in the below graphic from the company's S-1 filing:

Image Source: Peloton S-1 Filing

Setting some of the pre-IPO hype aside, let's focus back in on what Peloton has done right. As you can see in the graphic down below, Peloton has rapidly added Connected Fitness Subscribers (attached to a Connected Fitness Product) and Members (unique logins averaging a bit more than 2 per Connected Fitness Product).

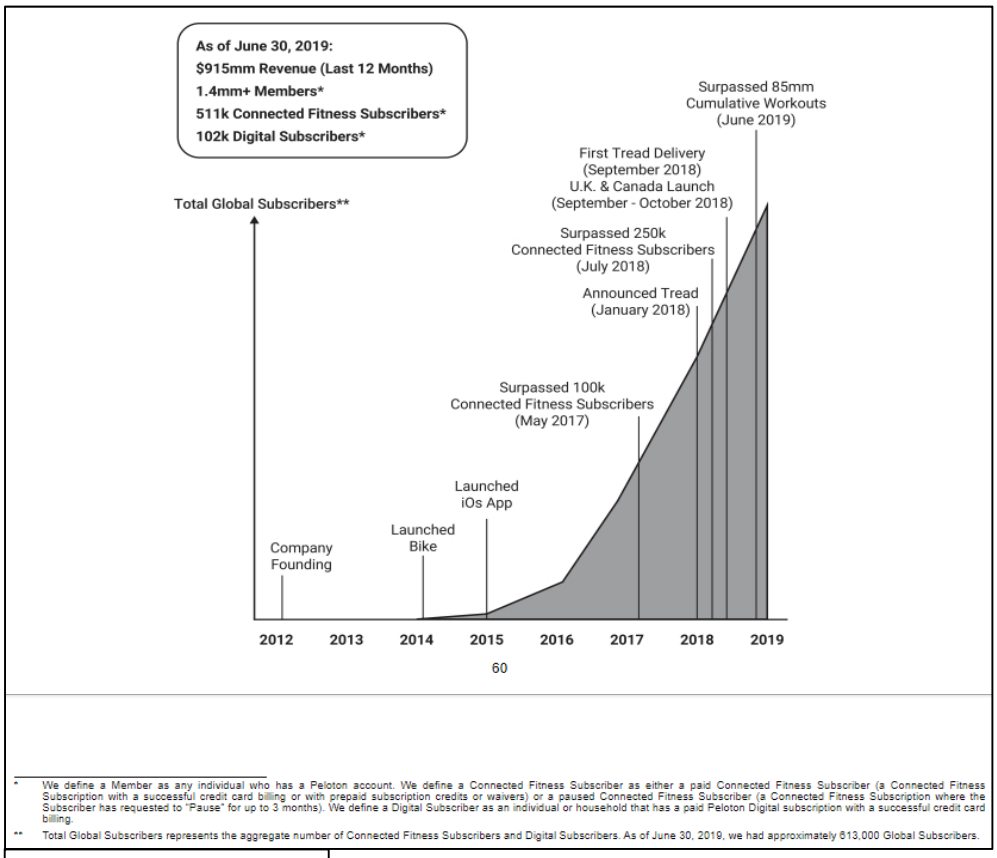


Image Source: Peloton S-1 Filing

So, we find it quite impressive that the company has managed to gather just over 500k Connected Fitness Subscribers, having only launched the bike back in 2014. Let's go over the costs involved for Members who want to experience PTON's all encompassing "experience." The bike costs $2,245 or $58/month for 39 months with (outside partner provided) zero percent financing. The Tread sells for $4,295 or 24 monthly payments of $179 with zero percent financing. **We are not certain how tight the underwriting is to achieve this financing, so it is a question mark what FICO and other factors are necessary so as not to go out of pocket up front.** Will this financing prove to be cyclical based on the partner(s) underwriting decisions? Having bought the hardware, you must pay a $39/month subscription for the entire household to access all the company's content.

The next question is: do people use the equipment once they have paid for it? **The answer appears to be yes most do, and the metrics are improving.** This must be attributed to an ever-larger library of content and/or the fact that they are selling to people that are even more enthusiastic about their workouts thus far. See the below graphics to see the increase in Connected Fitness Subscribers, Total Workouts and the relatively low churn of existing subscribers:

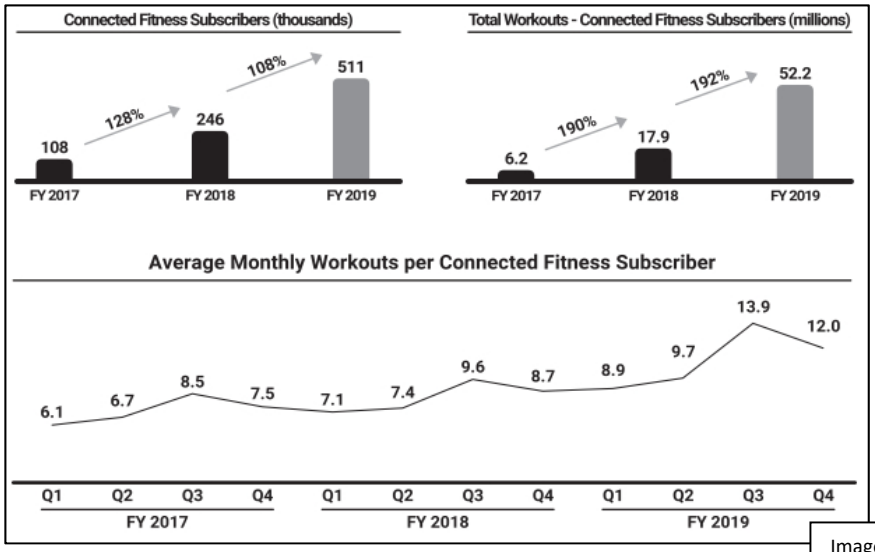


Image Source: Peloton S-1 Filing

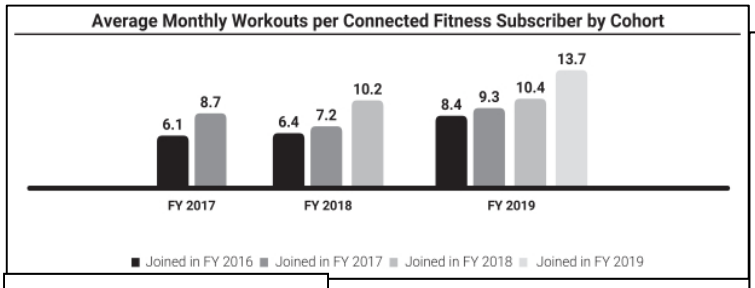
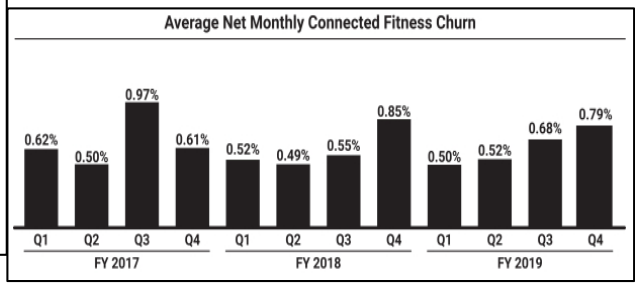


Image Source: Peloton S-1 Filing



Opportunity

We consider our market opportunity in terms of a Total Addressable Market, or TAM, which we believe is the market we can reach over the long-term in our current and announced markets, and a Serviceable Addressable Market, or SAM, which we address with our current product verticals and price points.

According to our research, our TAM is 67 million households, of which 45 million are in the United States. Within our TAM, we estimate that 52 million households are interested in learning more about our Connected Fitness Products without seeing the price. We estimate that our SAM is 14 million Connected Fitness Products, with 12 million represented in the United States. Historically, our SAM has grown as our brand awareness has increased. With low brand awareness in our current international markets, we believe we will see SAM expand as we make further investments in building brand and product awareness in these regions. We will grow both TAM and SAM as we expand beyond our current geographies and grow SAM as we develop new Connected Fitness Products and content in new fitness verticals. With approximately 577,000 Connected Fitness Products sold globally as of June 30, 2019, we are approximately 4% penetrated in our SAM of 14 million. For a discussion of the methodology used in determining our TAM and SAM, see the section titled "Industry and Market Data."

Image Source: Peloton S-1 Filing

While these initial statistics in the first few years of Peloton's existence are undeniably impressive, **we would argue that the most intense and loyal subscribers are of course the first ones that proved themselves willing to shell out the money for PTON's hardware and connected experience.** These are likely people that are hardcore cycling enthusiasts, hardcore gym and workout aficionados, participants in boutique workout programs such as Soul Cycle (whose IPO failed to launch), Orange Theory, etc. **It should be noted that even amongst these initial cohorts, fully 8% of hardware ever sold does not have a Connected Fitness Subscription attached as at June 30, 2019.** This means that those pieces of equipment are either being ridden w/out PTON's content, or more likely they are acting as the proverbial dusty coat-hanger in someone's basement.

A key part of our short case is just that. We fully expect that later purchasers of PTON's equipment to prove to be less enthusiastic than those from the first 5 years to date. **While many might feel the scourge of sunk costs and therefore not want to quit their subscription while they are still paying off their expensive piece of hardware, I suspect that more and more pieces of equipment either go dormant or find their way to the grey market of eBay Inc (EBAY), Craig's List, etc.** This will undermine both new hardware sales and it will also hurt the so far impressive retention (low churn) rates.

Aside from retention of existing and future users, the bigger question considering PTON's stratospheric valuation is just how big is the target market? In addressing this question, the company talks about the number of gym memberships in the country and the world as well as the number of stationary bikes and treadmills sold each year. The firm goes on to say that their internal customer surveys show that most of them were not even in the market for hardware when they bought a Peloton piece of equipment. We think this provides evidence that it is the wealthy and those with very serious commitments to cycling, running, and fitness, that are the first ones to have taken up these products. **The casual gym goer or weightlifter, or elliptical user simply will not be as inclined to spend the cash to follow the early adopters.** Let's look at the company's funnel of Total Addressable Market ("TAM") and Serviceable Addressable Market ("SAM").

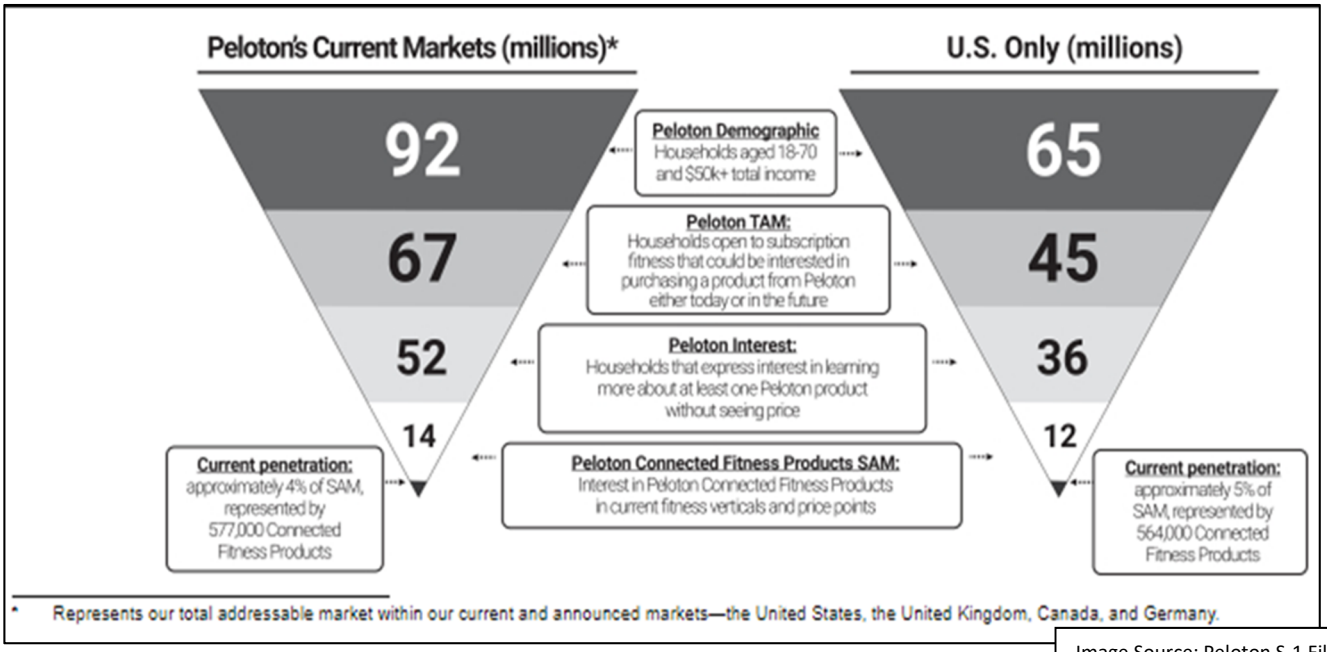


Image Source: Peloton S-1 Filing

What cannot be argued is that the company has seen very rapid subscriber and revenue growth to date, as can be seen below. **Unfortunately, our view is that triple digit growth rates will soon be a thing of the past as the company moves past the early adopters and onto the more casual gym goers who have never set foot inside a Soul Cycle or Flywheel, and therefore might not be clamoring to have the experience duplicated all by their lonesome at home.**

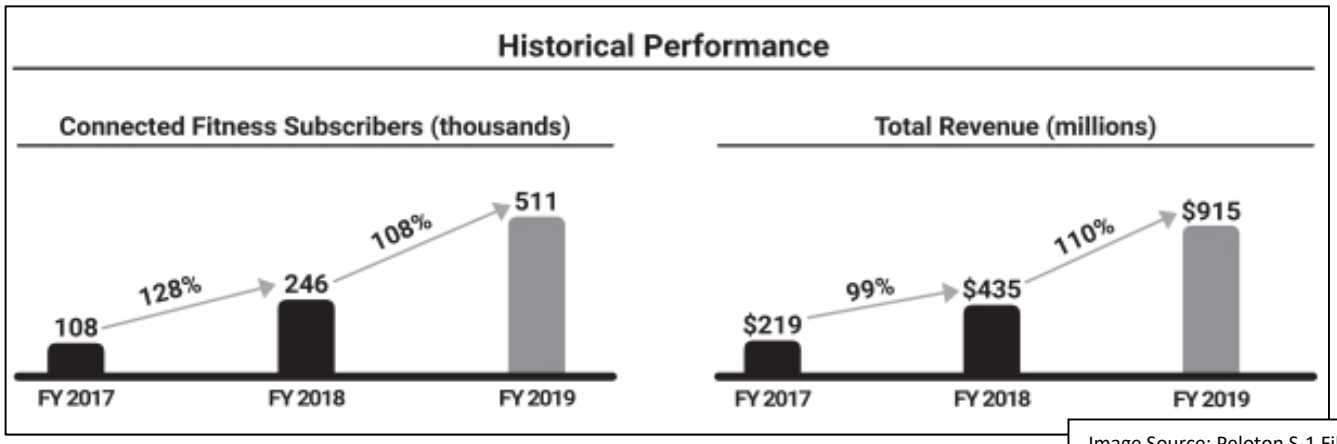


Image Source: Peloton S-1 Filing

Another reason why we think the sledding will be tougher in the future as compared to the past is competition. You may have seen one of the many Peloton commercials that are plastered all over the television set, but then you might also have seen an ad for a competing product called the Mirror. The Mirror is a wall mounted screen/mirror that is a superior form factor for classes that do not involve a piece of hardware like the bike or treadmill. They offer barre, boxing, cardio, dance, kickboxing, Pilates, restorative yoga, strength, stretch, and yoga flow classes. The Mirror costs $1,495 and $39/month and is probably a superior product for these types of classes. Since the company is privately-held (venture backed), it is hard to tell how far along they are at this moment in terms of subscribers, revenue, and content.

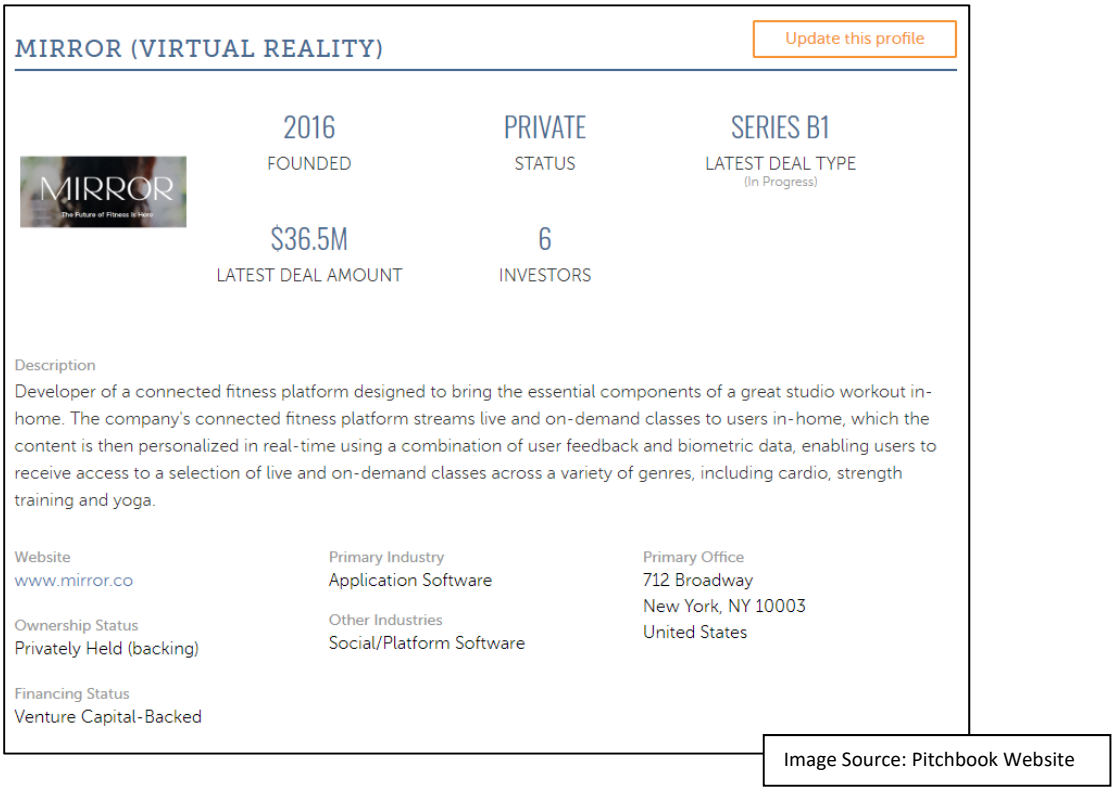


Image Source: Pitchbook Website

Suffice it to say that Mirror is venture backed and spending plenty on ads. This much we know. Another competitor, though troubled, is Flywheel. Flywheel offers boutique on premise classes (some studios have closed, and the firm was seized by its lenders), but it has also embarked on a distributed model for cycling at home. In fact, Peloton and Flywheel are locked in litigation according to a *Financial Times* article dated December 19, 2018.

It's also not hard to envision a company just offering classes via subscription for consumer's existing devices mounted on any old bike or treadmill. In fact, Peloton itself offers just such a service which it calls its Digital Subscriptions. It offers these for $19.49/month and had 102k subscribers as of June 30, 2019. This is a cheap and quick fix for those that don't want to shell out over $2k for a Peloton-branded, connected stationary bike. Again, we don't see why the Mirror might not go into cycling or running/walking to compete even more directly with Peloton.

Now, let's talk numbers. As of this writing, and despite having traded down since its IPO, Peloton still enjoys a market cap over $6 billion. The company only put up revenue of $719.2 million in its fiscal year ending June 30, 2019. **That means PTON is trading at 8.3 time trailing sales! And that's the only multiple that makes sense as earnings, EBITDA, and adjusted EBITDA (stripping out important costs like sizable stock option expenses), are all negative.** While we admit this wouldn't be a problem if we could chart the course to a more normal earnings or free cash flow multiple in the foreseeable future, we struggle mightily to do so. To date, PTON has not shown us that it is a scalable business. As you can see in the graphic below, positive and growing gross profits are being chewed up by ever growing R&D, Sales and Marketing, and General and Administrative costs.

Image Source: Peloton S-1 Filing

	Fiscal Year Ended June 30,		
	2017	2018	2019
	(in millions)		
Connected Fitness Products:			
Revenue	$ 183.5	$ 348.6	$ 719.2
Cost of revenue	113.5	195.0	410.8
Gross profit	$ 70.0	$ 153.6	$ 308.4
Subscription:			
Revenue	$ 32.5	$ 80.3	$ 181.1
Cost of revenue	29.3	45.5	103.7
Gross profit	$ 3.2	$ 34.7	$ 77.4
Other:			
Revenue	$ 2.6	$ 6.2	$ 14.7
Cost of revenue	1.9	4.9	17.0
Gross profit	$ 0.8	$ 1.3	$ (2.3)
Consolidated:			
Revenue	$ 218.6	$ 435.0	$ 915.0
Cost of revenue	144.7	245.4	531.4
Gross profit	$ 73.9	$ 189.6	$ 383.6

Reconciliation of Gross Profit

Operating expenditures, interest (income) and other expense, and taxes are not allocated to individual segments as these are managed on an entity wide group basis. The reconciliation between reportable segment gross profit to consolidated loss before tax is as follows:

	Fiscal Year Ended June 30,		
	2017	2018	2019
	(in millions)		
Segment Gross Profit	$ 73.9	$ 189.6	$ 383.6
Research and development	(13.0)	(23.4)	(54.8)
Sales and marketing	(86.0)	(151.4)	(324.0)
General and administrative	(45.6)	(62.4)	(207.0)
Total other income (expense), net	(0.3)	(0.3)	6.7
Loss before provision for income taxes	$ (71.1)	$ (47.8)	$ (195.6)

Image Source: Peloton S-1 Filing

	Fiscal Year Ended June 30,		
	2017	2018	2019
	(dollars in millions)		
Subscription revenue	$ 32.5	$ 80.3	$ 181.1
Less: Cost of subscription(1)	29.3	45.5	103.7
Subscription gross profit	3.2	34.7	77.4
Subscription gross margin	9.7%	43.3%	42.7%
Adjusted to exclude the following:			
Depreciation and amortization expense	$ 1.2	$ 2.8	$ 11.3
Stock-based compensation expense	0.1	0.5	3.2
Subscription Contribution	$ 4.4	$ 38.0	$ 91.9
Subscription Contribution Margin	13.5%	47.5%	50.8%

(1) Included in cost of subscription are content costs for past use as follows:

	Fiscal Year Ended June 30,		
	2017	2018	2019
	(in millions)		
Content costs for past use(1)	$ 15.5	$ 14.5	$ 16.4

(1) From time-to-time, we execute music royalty agreements with various music rights holders. As part of these go-forward license agreements, we may also enter into agreements whereby we are released from all potential licensor claims regarding our alleged past use of copyrighted material in our content in exchange for a mutually-agreed payment. We refer to these payments as content costs for past use. Included in Subscription Contribution and Subscription Contribution Margin are content costs for past use. These costs had a negative basis point impact on Subscription Contribution Margin of 4,788, 1,805, and 908 for fiscal 2017, 2018, and 2019, respectively.

Given the competitive situation, we have some sympathy for why Peloton is spending so much on ad dollars to try and outspend, outgrow, and ultimately kill the competition. But is this really a winner-take-all industry? The presence of Mirror and their multiple rounds of VC funding make us think not. **If this turns out to be a duopoly, it still could mean massive pricing and margin pressure as the industry itself grows. There will always be incentive to undercut the other fellow if there are at least two players in this game, let alone the 3 there are now.**

Will boutique on-premise classes have a renaissance at the expense of working out at home in front of a screen? Surely there will be room for both, but at what market size, respectively? If you pay 8.3 times sales for Peloton, you are betting this is a winner-take-all scenario and that Peloton will see substantial positive operating leverage, leading to outsized profit margin in the future. Let's just say we'll "take the under" as the skeptic on this recent deal. That doesn't mean we don't want to ride one of the bikes, though!

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

Inaugural Letter to Members

July 1, 2016

Dear Valued Member,

Welcome! You are one of a very limited number of members that will ever bear witness to the pages that follow.

The launch week of the Nelson Exclusive coincided with news that Britain has voted to leave the European Union. The decision, while sending the European banks tumbling violently, does little to muddy the context setting the background of the inaugural edition of this publication.

Broader stock market valuations are at frothy levels, and interest rates continue to hover near all-time lows. The investment-decision landscape is more complicated today than ever before for all types of investors, from those seeking long-term capital appreciation to those that are targeting certain income goals. Cyclicals today are trading at peak multiples on peak earnings, and even consumer staples equities have reached valuation levels that may be more appropriate for aggressive growth equities, not mature operators. *Said differently, the market has laid down the gauntlet.*

The next few years in the markets may be among the most difficult witnessed since the Great Recession. Even a broader market pullback 20% from current all-time highs wouldn't be abnormal given that the collective market valuation of S&P 500 companies has effectively tripled from the March 2009 panic bottom. The launch of the Nelson Exclusive in such conditions can be considered perilous as broader market performance inevitably will act as ballast to the returns of ideas surfaced. In this spirit, I want to remind you that not all ideas in this publication will be successful, and some that are eventually may encounter tough sledding over extended periods of time. As a swimmer cannot achieve his best time swimming against the current, a stock selector cannot achieve his best performance in a down market. Regardless, the value placed on a steady hand during challenging times is priceless.

Let's first cover what the Exclusive is and then we'll talk about what it is not. As you know, the Valuentum investment coverage universe is vast, and what we're seeking to deliver in this publication is ideas that fall outside its reach. We're breaking down the traditional barriers of equity coverage to identify underfollowed gems across the investing spectrum, delivering in each monthly edition one idea for income investors, one idea for readers seeking long-term capital appreciation, and a bonus idea for those looking for a "short" consideration (1). Underfollowed doesn't mean obscure, however, and the ideas that we're targeting will be investable ones, avoiding thinly-traded instruments and penny stock "traps." We'll clearly define our expected time horizon for each consideration, and where applicable, we'll update our theses in subsequent editions. We'll keep score, tracking performance over time.

Let's talk about what the Exclusive isn't. The Exclusive does not constitute individual investment advice, and the ideas within it are not personal recommendations. Each of you reading should always work with your

personal financial advisor who knows your individual goals and risk tolerances. I do not. Only you and your personal financial advisor know what's best for your life circumstances. The personal financial advising markets and what we do at Valuentum via financial publishing are two different verticals in the same industry, but they are different nonetheless. I just want to be very clear about this because I can never tell you to buy or sell anything at any time, even if this may be what you want. It's not that I don't have conviction in my work – it's the rules of the business.

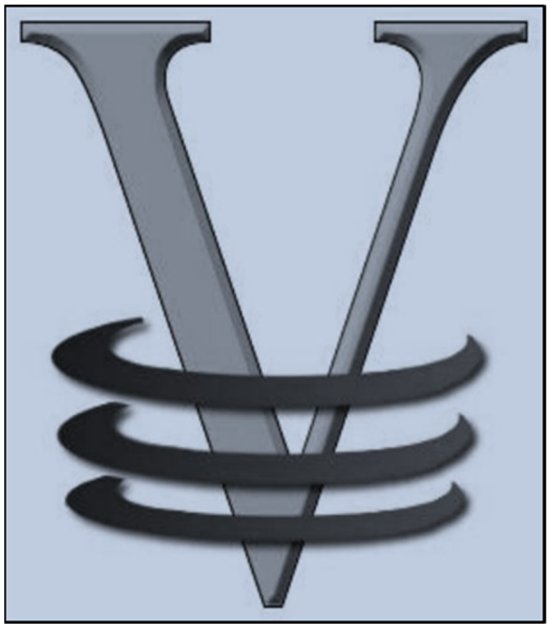
Within the twelve editions of the Nelson Exclusive each year, we'll be highlighting in total 36 ideas for consideration with varying investment parameters. That's a lot. Depending on the time horizon set forth with each idea, fantastic performance might mean a success rate of 60%, great performance might be 55%, average performance might be 50%, while anything below that mark may constituent a poor showing. Obviously, I'm aiming for a 100% success rate, but I also have to be realistic. The great Joe DiMaggio may have hit safely for 56 consecutive games in the last baseball season before the United States was thrust into World War II, but he "only" hit .357 that year. That season of '41, the great Ted Williams would be the last player to hit .400, meaning that one of the best hitters in baseball…ever…was still called out ~60% of the time.

The greatest investors face a similar paradigm. Stock selection is a process where there will be homeruns and strikeouts. You know me. The Exclusive is not a "get-rich-quick" product, and you should keep a close eye on your wallet if you encounter anyone promising anything of the sort. In the inaugural edition of the Nelson Exclusive, I'm going to take 36 swings – they are going to be hard and through the zone, and I'm not going to pull my shoulder out or take my eye off the ball. Market conditions are expected to be stormy in coming years as "reversion-to-the-mean" dynamics rain down, and a crafty lefthander with great "stuff" may be on the mound, but we're stepping up to the plate and digging in.

Batter up!

Sincerely,

Brian Nelson, CFA
President, Investment Research & Analysis
Valuentum Securities, Inc.
brian@valuentum.com



P.S. On a very personal note, I wanted to thank you for your continued support. Without you, neither the Nelson Exclusive publication nor Valuentum would exist. This fact is not lost on me. I thank you deeply.

The Nelson Exclusive: Volume 4, Issue 10

The Nelson Exclusive is published monthly. Contact us at info@valuentum.com for more information.

(1) From the SEC's website: A short sale is the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor. Short sales are normally settled by the delivery of a security borrowed by or on behalf of the investor. The investor later closes out the position by returning the borrowed security to the stock lender, typically by purchasing securities on the open market.

Investors who sell stock short typically believe the price of the stock will fall and hope to buy the stock at the lower price and make a profit. Short selling is also used by market makers and others to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security. If the price of the stock rises, short sellers who buy it at the higher price will incur a loss.

Brokerage firms typically lend stock to customers who engage in short sales, using the firm's own inventory, the margin account of another of the firm's customers, or another lender. As with buying stock on margin, short sellers are subject to the margin rules and other fees and charges may apply (including interest on the stock loan). If the borrowed stock pays a dividend, the short seller is responsible for paying the dividend to the person or firm making the loan (Source: SEC https://www.sec.gov/answers/shortsale.htm)

Short selling is not for all types of investors, and readers should consult their personal financial advisor that understands their individual goals and risk tolerances before considering any investment or any strategy. Potential losses for an investor engaging in a short selling strategy are theoretically infinite.

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