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HIGH YIELD DIVIDEND NEWSLETTER

Digital Realty Starts 2020 Off Right

Latest Changes to High Yield Dividend Newsletter
Previously Removed: 5% in AMLP – November 18
Previously Added: 2.5% to T; 2.5% to PM – November 18

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"THE NOVEL CORONAVIRUS EPIDEMIC IS SPREADING, WITH NUMEROUS CASES NOW REPORTED IN SOUTH KOREA, ITALY, IRAN, AND ELSEWHERE. EVEN THE U.S. CENTERS FOR DISEASE CONTROL AND PREVENTION SEES THE CHANCES OF THE EPIDEMIC SPREADING TO THE U.S. AS LIKELY."
– CALLUM TURCAN

Image Source: *Digital Realty Trust Inc – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

By Callum Turcan

Dear members,

On February 13, the data center real estate investment trust ('REIT') Digital Realty Trust Inc (DLR) reported fourth quarter and full-year earnings for 2019 after the market close. The firm's top-line marginally missed consensus estimates as its funds from operations ('FFO') per share modestly beat consensus estimates. Shares of DLR marched up the following day as investors priced in the FFO per share beat. However, DLR has more recently come under fire due to the ongoing market selloff. We continue to like shares of DLR as a holding in both our High Yield Dividend Newsletter and Dividend Growth Newsletter portfolios. As of this writing, Digital Realty **yields ~3.4%.**

Earnings Overview and a Tough 2019

The REIT's FFO per share on a diluted basis marched up over 5% year-over-year in the fourth quarter to $1.62, and for the full-year was up almost 5% year-over-year, reaching $6.66 per share in 2019. However, please note that Digital Realty's adjusted FFO per share fell by a tad over 2% year-over-year in 2019 to $5.93. **This was expected due to elevated levels of lease expirations last year and pressure on rental rates in numerous markets**, with management having this to say during Digital Realty's fourth quarter 2019 conference call (emphasis added):

> *"We signed a $117 million of renewals during the fourth quarter in addition to new leases signed. As you may recall,* ***2019 was our all-time high in terms of lease expirations*** *and we signed over $500 million of renewal leasing in 2019, more than 50% higher than our previous record year with a weighted average lease term of nearly nine years. For the full year,* ***we retained a little over 80% of expiring leases right in line with our long-term average while cash rents rolled down 1.3%, much better than our initial expectation of down high single-digits.***
>
> *As you may recall, we successfully executed both legacy deal our long-term top customer renewals, as well as the long-awaited legacy DFT customer renewal in 2019. As you can see from the lease expirations schedule on Page 13 [the upcoming graphic down below], less than 16% of the portfolio expires in any given year compared to the 23% we faced at the beginning of last year, which should set the stage for a low churn hurdle going forward.* ***Aside from a few select supply constrained regions in metro areas, we have yet to see broad based rental rate growth across most markets."***

Pressures stemming from the US-China trade war and slowing global economic activity in key regions made 2019 a tougher year for data center firms than in the recent past. That being said, Digital Realty performed well relatively speaking and investors rewarded the REIT for its efforts. Please note that we really appreciate Digital Realty's more manageable lease expiration schedule going forward. The upcoming graphic is the one cited by management up above.

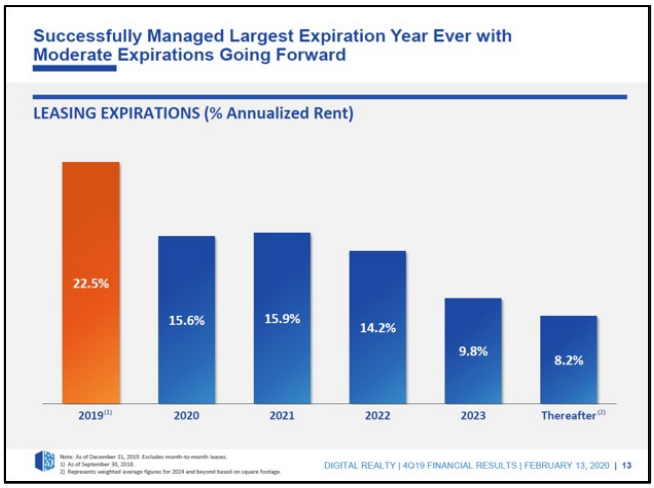


Image Shown: *Going forward, Digital Realty's lease expiration schedule is much more manageable.* ***Image Source:*** *Digital Realty – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

Looking ahead, Digital Realty's outlook is much brighter for several reasons that we'll cover in just a moment. Before then, please note that Digital Realty's AFFO payout ratio (dividends per share divided by AFFO per share) stood at 72.9% in 2019.

While an imperfect metric, we like REITs that maintain AFFO payout ratios below 80% as that provides for a better buffer should problems arise, like elevated lease expirations. The REIT carries an adjusted Dividend Cushion ratio of 2.9x, earning Digital Realty a GOOD Dividend Safety rating (given its need to tap capital markets to refinance its large debt load, which we'll cover later on) and an EXCELLENT Dividend Growth rating.

Moving Deeper into Europe

Back in October 2019, Digital Realty announced it planned to merge with InterXion Holding NV (INXN), a European-focused data center company, in an all-stock deal. For each share of INXN, InterXion shareholders would receive 0.7067 share of DLR.

On February 27, 2020, InterXion shareholders voted to approve the deal, which is expected to close during the first half of 2020. For Digital Realty, this deal further solidifies its position as a leader in the global data center space that provides colocation and interconnection services. It already has a big presence in London and Dublin and wants to now expand its European operations into mainland Europe in a big way.

At the time of the initial announcement of the merger, InterXion serviced 11 countries and 13 major metropolitan areas that can offer "consistent, high-quality services with low-latency access to approximately 70% of the GDP in Europe" which provides Digital Realty a nice growth runway. We are supportive of this deal, as is Institutional Shareholder Services (the proxy advisor company). Please note that while Digital Realty isn't seeing widespread rental rate growth, **rental rates continue to rise in key metropolitan markets. Buying InterXion gives Digital Realty access to several of those markets, which is why we view this deal as augmenting its favorable outlook after a tough 2019.**

Digital Realty Makes a Smart Buy

To keep the momentum going, Digital Realty announced on February 12 that it had reached a deal with Clise Properties (a privately-held property management firm) to acquire a 49% ownership interest in the Westin Building Exchange. That building is situated in the heart of the mega-tech hub Seattle, Washington, and **marks another one of Digital Realty's forays into a very high growth metropolitan market.** When the deal closes, Digital Realty will take over operatorship of the building. Here's what the press release had to say:

> *The Westin Building Exchange serves as the primary interconnection hub for the Pacific Northwest, linking Canada, Alaska and Asia along the Pacific Rim. The building is the sixth most densely interconnected facility in North America, and is home to leading global cloud, content and interconnection providers, housing over 150 carriers and more than 10,000 cross-connects. The 34-story tower is adjacent to Amazon's (AMZN) 4.1 million square foot urban campus and overlooks Elliott Bay as well as the downtown Seattle skyline…*
>
> *…The Westin Building Exchange occupies a unique position in the communications infrastructure landscape, given customers' growing propensity to deploy IT infrastructure at centers of data exchange around the world, bringing users, things, applications, clouds and networks to the data. Digital Realty's investment in the Westin Building will unlock new possibilities for customers to scale digital transformation by removing data gravity barriers.*
>
> *The Westin Building Exchange sits at the digital crossroads of the Pacific Northwest and provides direct and virtual access to one of the richest communities of cloud and network providers, powered by Digital Realty's Service Exchange. When fully integrated into PlatformDIGITAL™, the Westin Building Exchange will play a strategic role in addressing customers' coverage, capacity and ecosystem connectivity needs with a single data center provider.*

Financial terms weren't disclosed, but it appears this purchase is highly complementary to Digital Realty's long-term goal of targeting "network dense" areas that are more likely to experience rental rate growth and retain very high occupancy/usage rates. We like the firm's strategic pivot.

Moving into India

Expanding its footprint in Europe and Seattle sets the stage for stronger near- and medium-term growth and moving into India underpins its long-term growth trajectory. In October 2019, Digital Realty signed a memorandum of understanding with India's Adani Group to jointly develop and operate data centers in the sub-continent. As these are still early days, Digital Realty's management team didn't have much to say during the REIT's latest quarterly conference call, but they did mention this;

> *"We also executed a memorandum of understanding with the Adani Group to pursue a joint venture in India and we are actively exploring opportunities to plant our first flag in this vast untapped market with tremendous growth potential."*

Digital Realty has contemplated moving into India and other south and southeast Asian markets (beyond its existing position in Singapore) for some time. The REIT is getting closer now to making that a reality.

Managed Debt Load

As you can see in the upcoming graphic on the next page, Digital Realty's debt maturity schedule is quite manageable. Pro forma for a forward equity offering and expected asset sale proceeds, Digital Realty's net debt to adjusted EBITDA ratio stood at 5.0x during the fourth quarter of 2019. We would like to see that shift down over time.

Please note Digital Realty is capital market dependent and needs to retain access to debt and equity markets to refinance its large debt load (net debt stood at ~$10.0 billion as of December 30, 2019). Given its investment grade credit ratings (BBB/Baa2/BBB) and the strong performance of shares of DLR of late, **we view Digital Realty as retaining quality access to capital markets at attractive rates.**

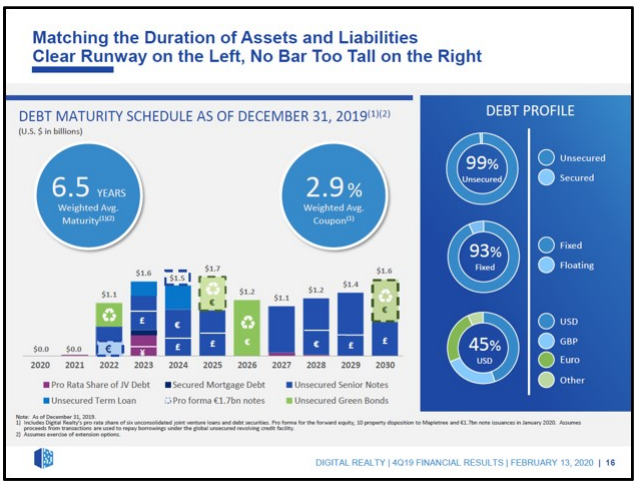


Image Shown: *We like Digital Realty's managed debt maturity schedule.* ***Image Source:*** *Digital Realty – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

Concluding Thoughts

When Digital Realty files its 10-K filing for 2019 (which has yet to be the case as of late-February), we'll have more to say on the company as it relates to its cash flow profile, balance sheet position, and other financials. For now, while 2019 was rough, it wasn't as bad as management had expected.

Moving into metropolitan markets and targeting "network dense" areas will go a long way in improving the REIT's near- and medium-term outlook, which we appreciate. We continue to like shares of DLR in our both our High Yield Dividend Newsletter and Dividend Growth Newsletter portfolios, and see DLR being well-positioned to ride out ongoing market turbulence as fears over the novel coronavirus epidemic spread.

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

Banking Sector Analysis

By Matthew Warren

This month, we want to address two items regarding the banking space, which we have discussed on numerous occasions over these past few months.

The first is an update on the dividend yields being offered up by "Mr. Market". As interest rates have come down substantially over the past month, expectations for reductions in net interest margins ('NIMs'), and a higher probability of recession being baked into the cake, have knocked the banking sector down substantially as well. Using stock prices and projected dividend yields as of midday Thursday February 27, 2020, you can see in the below graphic that several banks are now offering prospective yields of close to ~5%. **This is a tremendous spread over safe assets such as banking accounts**, the 10-year government bonds, and even the 30-year government bonds.

		Share Price	Market Cap (B)	Forward Dividend	Yield
JP Morgan	JPM	$ 123.31	$ 378.90	$ 3.60	2.9%
Bank of America	BAC	$ 29.55	$ 257.90	$ 0.72	2.4%
Wells Fargo	WFC	$ 43.41	$ 179.50	$ 2.04	4.7%
Citigroup	C	$ 66.03	$ 139.10	$ 2.04	3.1%
Morgan Stanley	MS	$ 46.53	$ 71.20	$ 1.40	3.0%
Goldman Sachs	GS	$ 211.56	$ 73.10	$ 5.00	2.4%
U.S. Bancorp	USB	$ 48.90	$ 74.5	$ 1.68	3.4%
Truist Financial Corporation	TFC	$ 49.47	$ 66.3	$ 1.80	3.6%
The PNC Financial Services Group, Inc.	PNC	$ 134.73	$ 58.3	$ 4.60	3.4%
M&T Bank	MTB	$ 152.50	$ 19.9	$ 4.40	2.9%
KeyCorp	KEY	$ 17.26	$ 16.9	$ 0.74	4.3%
Fifth Third Bancorp	FITB	$ 26.07	$ 18.5	$ 1.08	4.1%
First Republic Bank	FRC	$ 107.52	$ 18.1	$ 0.76	0.7%
Citizens Financial Group	CFG	$ 33.40	$ 14.3	$ 1.56	4.7%
Regions Financial Corporation	RF	$ 14.35	$ 13.7	$ 0.62	4.3%
Huntington Bancshares	HBAN	$ 12.70	$ 13.0	$ 0.60	4.7%
Comerica	CMA	$ 55.03	$ 7.8	$ 2.72	4.9%

Image Data Source: *Yahoo Finance*

The four stocks in green are those that we have highlighted previously as potential opportunities for dividend-seeking investors. The current yields are that much more enticing, ESPECIALLY if you are of the view that a near-term recession IS NOT in the cards, but this is a highly debatable point this late in the cycle and with the novel coronavirus ('COVID-19') epidemic wreaking havoc on global supply lines and confidence in group and travel-oriented activities in the hardest hit countries. Will the disease spread in large numbers and scare many more folks indoors? This is a great unknown at this point, **but the signs are not good**, and perhaps it's a question of how quickly it will pass rather than if and when sizable numbers of sick people turn up in countries around the globe.

So, what does this mean for the banking industry? Let us invert the question and assume the virus does cause a recession of unknown magnitude and duration at this stage. A recession means several things for banks, though again the size and shape of the pain will and does vary from one recession to the next. Revenues will come under pressure as loan and deposit growth slows (or turns negative), and net interest margins come under pressure from lower interest rates and a flattening (or inverted) yield curve.

To the extent a bank participates in these markets, investment banking and trading revenues generally come under pressure as activity, while volatile, usually decreases overall. Bad loans increase which increases expenses, though lower rates help offset this pressure to some degree. Revenue pressure means worse efficiency ratios, though this pressure can sometimes be ameliorated by cost cutting. Basically, revenue and cost lines all move in the wrong direction, pressuring earnings to some degree, depending on the severity of the recession (in the footprint where the bank operates).

However, as we have outlined in previous pieces, these dividends are generally well-covered by earnings, leaving space for earnings declines to not necessarily amount to dividend declines. We will stress here again that the severity of the recession is a key question in this regard. The point is that these yields up towards ~5% are not as safe as a 10-year "govvy". They are not guaranteed as is a deposit at the bank itself. Bank stock prices can decline as they have in the past month as fears of the coronavirus and possible recession have mounted.

All that being said, we view these four green-highlighted banks in the bank-related graphic on the previous page as very enticing from an income-seeking perspective if their main goal is maximizing dividend yields. Recessions are already partially baked into the stock prices of these banks. Please note the share prices of the aforementioned banks could come under pressure if recession fears mount, but that is also true for other similar bond-proxy operating companies.

We would also like to emphasize that we don't see any huge imbalances in the banking system like there were in the lead up to the Great Financial Crisis. While prices of real estate might be on the high side, there is not the same frenzy of activity that there was last time around.

Furthermore, the most leveraged companies are largely borrowing outside the banking system from business development companies and the leveraged lending market (facilitated by banks, but largely not held on the balance sheet in size). **The greatest risk to the banking system, in our view, is if deflation were to take hold around the globe, but that still remains a tail risk at this point in time, as opposed to any type of base case scenario.**

We should also once again mention that Wells Fargo (WFC) is probably the most controversial of these four banks, as they continue to face regulatory pressure to reform the bank in the wake of the cross-selling scandals from a few years ago. Its new CEO Charles Scharf will be working as quickly as possible to put these problems in the rear-view mirror, but it could easily take a couple years to do so (plus or minus). In the meantime, the bank is not able to take advantage of opportunities like peers Bank of America (BAC) and JPMorgan (JPM) have been actively pursuing.

Switching gears, let's talk about those other two large US-focused banks. We have previously featured Bank of America preferred shares as a high quality income generating opportunity for yield-seeking investors. JPMorgan is clearly the current best in class large US bank. While JPMorgan is riding on serious momentum of fundamental operating success, so is come from behind Bank of America. While we can't proclaim that Bank of America will necessarily catch up to the titleholder, **we are convinced that they can continue to close the gap, driving fundamental and stock price performance for years to come.** Let's look at the key metrics in the below graphic:

	Efficiency Ratio	Net Interest Margin	Charge offs	ROE	ROTCE
JPM	57.00%	2.46%	0.60%	15.00%	19.00%
BAC	60.17%	2.43%	0.38%	10.62%	14.86%

Image Data Source: *Annual Reports*

As you can see in the previous graphic, JPMorgan puts up superior numbers where it counts: return on equity ('ROE') and return on tangible common equity ('ROTCE'). These are the numbers that drive a higher valuation on the stock market, along with the growth of earnings power.

What we find quite shocking is just how close NIMs are for these two enormous banks. With balance sheets measured in the trillions and hundreds of billions of dollars, both banks are within a hair of each other when it comes to how much profit they can derive from borrowing at a low cost and then lending the money back out at a higher cost. What is further fascinating is that Bank of America appears to be garnering a similar NIM even though they seem to be taking less risk, as evidenced by their lower charge off rate--all of these figures are for the calendar year 2019.

So, the glaring takeaway is that JPMorgan is operating with a better (lower) efficiency ratio than Bank of America. This metric is the operating costs divided by the net revenues of the bank, so lower is always better. Business mix matters, so this is not always apples to apples, but these two banks are similarly situated when it comes to mix. What it implies is that JPMorgan is simply the better operator.

The flipside of that coin is that Bank of America has room for improvement in its efficiency ratio, which would then boost its return on capital metrics (and in turn, potentially, the valuation of its common equity). In fact, Bank of America has been on a multi-year efficiency improvement drive that has been bearing substantial fruit. While perhaps the going gets tougher going forward after much low-hanging fruit has already been plucked, best in class peer JPMorgan provides the example of what can be done.

We are optimistic on Bank of America's outlook and we think they will continue to advance their digital capabilities, driving efficiency ratios and returns on capital into the future. Please note shares of BAC are included in our Dividend Growth Newsletter portfolio at a modest weighting.

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

[Please see next page for a summary of portfolio activity during 2019.]

Corrections Notice: The January 2020 and February 2020 editions of the High Yield Dividend Newsletter incorrectly stated those iterations were "Edition 1 Volume 3" and "Edition 2 Volume 3" of the High Yield Dividend Newsletter publication, respectively, when that instead should have stated "Edition 3 Volume 1" and "Edition 3 Volume 2", respectively. We apologize for any confusion.

Tracking the High Yield Dividend Newsletter	Price -- 12/31/2018 or at open*	Interim Dividends	Price -- 12/31/2019 or at close**
CORE			
Alerian MLP ETF (AMLP) -- *removed* November 18	8.73	0.78	7.83
Added 2.5pts of AT&T (T) -- November 18	*39.21*	-	39.08
Added 2.5pts of Philip Morris (PM) -- November 18	*84.57*	1.17	85.09
Global X SuperDividend ETF (SDIV)	17.10	1.54	17.69
Global X SuperIncome Preferred ETF (SPFF)	11.03	0.71	11.74
iShares International Select Dividend ETF (IDV)	28.71	1.73	33.57
iShares MSCI Australia ETF (EWA)	19.25	0.90	22.64
iShares U.S. Preferred Stock ETF (PFF)	34.23	2.00	37.59
Invesco Senior Loan Portfolio (BKLN)	21.78	1.11	22.82
ProShares High Yield -- Interest Rate Hedged (HYHG)	62.09	3.97	65.44
Utilities Select Sector SPDR (XLU) -- *added August 22*	*61.61*	0.99	64.62
Vanguard Real Estate ETF (VNQ) - *added April 1*	*85.91*	2.53	92.79
EQUITY			
AT&T (T)	28.54	2.04	39.08
BP PLC (BP)	37.92	2.46	37.74
CubeSmart (CUBE) -- *added August 22*	*35.13*	0.65	31.48
Digital Realty Trust (DLR)	106.55	4.32	119.74
Enterprise Products Partners (EPD)	24.59	1.76	28.16
Iron Mountain (IRM) -- *removed August 1*	32.41	1.22	29.97
Magellan Midstram Partners (MMP)	57.06	4.04	62.87
Omega Healthcare Investors (OHI) -- *removed March 1*	35.15	0.66	34.72
Philip Morris (PM) -- *added August 1*	*82.41*	2.34	85.09
Public Storage (PSA)	202.41	8.00	212.96
Schlumberger*, added January 18, removed August 1*	*43.00*	1.00	38.07
Realty Income Corporation (O) -- *removed April 1*	63.04	0.68	72.03
Tallgrass Energy LP (TGE) -- *removed August 1*	24.34	1.59	18.25

* As shown in the January 2019 edition of the High Yield Dividend Newsletter, or price at entry point

** Price as of December 31, 2019, or price at close

-- THE HIGH YIELD DIVIDEND SPOTLIGHT IS ON THE NEXT PAGE --

High Yield Spotlight: Merck & Co Inc (MRK) is a High Quality Pharmaceutical Play

Our **March 2020 High Yield Divided Newsletter Spotlight** is the pharmaceutical giant Merck & Co Inc (MRK) --- **~3.1% yield** --- which comes with a stellar cash flow profile, promising outlook, and long legs as it relates to its best-selling oncology drug Keytruda. Please note that while large pharmaceutical companies tend to have a whole slate of treatments and products to sell, it's the top dogs in this space that really determine how they perform financially in the medium-term. According to Merck's 2019 Annual Report, the patents for Keytruda will last for some time: through 2028 in the US, 2028 in the EU for patents and 2030 for the supplementary protection certificates ('SPCs'), 2032-2033 in Japan, and 2028 in China. That provides Merck with a nice financial outlook, in our view.

In the upcoming graphic down below, it becomes clear why Keytruda is so important to Merck's success. **The drug was responsible for almost a quarter of its revenues in 2019, and just as importantly, saw sales almost triple from 2017 to 2019.**

Product Sales

Total Company sales, including sales of the Company's top pharmaceutical products, as well as sales of animal health products, were as follows:

($ in millions)	2019	2018	2017
Total Sales	$ 46,840	$ 42,294	$ 40,122
Pharmaceutical	41,751	37,689	35,390
Keytruda	11,084	7,171	3,809
Januvia/Janumet	5,524	5,914	5,896
Gardasil/Gardasil 9	3,737	3,151	2,308
ProQuad/M-M-R II/Varivax	2,275	1,798	1,676
Bridion	1,131	917	704
Isentress/Isentress HD	975	1,140	1,204
Pneumovax 23	926	907	821
NuvaRing	879	902	761
Zetia/Vytorin	874	1,355	2,095
Simponi	830	893	819
Animal Health	4,393	4,212	3,875
Livestock	2,784	2,630	2,484
Companion Animals	1,609	1,582	1,391
Other Revenues[1]	696	393	857

[1] *Other revenues are primarily comprised of Healthcare Services segment revenue, third-party manufacturing sales, and miscellaneous corporate revenues, including revenue hedging activities.*

Image Shown: *An overview of Merck's top selling treatments and products.* ***Image Source:*** *Merck – 2019 Annual Report*

Merck is in the process of spinning off "its Women's Health, trusted Legacy Brands, and Biosimilars businesses into a new, yet-to-be-named, independent, publicly traded company" and combined, these businesses are estimated to generate around $6.5 billion in total revenues in 2020. The idea is that by shedding business segments that are no longer protected by patents or simply don't fit in with its long-term strategy, Merck can better focus on its "four pillars" which include its "Oncology, Vaccines, Hospital and Animal Health" businesses. **That spinoff is expected to yield $1.5 billion in operational efficiencies by 2024**, materially augmenting its free cash flow growth trajectory. Management expects the move will be completed in the first half of 2021 and stressed that Merck will retain its current annualized payout level of $2.44 per share after the deal goes through. Additionally, Merck mentioned that it intends on boosting its payout ratio up to 47%-50% over time if the deal goes through (the targeted payout ratio appears to be based on its diluted EPS figure).

The new entity is dubbed NewCo, for now, and is expected to pay Merck a special tax-free $8.0-$9.0 billion dividend once the deal closes. NewCo is expected to start off with $8.5-$9.5 billion in debt, largely to fund the special dividend and for working capital needs. Additionally, Merck expects NewCo to pay out a "meaningful" dividend over time, which will be entirely incremental to Merck's current dividend. NewCo's debt load should be well-covered due to its strong cash flows, according to Merck's management team. In 2021, Merck estimates NewCo's revenue growth rate would be in the low-single-digits as these businesses are not high growth opportunities by any means. Management provided some additional details on this maneuver in the upcoming graphic down below.

Image Shown: *A look at the two independent companies should this transaction go through, Merck and NewCo, and their different strategic goals.* ***Image Source:*** *Merck – Fourth Quarter and Full-Year 2019 Earnings IR Presentation*

We see this as a good call by Merck's management team and one that should unlock a meaningful amount of shareholder value. Operational efficiencies, margin improvements, the cash proceeds from the special dividend, and a shift towards higher growth areas would augment Merck's free cash flow growth prospects in a material way going forward.

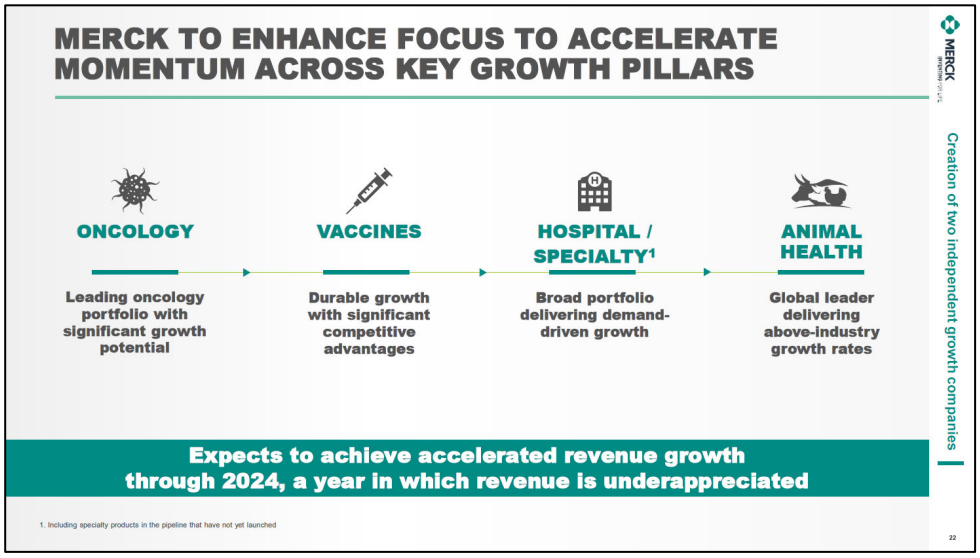


Image Shown: *The four pillars of Merck's business post-NewCo Deal.* ***Image Source:*** *Merck – Fourth Quarter and Full-Year 2019 Earnings IR Presentation*

Please note the stellar increase in Merck's free cash flows over the past few years in the upcoming graphic down below. From 2017 to 2019, Merck saw its net operating cash flow grow more than double to $13.4 billion. While its capital expenditures also grew materially during this period, Merck's free cash flow increased by over 218%, hitting ~$10.0 billion in 2019.

Consolidated Statement of Cash Flows
Merck & Co., Inc. and Subsidiaries
Years Ended December 31
($ in millions)

	2019	2018	2017
Cash Flows from Operating Activities			
Net income	$ 9,777	$ 6,193	$ 2,418
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,652	4,519	4,676
Intangible asset impairment charges	1,040	296	646
Charge for the acquisition of Peloton Therapeutics, Inc.	993	—	—
Charge for future payments related to collaboration license options	—	650	500
Provisional charge for one-time transition tax related to the enactment of U.S. tax legislation	—	—	5,347
Deferred income taxes	(556)	(509)	(2,621)
Share-based compensation	417	348	312
Other	184	978	190
Net changes in assets and liabilities:			
Accounts receivable	294	(418)	297
Inventories	(508)	(911)	(145)
Trade accounts payable	399	230	254
Accrued and other current liabilities	376	(341)	(922)
Income taxes payable	(2,359)	827	(3,291)
Noncurrent liabilities	(237)	(266)	(123)
Other	(32)	(674)	(1,087)
Net Cash Provided by Operating Activities	13,440	10,922	6,451
Cash Flows from Investing Activities			
Capital expenditures	(3,473)	(2,615)	(1,888)
Purchases of securities and other investments	(3,202)	(7,994)	(10,739)
Proceeds from sales of securities and other investments	8,622	15,252	15,664
Acquisition of Antelliq Corporation, net of cash acquired	(3,620)	—	—
Acquisition of Peloton Therapeutics, Inc., net of cash acquired	(1,040)	—	—
Other acquisitions, net of cash acquired	(294)	(431)	(396)
Other	378	102	38
Net Cash (Used in) Provided by Investing Activities	(2,629)	4,314	2,679

Image Shown: *A look at the stellar growth in Merck's free cash flows from 2017 to 2019.* ***Image Source:*** *Merck – 2019 Annual Report*

As you can see in the upcoming graphic down below, Merck's annual dividend obligations stood at $5.7 billion in 2019. Furthermore, the company spent $4.8 billion repurchasing its stock last year, and some of those repurchases were effectively funded by its balance sheet.

Cash Flows from Financing Activities			
Net change in short-term borrowings	(3,710)	5,124	(26)
Payments on debt	—	(4,287)	(1,103)
Proceeds from issuance of debt	4,958	—	—
Purchases of treasury stock	(4,780)	(9,091)	(4,014)
Dividends paid to stockholders	(5,695)	(5,172)	(5,167)
Proceeds from exercise of stock options	361	591	499
Other	5	(325)	(195)
Net Cash Used in Financing Activities	(8,861)	(13,160)	(10,006)
Effect of Exchange Rate Changes on Cash, Cash Equivalents and Restricted Cash	17	(205)	457
Net Increase (Decrease) in Cash, Cash Equivalents and Restricted Cash	1,967	1,871	(419)
Cash, Cash Equivalents and Restricted Cash at Beginning of Year (includes $2 million of restricted cash at January 1, 2019 included in Other Assets)	7,967	6,096	6,515
Cash, Cash Equivalents and Restricted Cash at End of Year (includes $258 million of restricted cash at December 31, 2019 included in Other Assets - see Note 6)	$ 9,934	$ 7,967	$ 6,096

Image Shown: *A look at Merck's historical annual dividend obligations, which are well covered by its free cash flows.* ***Image Source:*** *Merck – 2019 Annual Report*

In the upcoming graphic down below, please note Merck's net debt load stood at $15.9 billion at the end of 2019 (inclusive of short-term investments and short-term debt, but not including Merck's $1.5 billion long-term 'investments' line-item which includes marketable debt securities, publicly traded equities, and equity securities). However, please keep in mind that Merck's $2.7 billion all-cash purchase of ArQule closed in January 2020, which changes this picture somewhat but not by much. The expected cash infusion from the NewCo spinoff will provide a nice boost to Merck's cash pile, however, the company noted it intends on using at least some of those proceeds for share repurchases and other endeavors. Merck will provide more information on that front later on, according to the press release announcing the deal.

Consolidated Balance Sheet
Merck & Co., Inc. and Subsidiaries
December 31
($ in millions except per share amounts)

	2019	2018
Assets		
Current Assets		
Cash and cash equivalents	$ 9,676	$ 7,965
Short-term investments	774	899
Accounts receivable (net of allowance for doubtful accounts of $86 in 2019 and $119 in 2018)	6,778	7,071
Inventories (excludes inventories of $1,480 in 2019 and $1,417 in 2018 classified in Other assets - see Note 7)	5,978	5,440
Other current assets	4,277	4,500
Total current assets	27,483	25,875
Investments	1,469	6,233
Property, Plant and Equipment (at cost)		
Land	343	333
Buildings	11,989	11,486
Machinery, equipment and office furnishings	15,394	14,441
Construction in progress	5,013	3,355
	32,739	29,615
Less: accumulated depreciation	17,686	16,324
	15,053	13,291
Goodwill	19,425	18,253
Other Intangibles, Net	14,196	13,104
Other Assets	6,771	5,881
	$ 84,397	$ 82,637
Liabilities and Equity		
Current Liabilities		
Loans payable and current portion of long-term debt	$ 3,610	$ 5,308
Trade accounts payable	3,738	3,318
Accrued and other current liabilities	12,549	10,151
Income taxes payable	736	1,971
Dividends payable	1,587	1,458
Total current liabilities	22,220	22,206
Long-Term Debt	22,736	19,806
Deferred Income Taxes	1,470	1,702
Other Noncurrent Liabilities	11,970	12,041
Merck & Co., Inc. Stockholders' Equity		
Common stock, $0.50 par value Authorized - 6,500,000,000 shares Issued - 3,577,103,522 shares in 2019 and 2018	1,788	1,788
Other paid-in capital	39,660	38,808
Retained earnings	46,602	42,579
Accumulated other comprehensive loss	(6,193)	(5,545)
	81,857	77,630
Less treasury stock, at cost: 1,038,087,496 shares in 2019 and 984,543,979 shares in 2018	55,950	50,929
Total Merck & Co., Inc. stockholders' equity	25,907	26,701
Noncontrolling Interests	94	181
Total equity	26,001	26,882
	$ 84,397	$ 82,637

Image Shown: *Merck's net debt load is manageable given its solid cash flow profile.* ***Image Source:*** *Merck – 2019 Annual Report*

Buying ArQule gives Merck a nice pipeline of potential treatments for hematological (the study of blood as it relates to health and diseases) malignancies. Here's a brief note on ArQule's leading drug candidate which likely caught Merck's eye, from the press release announcing the deal;

> *"ArQule is a publicly traded biopharmaceutical company focused on kinase inhibitor discovery and development for the treatment of patients with cancer and other diseases. ArQule's lead investigational candidate, ARQ 531, is a novel, oral Bruton's tyrosine kinase ('BTK') inhibitor currently in a Phase 2 dose expansion study for the treatment of B-cell malignancies…*
>
> *BTK inhibition has been shown to prevent B-cell receptor signaling that is critical for the survival and proliferation of leukemic cells in many B-cell malignancies. ARQ 531 is a highly selective, reversible inhibitor that blocks both wild-type BTK and the C481S mutant form of the enzyme that is commonly associated with resistance to other BTK inhibitors. In early clinical trials, ARQ 531 demonstrated a manageable safety profile and early signs of anti-tumor activity for the treatment of patients with relapsed or refractory chronic lymphocytic leukemia ('CLL') and Richter's Transformation."*

The company is utilizing M&A activities to diversify its product mix. Large pharmaceutical companies tend to be serial acquirers as new drugs and drug pipelines are constantly needed to replace older treatments after patents expire or branded competition comes to the market.

Merck acquired Peloton Therapeutics for $1.2 billion in cash upfront in July 2019 (contingent payments may run up to $1.15 billion if certain milestones are met) to gain access to its "novel small molecule therapeutic candidates targeting hypoxia-inducible factor-2α ('HIF-2α') for the treatment of patients with cancer and other non-oncology diseases". In April 2019, Merck acquired Antelliq Corporation for $2.3 billion in cash along and spent $1.3 billion repaying that firm's debt to bulk up its 'Animal Health' segment as Antelliq is "a leader in digital animal identification, traceability and monitoring solutions". Also in April 2019, Merck bought out Immune Design, "a late-stage immunotherapy company employing next generation *in vivo* approaches to enable the body's immune system to fight disease", for $0.3 billion in cash. These kinds of deals are to be expected going forward, however, the pace of such acquisitions might slow down as 2019 was a big year for Merck concerning its M&A activity relative to its historical performance.

Merck has plenty of confidence in both its near- and long-term financial trajectory, which we appreciate. Guidance for 2020 calls for meaningful revenue growth, with Robert Davis, Merck's CFO, having this to say during the firm's latest quarterly conference call;

> *"Now, let's move to our outlook for 2020, a year in which we continue to operate as a combined entity. My remaining comments will be on a non-GAAP basis. We expect full year 2020 revenue to be between $48.8 billion and $50.3 billion, which represents 4% to 7% growth versus 2019. This range assumes a negative impact from foreign exchange of less than 1 percentage point using mid-January rates…*
>
> *Longer term, Merck continues to expect strong revenue growth, driven by growing demand for innovative products. And looking out to 2024, we believe our revenue growth potential is underappreciated, even more so as we begin to realize the benefits of this transaction [the aforementioned NewCo deal].*
>
> *We continue to expect meaningful operating margin expansion over time. The separation of NewCo enables $1.5 billion in pre-tax operating efficiencies, ratable over three years. While initially Merck's operating margins will decline slightly, we expect to achieve operating margins of greater than 40% in 2024, higher than Merck would have achieved as a combined company."*

Pivoting back to Keytruda for a moment, please note that while this oncology drug has already performed spectacularly over the past few years, its outlook for sales growth remains quite bright. Merck continues to win new approvals for Keytruda across the globe all the time, as you can see in the upcoming graphics down below.

Keytruda	December 2019	The Japanese Ministry of Health, Labour and Welfare (MHLW) approved *Keytruda* for three new first-line indications across advanced renal cell carcinoma (RCC) and recurrent or distant metastatic head and neck cancer.
	November 2019	EC approved two new regimens of *Keytruda* as first-line treatment for metastatic or unresectable recurrent head and neck squamous cell carcinoma (HNSCC).
	November 2019	The China National Medical Products Administration (NMPA) approved *Keytruda* for first-line treatment of metastatic squamous non-small cell lung cancer (NSCLC) in combination with chemotherapy.
	October 2019	NMPA approved *Keytruda* as monotherapy for first-line treatment of certain patients with advanced NSCLC whose tumors express PD-L1.
	September 2019	FDA approved *Keytruda* plus Lenvima combination treatment for patients with certain types of endometrial carcinoma.
	September 2019	EC approved *Keytruda* in combination with axitinib as first-line treatment for patients with advanced RCC.
	July 2019	FDA approved *Keytruda* for recurrent locally advanced or metastatic squamous cell carcinoma of the esophagus in patients whose tumors express PD-L1 combined positive score [CPS] (CPS ≥10) with disease progression after one of more prior lines of systemic therapy.

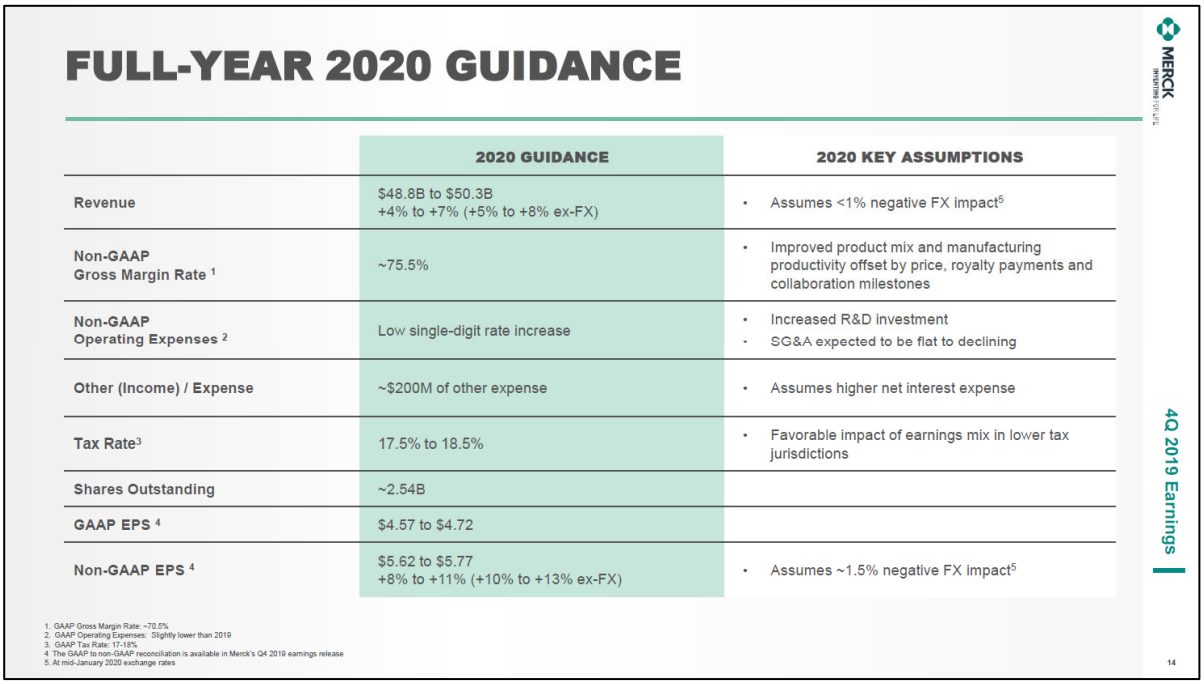
Keytruda	June 2019	FDA approved *Keytruda* as monotherapy for patients with metastatic small-cell lung cancer (SCLC) with disease progression on or after platinum-based chemotherapy and at least one other prior line of therapy.
	June 2019	FDA approved two indications for *Keytruda* for first-line treatment of patients with metastatic or with unresectable, recurrent HNSCC as monotherapy for patients whose tumors express PD-L1 CPS ≥1 or in combination with platinum and fluorouracil regardless of PD-L1 expression.
	April 2019	FDA approved *Keytruda* in combination with axitinib for first-line treatment of patients with advanced RCC.
	April 2019	FDA approved an expanded label for *Keytruda* as monotherapy for the first-line treatment of patients with stage III NSCLC who are not candidates for surgical resection or definitive chemoradiation, or metastatic NSCLC, and whose tumors express PD-L1 (tumor proportion score [TPS] ≥1%) as determined by an FDA-approved test, with no epidermal growth factor receptor (EGFR) or anaplastic lymphoma kinase positive (ALK) genomic tumor aberrations.
	April 2019	EC approved new extended dosing schedule for *Keytruda* for all approved monotherapy indications.
	April 2019	NMPA approved *Keytruda* for first-line treatment of metastatic nonsquamous NSCLC in combination with chemotherapy.
	March 2019	EC approved *Keytruda* in combination with chemotherapy for first-line treatment of adults with metastatic squamous NSCLC.
	February 2019	FDA approved *Keytruda* for the adjuvant treatment of patients with melanoma with involvement of lymph node(s) following complete resection.
	January 2019	MHLW approved *Keytruda* for five indications, including three expanded uses in advanced NSCLC, one in melanoma, as well as a new indication in advanced microsatellite instability-high tumors.

Images Shown: *A look at the various approvals Keytruda has won in the recent past.* ***Images Source:*** *Merck – 2019 Annual Report*

We caution that Merck may face pricing pressure for its Keytruda sales in the future should there be wholesale changes to the US healthcare system. Additionally, there will be pricing pressures in Japan as you can see in the below excerpt (from Merck's 2019 Annual Report);

> *"…in Japan, the pharmaceutical industry is subject to government-mandated biennial price reductions of pharmaceutical products and certain vaccines, which occurred in 2018 and will occur again in 2020. Furthermore, the government can order re-pricings for specific products if it determines that use of such product will exceed certain thresholds defined under applicable re-pricing rules. Pursuant to those rules, the Japanese government reduced the price of Keytruda by 17.5% effective February 2020. Additionally, Keytruda will be subject to another significant price reduction in April 2020 under a provision of the Japanese pricing rules."*

Even so, Merck's financial trajectory still appears quite favorable as 2020 gets underway. Keytruda's growth outlook is rock-solid, Merck's net debt load is manageable given its strong free cash flows, its planned spinoff of slow growth assets and the related synergies will go a long way in enhancing its future free cash flows, and recent acquisitions may yield powerful new sources of upside. **Sales of Keytruda remain well-protected by Merck's patents, providing for some level of certainty in Merck's financial performance going forward.** We view Merck as a high quality income generator with room for upside, supported by its quality dividend coverage (its Dividend Cushion ratio currently sits at 2.3x, earning it a GOOD Dividend Safety rating). In the final graphic of this piece down below, management provides greater detail on the firm's 2020 guidance.



FULL-YEAR 2020 GUIDANCE

	2020 GUIDANCE	2020 KEY ASSUMPTIONS
Revenue	$48.8B to $50.3B +4% to +7% (+5% to +8% ex-FX)	• Assumes <1% negative FX impact[5]
Non-GAAP Gross Margin Rate [1]	~75.5%	• Improved product mix and manufacturing productivity offset by price, royalty payments and collaboration milestones
Non-GAAP Operating Expenses [2]	Low single-digit rate increase	• Increased R&D investment • SG&A expected to be flat to declining
Other (Income) / Expense	~$200M of other expense	• Assumes higher net interest expense
Tax Rate[3]	17.5% to 18.5%	• Favorable impact of earnings mix in lower tax jurisdictions
Shares Outstanding	~2.54B	
GAAP EPS [4]	$4.57 to $4.72	
Non-GAAP EPS [4]	$5.62 to $5.77 +8% to +11% (+10% to +13% ex-FX)	• Assumes ~1.5% negative FX impact[5]

1. GAAP Gross Margin Rate: ~70.5%
2. GAAP Operating Expenses: Slightly lower than 2019
3. GAAP Tax Rate: 17-18%
4. The GAAP to non-GAAP reconciliation is available in Merck's Q4 2019 earnings release
5. At mid-January 2020 exchange rates

MERCK

4Q 2019 Earnings

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Image Shown: *An overview of Merck's guidance for 2020.* ***Image Source:*** *Merck – Fourth Quarter and Full-Year 2019 Earnings IR Presentation*

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

Self-Storage Industry Faces a Rocky 2020, But Long-Term Outlook Remains Bright

Image Source: *CubeSmart – November 2019 IR Presentation*

By Callum Turcan

With housing costs rising aggressively in "Tier 1" and "Tier 2" cities across the East and West coasts in the US, that has created an immense need from households for additional storage space but at a much lower cost than simply buying a larger home, apartment, or condo. This has created a major secular growth trend that we've highlighted repeatedly in our High Yield Dividend Newsletter ('HYDN') by including shares of CubeSmart (CUBE) and Public Storage (PSA) in our HYDN portfolio, both of which are self-storage focused real estate investment trusts ('REITs'). Both self-storage REITs have steadily grown their already sizable payouts over the past several years and we expect that to continue to be the case going forward, with shares of CUBE and PSA **yielding ~4.3% and ~3.8%**, respectively, as of this writing.

Tough 2020 Ahead

Weak 2020 guidance put out by Extra Space Storage Inc (EXR), which includes forecasts that call for -0.5% (negative 0.5%) to +1.0% same-store net operating income ('NOI') growth due largely to relatively modest same-store revenue growth being offset by significant same-store expense growth (as forecasted), has spooked investors. Rising property taxes, payroll expenses, and marketing costs are key components here. Extra Space Storage's management noted supply growth was an issue as the industry is expanding to meet expected future demand. Here's a brief excerpt from Extra Space Storage's latest quarterly conference call;

> *"Most of the headwinds faced in 2019 will continue to be present in 2020. The supply cycle we find ourselves in will continue to dampen performance, but it is moderating and will reverse." --- Joseph Margolis, CEO of Extra Space Storage*

Pivoting to CubeSmart, the firm had a similar forecast for 2020, with the company forecasting -1.5% (negative 1.5%) to flat same-store NOI growth this year. Revenue growth is expected to be very modest with forecasted rising operating expenses eating up those expected incremental sales and then some. Here's what CubeSmart's management had to say during the firm's latest quarterly conference call (emphasis added);

> *"We reported a solid quarter yesterday [February 20, 2020] and a continuously challenging operating environment. Throughout the year, in spite of the internal growth headwinds caused by the ongoing impact of new supply, we generated growth in our funds from operations through expansion of our third-party management program, the utilization of joint-ventures, the lease-up of our non-stabilized portfolio and successful capital raising in both the debt and equity markets.*
>
> *2020 will be a year of transition, as our industry absorbed the new supply delivered over the last several years.* ***Our outlook for the future remains positive, as our current supply data for our top 12 markets points to 2019 being the peak year for new deliveries, markets that experienced the impact of new supply early in the cycle are seeing a solid slowdown in expected future deliveries."*** *--- Christopher Marr, CEO of CubeSmart*

Public Storage didn't provide same-store NOI guidance for 2020 in its press release or during the quarterly conference call, and please note the company bid to acquire National Storage REIT which owns self-storage assets in Australia in early-2020 through a deal reportedly valued at ~$1.9 billion. The firm has various international operations along with its core US operations (38 states and the District of Columbia according to its website), particularly in Western Europe, so this acquisition fits in with its long-term goals. Public Storage noted that 2020 would be another tough year, largely due to ongoing supply additions, but that the market was showing signs of adjusting. Here's what Public Storage's management team had to say during the REIT's latest quarterly conference call;

> *"We feel like we have a strong tool kit to continue to maneuver through higher supply markets… some of that is shifting the supply picture nationally. We'll have another strong year of deliveries in 2020. It could be plus or minus say 10% down from what we saw in 2019. Again, these are elevated levels of construction that we're now going into the fourth year of a range of anywhere from $4 billion to $5 billion in deliveries…*
>
> *The interesting thing and it ties to the resiliency of the product overall, the resiliency of our own brand, et cetera is we are seeing deliveries come down in markets like Denver, Charlotte, Houston, Austin and Chicago; and not ironically those are some of the markets now that we're actually starting to see some decent percolation, and we're encouraged by that.*
>
> *Now going into this next year, we've got our eyes wide open on markets like Portland, Boston, Seattle, Miami, D.C. and New York, because there's more deliveries coming to those markets, some of which haven't had the kind of development activity in quite some time…*
>
> *…the outlook beyond even this year is more murky… It's too soon to tell. But again, we'll continue to use all those tools that we've got." --- Joe Russell, CEO of Public Storage, responding to an analyst's question*

What we take away from the aforementioned management team's comments is that 2020 will be a tough or at best a middling time for the US self-storage space. However, given ongoing demand growth for self-storage facilities in the US (particularly in high-growth and expensive major metropolitan markets), the additional supply brought online over the past few years will be absorbed and the industry's near-term outlook will look far different by the end of this year (or possibly a bit later) than it stands at the start of 2020. **Pushing into international markets is a smart way to get around this temporary headwind, in our view.**

Given the strength of CubeSmart's and Public Storage's free cash flow profiles, made more impressive by the fact that most REITs aren't free cash flow positive, we are comfortable waiting out short-term turbulence given the nice medium- and long-term upside the self-storage REIT space provides. Here we would like to highlight that most REITs are not free cash flow positive due to the enormous investments they tend to make in new properties that often consume virtually all of their net operating cash flows, generally speaking, **which sets firms like CubeSmart and Public Storage apart from the rest of the REIT world.**

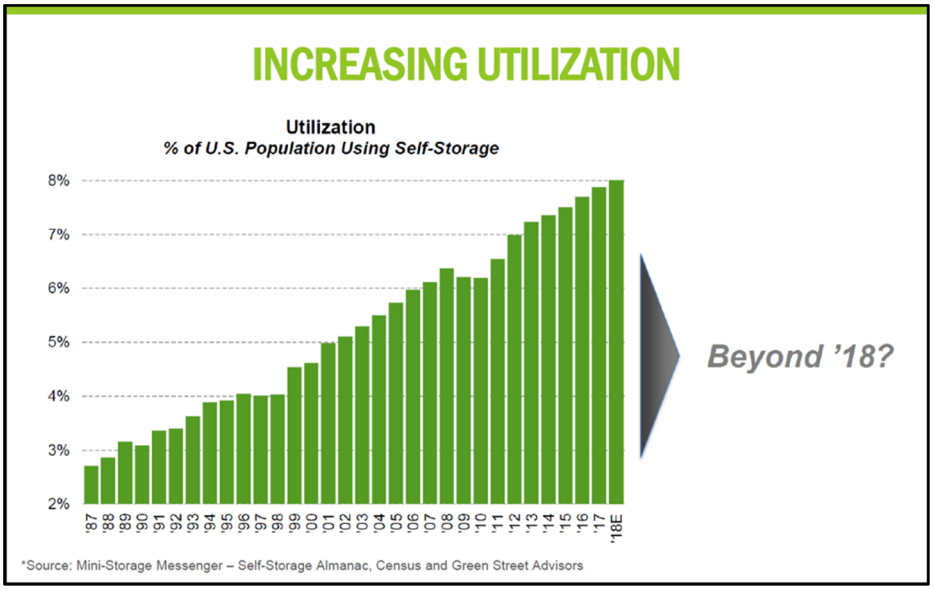

Image Shown: *The self-storage industry in the US is supported by powerful secular growth tailwinds.* ***Image Source:*** *Extra Space Storage – January 2020 IR Presentation*

According to third-party data cited by Extra Space Storage, it appears the relatively younger demographic groups in the US offer the most upside when it comes to growing self-storage demand going forward. In the meantime, the "Baby Boomer" demographic is still a big source of demand for self-storage facilities, **highlighting the widespread appeal of these properties as relatively cheap storage options.**

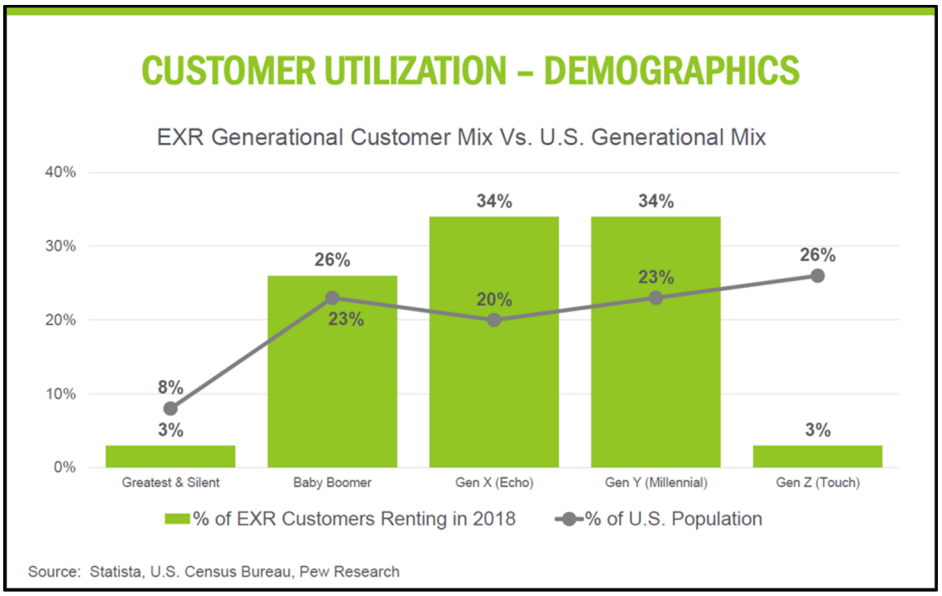

Image Shown: *Younger demographic groups in the US are increasingly utilizing self-storage options, however, self-storage is also popular amongst relatively older generations as well.* ***Image Source:*** *Extra Space Storage – January 2020 IR Presentation*

Financial Overview

In 2019, CubeSmart generated almost $332 million in net operating cash flow and spent a bit over $140 million on capital expenditures (defined as 'additions and improvements to storage properties' plus 'development costs', we wouldn't consider 'acquisitions of storage properties', 'cash paid for partner's interest in real estate venture, net of cash, cash equivalents and restricted cash acquired', or 'investment in real estate ventures' to be capital expenditures as those are activities within the realm of M&A), allowing for just over $191 million in free cash flows.

Those free cash flows covered most of CubeSmart's $246 million in 'distributions paid to common shareholders' during this period, keeping in mind CubeSmart is a capital market dependent entity. CubeSmart exited 2019 with $55 million in cash and cash equivalents along with $4 million in restricted cash versus over $1.8 *billion* in senior unsecured notes net and $96 million in mortgage loans and notes payable.

For clarity, for capital market dependent entities like CubeSmart, **we also take their ability to issue equity and tap debt markets into account when evaluating their payout coverage** on a forward-looking basis. As it relates to our Dividend Cushion ratio, the numerator in that metric on an *adjusted basis* includes a REIT's expected proceeds from equity issuance over the relevant five-year period. CubeSmart carries investment grade credit ratings (BBB/Baa2) and recent financing activities indicate the REIT retains quality access to debt markets at attractive rates.

Pivoting to Public Storage, that REIT generated ~$2.1 billion in net operating cash flow in 2019 while spending ~$0.5 billion on capital expenditures (defined as 'payments for capital expenditures to maintain real estate facilities' plus 'payments for development and expansion of real estate facilities'). Just under $1.6 billion in free cash flow almost covered just over $1.6 billion in 'distributions paid to preferred shareholders, common shareholders and restricted share unitholders' during this period, keeping in mind Public Storage is also a capital market dependent entity like CubeSmart. At the end of 2019, Public Storage carried $0.4 billion in cash and cash equivalents versus $1.9 billion in notes payable. Like CubeSmart, Public Storage carries investment grade credit ratings (A/A2) and recent financing activities indicate the REIT retains quality access to debt markets at attractive rates.

Concluding Thoughts

The payouts of both CubeSmart and Public Storage are still well-protected after considering their ability to tap capital markets at attractive rates, along with their nice free cash flow profiles, in our view. While there are risks if capital markets freeze up, given that both entities generate meaningful free cash flows, carry solid investment grade credit ratings, and have seen their equity prices perform quite well relatively speaking, we view CubeSmart and Public Storage as high quality income generating entities that should retain access to capital markets going forward. 2020 may be tough compared to years past, but as supply growth cools off, secular growth tailwinds continue to support the domestic self-storage industry's promising long-term outlook. International markets offer additional upside, which Public Storage has been actively capitalizing on and we appreciate that.

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

Philip Morris International Shifts Higher From Fall 2019 Lows

Image Shown: *We increased the weighting in shares of Philip Morris International in the High Yield Newsletter portfolio back on November 18, 2019. Shares of PM have rallied aggressively off of their Fall 2019 lows through the middle of February 2020, before fears over the novel coronavirus epidemic took hold.*

By Callum Turcan

One of our favorite high yield ideas out there is Philip Morris International Inc (PM), and please note we increased the weighting of shares of PM in our High Yield Dividend Newsletter portfolio back on November 18, 2019, and our timing couldn't have been better considering shares of PM have aggressively rallied since September 2019 through the middle of February 2020 (until the novel coronavirus epidemic started spreading worldwide and investors' fears surged starting in late-February). Shares of PM **yield ~5.6%** as of this writing.

Great Cash Flow Profile, Negligible Shareholder Dilution

From 2017 to 2019, Philip Morris International generated $8.2 billion in free cash flow on average per year. The company's dividend obligations averaged $6.9 billion per year during this period, and this is largely why we like Philip Morris International's dividend coverage. We'll cover its balance sheet in a moment (the firm has a net debt position), but given the stability of the company's free cash flow profile (a product of inelastic demand for tobacco products and the firm's pricing power), Philip Morris International should be able to keep making good on its dividend obligations going forward.

In 2019, the company generated $9.2 billion in free cash flow and spent $7.2 billion covering its dividend obligations. Philip Morris International doesn't allocate a meaningful amount towards share repurchases, and additionally, doesn't issue out a meaningful amount of equity per year (on a historical basis).

In the two upcoming graphics down below, please note the strength of Philip Morris International's free cash flow profile.

Consolidated Statements of Cash Flows
(in millions of dollars)

for the years ended December 31,	2019	2018	2017
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES			
Net earnings	$ 7,728	$ 8,286	$ 6,341
Adjustments to reconcile net earnings to operating cash flows:			
Depreciation and amortization	964	989	875
Deferred income tax (benefit) provision	(141)	(100)	(501)
Asset impairment and exit costs, net of cash paid (Note 21)	371	(3)	(10)
Cash effects of changes in:			
Receivables, net	(331)	53	(92)
Inventories	(548)	(613)	730
Accounts payable	451	(51)	425
Accrued liabilities and other current assets	1,108	910	(554)
Income taxes	75	(135)	1,370
Pension plan contributions	(200)	(110)	(66)
Other	613 [1]	252	394
Net cash provided by operating activities	10,090	9,478	8,912
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES			
Capital expenditures	(852)	(1,436)	(1,548)
Investments in unconsolidated subsidiaries and equity securities	(31)	(63)	(111)
Deconsolidation of RBH (Note 22)	(1,346) [2]	—	—
Net investment hedges	386	416	(1,527)
Other	32	85	103
Net cash used in investing activities	(1,811)	(998)	(3,083)

Image Shown: *Philip Morris International's net operating cash flow and capital expenditures for 2019 are underlined in red to showcase its free cash flow for that year.* ***Image Source:*** *Philip Morris International – 2019 10-K Filing with additions from the author*

for the years ended December 31,	2019	2018	2017
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES			
Short-term borrowing activity by original maturity:			
Net issuances (repayments) - maturities of 90 days or less	$ (364)	$ 255	$ (127)
Issuances - maturities longer than 90 days	989	—	1,634
Repayments - maturities longer than 90 days	(989)	—	(1,634)
Long-term debt proceeds	3,819	—	6,850
Long-term debt repaid	(3,998)	(2,484)	(2,551)
Dividends paid	(7,161)	(6,885)	(6,520)
Sale (purchase) of subsidiary shares to/(from) noncontrolling interests (Note 6)	51	(81)	5
Other	(408)	(456)	(426)
Net cash used in financing activities	(8,061)	(9,651)	(2,769)
Effect of exchange rate changes on cash, cash equivalents and restricted cash	27	(685)	1,085
Cash, cash equivalents and restricted cash[3]:			
Increase (Decrease)	245	(1,856)	4,145
Balance at beginning of year	6,620	8,476	4,331
Balance at end of year	$ 6,865	$ 6,620	$ 8,476
Cash Paid:			
Interest	$ 800	$ 882	$ 1,050
Income taxes	$ 2,430	$ 2,749	$ 3,403

[1] Includes the Loss on Deconsolidation of RBH ($239 million) and the Canadian tobacco litigation-related charge ($194 million) that were included in marketing, administration and research costs in the consolidated statements of earnings for the year ended December 31, 2019. For further details on these charges, see Note 22. *Deconsolidation of RBH.*

[2] Includes deconsolidation of RBH cash and cash equivalents of $1,323 million and restricted cash of $23 million.

[3] The amounts for cash and cash equivalents shown above include restricted cash of $4 million, $27 million and $29 million as of December 31, 2019, 2018 and 2017, respectively, which were included in other current assets in the consolidated balance sheets.

Image Shown: *Philip Morris International's dividend obligations for 2019 are underlined in red to highlight the firm's solid dividend coverage.* ***Image Source:*** *Philip Morris International – 2019 10-K Filing with additions from the author*

In the upcoming graphic down below, note that equity awards relative to Philip Morris International's outstanding share count have been marginal over the past several years. **Negligible dilution of shareholders via equity issuances, on a historical basis, represents another reason we really like Philip Morris International.** Furthermore, the company has no intention of issuing preferred stock according to its 2019 Annual Report.

Note 8.

Capital Stock:

Shares of authorized common stock are 6.0 billion; issued, repurchased and outstanding shares were as follows:

	Shares Issued	Shares Repurchased	Shares Outstanding
Balances, January 1, 2017	2,109,316,331	(557,930,784)	1,551,385,547
Issuance of stock awards		1,832,215	1,832,215
Balances, December 31, 2017	2,109,316,331	(556,098,569)	1,553,217,762
Issuance of stock awards		1,361,959	1,361,959
Balances, December 31, 2018	2,109,316,331	(554,736,610)	1,554,579,721
Issuance of stock awards		**1,314,942**	**1,314,942**
Balances, December 31, 2019	**2,109,316,331**	**(553,421,668)**	**1,555,894,663**

At December 31, 2019, 27,371,404 shares of common stock were reserved for stock awards under PMI's stock plans, and250 million shares of preferred stock, without par value, were authorized but unissued. PMI currently has no plans to issue any shares of preferred stock.

Image Shown: *Philip Morris International historically hasn't diluted shareholders via meaningful equity issuances, which we really appreciate, and that is highlighted by the underlined shares outstanding and the red arrow.* ***Image Source:*** *Philip Morris International – 2019 10-K Filing with additions from the author*

Balance Sheet Commentary

Pivoting now to Philip Morris International's balance sheet, the company exited 2019 with $6.9 billion in cash and cash equivalents versus $0.3 billion in short-term debt, $4.1 billion in long-term debt maturity in less than one year, and $26.7 billion in long-term debt. Please note that the line-item 'investments in unconsolidated subsidiaries and equity securities' includes various strategic assets and shouldn't be considered a part of its cash and cash equivalents balance, per se. **At the end of 2019, Philip Morris International had a net debt load of $24.2 billion, down from $25.2 billion at the end of 2018 and we appreciate management cutting the firm's net debt load down.**

Consolidated Balance Sheets
(in millions of dollars, except share data)

at December 31,	2019	2018
Assets		
Cash and cash equivalents	$ **6,861**	$ 6,593
Trade receivables (less allowances of $20 in 2019 and $25 in 2018)	**3,080**	2,950
Other receivables	**637**	614
Inventories:		
Leaf tobacco	**2,052**	2,318
Other raw materials	**1,596**	1,405
Finished product	**5,587**	5,081
	9,235	8,804
Other current assets	**701**	481
Total current assets	**20,514**	19,442
Property, plant and equipment, at cost:		
Land and land improvements	**566**	600
Buildings and building equipment	**4,132**	3,975
Machinery and equipment	**9,354**	9,096
Construction in progress	**394**	886
	14,446	14,557
Less: accumulated depreciation	**7,815**	7,356
	6,631	7,201
Goodwill (Note 3)	**5,858**	7,189
Other intangible assets, net (Note 3)	**2,113**	2,278
Investments in unconsolidated subsidiaries and equity securities (Notes 4 & 16)	**4,635**	1,269
Deferred income taxes	**1,153**	977
Other assets	**1,971**	1,445
Total Assets	$ **42,875**	$ 39,801

Image Shown: *Philip Morris International historically has kept a nice cash balance on hand, providing the firm a nice liquidity buffer that supports its dividend coverage.* ***Image Source:*** *Philip Morris International – 2019 10-K Filing with additions from the author*

at December 31,	2019	2018
Liabilities		
Short-term borrowings (Note 7)	$ 338	$ 730
Current portion of long-term debt (Note 7)	4,051	4,054
Accounts payable	2,299	2,068
Accrued liabilities:		
Marketing and selling	666	732
Taxes, except income taxes	5,837	5,088
Employment costs	1,042	794
Dividends payable	1,831	1,783
Other	1,973	1,366
Income taxes (Note 11)	796	576
Total current liabilities	18,833	17,191
Long-term debt (Note 7)	26,656	26,975
Deferred income taxes	908	898
Employment costs	3,634	3,083
Income taxes and other liabilities (Note 11)	2,443	2,393
Total liabilities	52,474	50,540
Contingencies (Note 18)		
Stockholders' (Deficit) Equity		
Common stock, no par value (2,109,316,331 shares issued in 2019 and 2018)	—	—
Additional paid-in capital	2,019	1,939
Earnings reinvested in the business	30,987	31,014
Accumulated other comprehensive losses	(9,363)	(10,111)
	23,643	22,842
Less: cost of repurchased stock (553,421,668 and 554,736,610 shares in 2019 and 2018, respectively)	35,220	35,301
Total PMI stockholders' deficit	(11,577)	(12,459)
Noncontrolling interests	1,978	1,720
Total stockholders' deficit	(9,599)	(10,739)
Total Liabilities and Stockholders' (Deficit) Equity	$ 42,875	$ 39,801

Image Shown: *Philip Morris International's net debt position is manageable given its strong free cash flow profile. From the end of 2018 to the end of 2019, Philip Morris International's net debt load fell which we appreciate.* ***Image Source:*** *Philip Morris International – 2019 10-K Filing with additions from the author*

Deconsolidation of RBH

Within the big tobacco space, lawsuits are to be expected. A subsidiary of Philip Morris International lost a big case in Canada back in May 2015, which culminated in its Canadian subsidiary Rothmans, Benson & Hedges Inc ('RBH') seeking creditor protection in 2019 after the massive legal ruling (~$12 billion that was to be paid out by RBH and a couple other tobacco companies, with RBH held liable for $2.3 billion) was upheld on appeal last year. Here's more on that from Philip Morris International's 2019 Annual Report (emphasis added):

> *In the first class action pending in Canada, Conseil Québécois Sur Le Tabac Et La Santé and Jean-Yves Blais v. Imperial Tobacco Ltd. (IMBBY), Rothmans, Benson & Hedges Inc. and JTI-Macdonald Corp. (JAPAY), Quebec Superior Court, Canada, filed in November 1998, RBH and other Canadian manufacturers (Imperial Tobacco Canada Ltd. and JTI-Macdonald Corp.) are defendants. The plaintiffs, an anti-smoking organization and an individual smoker, sought compensatory and punitive damages for each member of the class who allegedly suffers from certain smoking-related diseases. The class was certified in 2005. The trial court issued its judgment on May 27, 2015. The trial court found RBH and two other Canadian manufacturers liable and found that the class members' compensatory damages totaled approximately CAD 15.5 billion, including pre-judgment interest (approximately $11.7 billion).* ***The trial court awarded compensatory damages on a joint and several liability basis, allocating 20% to our subsidiary (approximately CAD3.1 billion, including pre-judgment interest (approximately $2.34 billion))…***
>
> *….As a result of the Court of Appeal of Quebec's decision in both the Létourneau and Blais cases… our subsidiary, Rothmans, Benson & Hedges Inc. ('RBH'), and the other defendants, JTI Macdonald Corp., and Imperial Tobacco Canada Limited, sought protection in the Ontario Superior Court of Justice under the Companies' Creditors Arrangement Act ('CCAA') on March 22, March 8, and March 12, respectively. CCAA is a Canadian federal law that permits a Canadian business to restructure its affairs while carrying on its business in the ordinary course. The initial CCAA order made by the Ontario Superior Court on March 22, 2019 authorizes RBH to pay all expenses incurred in carrying on its business in the ordinary course after the CCAA filing, including obligations to employees, vendors, and suppliers…*

…The administration of the CCAA process, principally relating to the powers provided to the court and the court appointed monitor, removes certain elements of control of the business from both PMI and RBH. As a result, ***PMI has determined that it no longer has a controlling financial interest over RBH as defined in ASC 810 (Consolidation), and PMI deconsolidated RBH as of the date of the CCAA filing.*** *PMI has also determined that it does not exert "significant influence" over RBH as that term is defined in ASC 323 (Investments-Equity Method and Joint Ventures). Therefore, as of March 22, 2019, PMI accounted for its continuing investment in RBH in accordance with ASC 321 (Investments-Equity Securities) as an equity security, without readily determinable fair value.*

Following the deconsolidation, the carrying value of assets and liabilities of RBH was removed from the consolidated balance sheet of PMI, and the continuing investment in RBH was recorded at fair value at the date of deconsolidation. The total amount deconsolidated from PMI's balance sheet was $3,519 million, including $1,323 million of cash, $1,463 million of goodwill, $529 million of accumulated other comprehensive earnings, primarily related to historical currency translation and $204 million of other assets and liabilities, net. ***While PMI is accounting for its investment in RBH as an equity security, PMI would recognize dividends as income upon receipt. However, while it remains under creditor protection, RBH does not anticipate paying dividends.***

Given Philip Morris International's strong performance in 2019 and its expansive international presence, this news didn't derail our thesis on the stock. We wanted to bring this to our members attention to highlight that the company is putting the RBH saga behind it, albeit slowly, and while its 2019 performance took a ding from the ruling being upheld by the Court of Appeals of Quebec, Philip Morris International remains a free cash flow cow with a nice outlook. **Please keep in mind RBH retains a large cash balance that can be used to help cover its legal expenses.** On a non-GAAP adjusted diluted EPS basis, Philip Morris International posted 2% annual growth in 2019 which rises to 10% when excluding foreign currency headwinds.

Operational Update

In 2019, Philip Morris International's 'cigarette and heated tobacco unit shipment volume' fell by 2.0% year-over-year as its cigarette shipment volume fell by 4.5%, which was offset by a surge in heated tobacco unit shipment volume which grew by 44.2% during this period. On an adjusted basis, total shipments fell by 1.4%, which was well below the industry average as you can see in the graphic below. **Please note price increases are utilized to offset lower shipment volumes of its traditional tobacco products.**

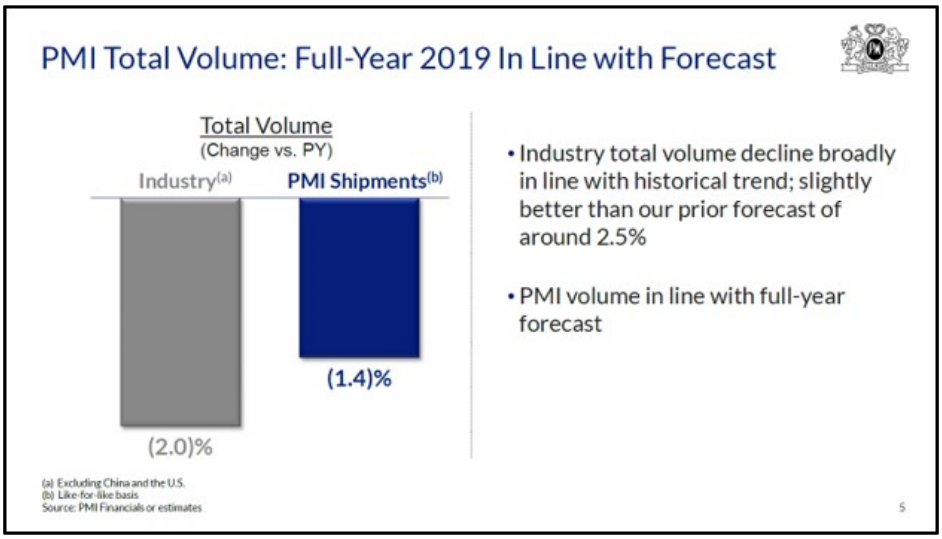

Image Shown: *Philip Morris International offset ongoing declines at its traditional tobacco business with sales of its heated tobacco products.* ***Image Source:*** *Philip Morris International – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

In the upcoming graphic below, **Philip Morris International showcases its pricing strength as the firm has been able to push through mid-single-digit pricing increases for more than a decade.** This is something that makes the tobacco space very appealing from a high-yield perspective, as barriers to entry and brand power enable firms to offset structural declines in conventional tobacco demand with material price increases on an ongoing basis. As tobacco products have inelastic demand curves, consumers continue to purchase Philip Morris International's products in relatively large quantities (keeping structural demand declines in mind, of course).

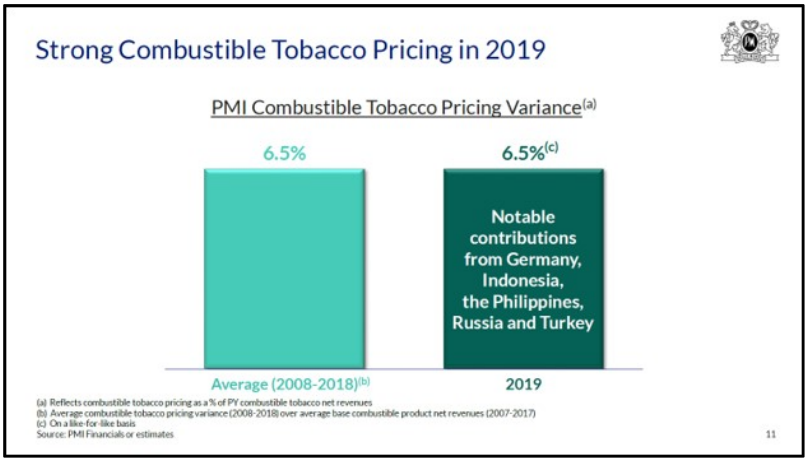

Image Shown: *Pricing power is essential to maintaining and improving Philip Morris International's free cash flows.* ***Image Source:*** *Philip Morris International – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

Philip Morris International was effectively able to grow its market share in 2019 on the back of the success of heated tobacco products like IQOS, which we appreciate. IQOS is targeted towards existing smokers by offering those consumers a healthier alternative to cigarettes, and sales of the product have performed quite well. The product is now available in 52 markets worldwide and please note the US FDA has approved the heated tobacco offering (unlike the once popular Juul product), with IQOS sales in the US starting up late last year.

Additionally, Philip Morris International is working with its partner Altria Group Inc (MO) to market the product in the US, and please note **IQOS is a fundamentally different product than the embattled Juul offering** (IQOS is targeted towards traditional smokers and is much more similar to a traditional cigarette in terms of flavor, functionality, taste, feel, etc., while Juul Labs' namesake product was aggressively targeted and marketed towards a younger non-smoking audience which is why it has caught so much flack of late).

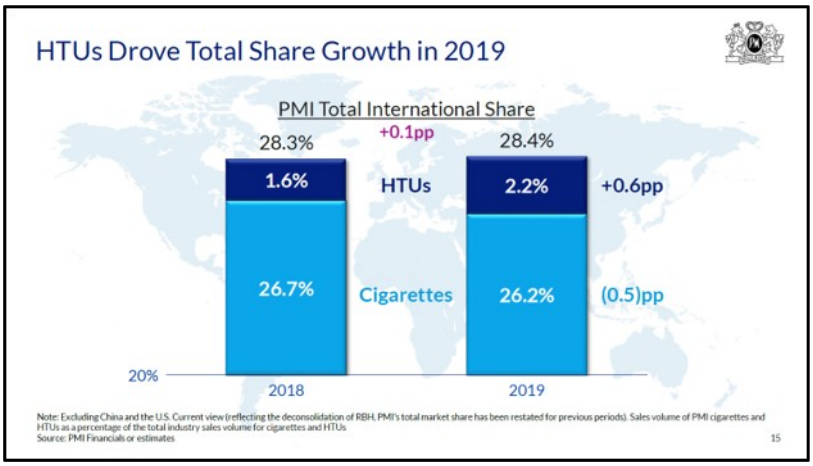

Image Shown: *Due to the strength of Philip Morris International's heated tobacco products, like IQOS, the firm was able to grow its total tobacco market share in 2019.* ***Image Source:*** *Philip Morris International – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

The upcoming graphic below highlights the rising success of IQOS, keeping in mind its recent launch in the US should help keep the momentum going. Please note the focus Philip Morris International is placing on converting existing smokers to the IQOS product, instead of trying to win over new smokers. **This is how tobacco companies effectively navigate the many regulations and potential public relations pitfalls within the industry.**

Image Shown: *The IQOS product continues to perform well, and we view this product line as offering the company a prime opportunity to maintain its stellar cash flow profile in a world where conventional tobacco use is declining.* ***Image Source:*** *Philip Morris International – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

Going forward, the strength of Philip Morris International's conventional tobacco products (led by its Marlboro brand) in terms of pricing power and rising sales of its heated tobacco products will enable the firm to continue improving its cash flow profile. Foreign currency movements need to be kept in mind, but **we appreciate management communicating that Philip Morris International is forecasted to generate ~$9.5 billion in free cash flow in 2020.** We view this strong forward guidance as the big reason why shares of PM have performed well recently, as management is expecting low single-digit free cash flow growth on an annual basis off a very high base this year.

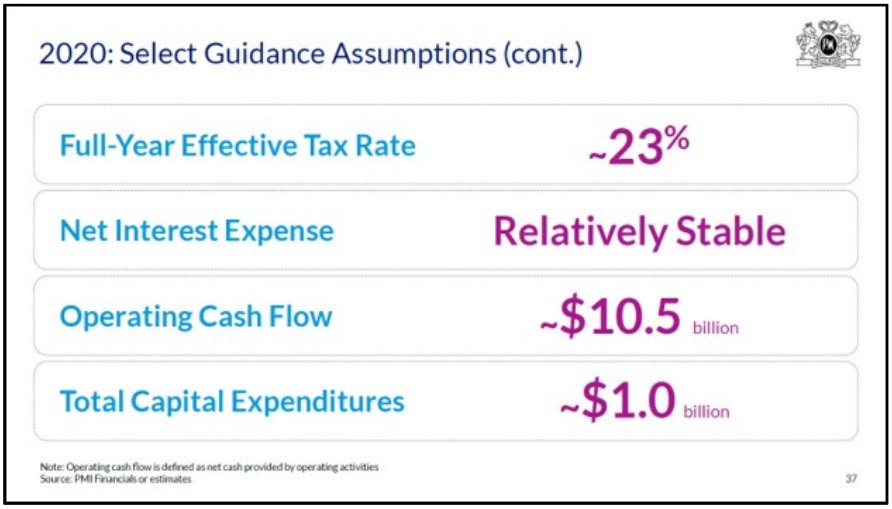

Image Shown: *Philip Morris International's free cash flow guidance for 2020 is quite impressive.* ***Image Source:*** *Philip Morris International – Fourth Quarter and Full-Year 2019 IR Earnings Presentation*

Concluding Thoughts

We continue to like Philip Morris International in our High Yield Dividend Newsletter portfolio, and we remain pleased with our decision to increase the weighting of shares of PM in the portfolio. The company's guidance for 2020 indicates further improvement in its free cash flow generation, potentially allowing for future per share dividend increases. On a final note, we want to stress that while Philip Morris International's Dividend Cushion ratio sits at 0.8x, we adjusted its Dividend Safety rating up to GOOD given its ability to refinance its net debt load and the stability of its free cash flows (while Philip Morris International is a capital market dependent entity, the firm retains quality access to capital markets). When we update our tobacco models, there's a good chance the company's Dividend Cushion ratio will improve given its declining net debt load, rising free cash flows, and improving outlook. We continue to monitor the potential impact the ongoing novel coronavirus epidemic might have of Philip Morris International and its 2020 guidance and will update our members as new information becomes available.

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

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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.*

THE SIMULATED HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO

We can't begin to tell you how excited we continue to be about the high yield space. We think we did pretty good the past few years given the uncertainty regarding Fed policy, and as you've noticed since the December 2018 bottom in the market, high yield dividend equities have bounced back.

We think the High Yield Dividend Newsletter portfolio positions us fairly well for whatever the market may throw at us, whether it's COVID-19 or another calamity. 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'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 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			
Global X SuperDividend ETF	SDIV	5.0%	9.00%
Global X SuperIncome Preferred ETF	SPFF	10.0%	5.88%
iShares International Select Dividend ETF	IDV	5.0%	5.21%
iShares MSCI Australia ETF	EWA	5.0%	3.97%
iShares U.S. Preferred Stock ETF	PFF	5.0%	5.25%
PowerShares Senior Loan Portfolio	BKLN	5.0%	4.85%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	6.17%
Utilities Select Sector SPDR	XLU	5.0%	2.77%
Vanguard Real Estate ETF	VNQ	10.0%	3.35%
EQUITY			
AT&T	T	7.5%	5.82%
BP PLC	BP	5.0%	7.99%
CubeSmart	CUBE	5.0%	4.33%
Digital Realty Trust	DLR	5.0%	3.51%
Enterprise Products Partners	EPD	5.0%	7.78%
Magellan Midstream Partners	MMP	5.0%	7.45%
Philip Morris	PM	7.5%	5.63%
Public Storage	PSA	5.0%	3.79%
Cash*	-	0.0%	1.75%
		100.0%	**5.39%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 3/1/2020. Est. Div. Yield retrieved from YahooFinance.

** Reflects high end of federal funds rate range*

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.*

Company Name	Symbol	Dividend Yield	Economic Castl	Multiplier
General Motors	GM	4.4%	Attractive	13.96
Honda	HMC	3.9%	Neutral	13.94
Gilead Sciences	GILD	3.9%	Very Attractive	12.98
Guess	GES	2.7%	Attractive	11.33
Lear Corp	LEA	2.8%	Attractive	10.98
Hewlett-Packard	HPQ	3.7%	Attractive	10.84
Bristol-Myers Squibb	BMY	2.9%	Very Attractive	10.29
Gap	GPS	6.0%	Attractive	10.25
Ralph Lauren	RL	2.8%	Attractive	10.08
Tapestry	TPR	5.2%	Attractive	9.95
H&R Block	HRB	4.5%	Very Attractive	9.91
Methode Electronics	MEI	1.6%	Attractive	9.75
Automatic Data Processing	ADP	2.8%	Very Attractive	9.70
Total	TOT	5.6%	Neutral	9.10
Cisco	CSCO	3.2%	Very Attractive	8.58
Cheesecake Factory	CAKE	3.7%	Attractive	8.52
Ethan Allen	ETH	4.9%	Unattractive	8.21
AVX Corp	AVX	2.5%	Attractive	7.50
Ford	F	6.5%	Neutral	7.47
Archer-Daniels-Midland	ADM	3.5%	Attractive	7.40
Novartis	NVS	3.1%	Attractive	7.27
Dick's Sporting	DKS	2.4%	Attractive	7.24
Resources Connection	RECN	3.6%	Attractive	7.03
McKesson	MCK	1.2%	Very Attractive	6.99
Harley-Davidson	HOG	4.2%	Attractive	6.97
Cardinal Health	CAH	4.2%	Attractive	6.95
Manpower	MAN	2.3%	Attractive	6.92
AmerisourceBergen	ABC	2.0%	Very Attractive	6.92
Walgreens Boots Alliance	WBA	3.1%	Attractive	6.81
Altria Group	MO	6.7%	Very Attractive	6.78
Caterpillar	CAT	2.8%	Very Attractive	6.77
Robert Half	RHI	2.0%	Very Attractive	6.77
British American	BTI	6.9%	Unattractive	6.74
Amgen	AMGN	2.6%	Very Attractive	6.74
Pfizer	PFE	3.9%	Attractive	6.71
Xerox	XRX	3.2%	Attractive	6.69
Expeditors Intl	EXPD	1.4%	Very Attractive	6.63
Cedar Fair	FUN	6.7%	Attractive	6.62
MKS Instruments	MKSI	0.7%	Attractive	6.56
Johnson & Johnson	JNJ	2.8%	Attractive	6.54
Paychex	PAYX	2.9%	Very Attractive	6.49
AstraZeneca	AZN	3.0%	Attractive	6.42
MSC Industrial	MSM	4.0%	Attractive	6.26
IBM	IBM	4.8%	Attractive	6.21
Rio Tinto	RIO	5.0%	Neutral	6.10
AbbVie	ABBV	5.4%	Very Attractive	6.04
Merck	MRK	2.6%	Very Attractive	6.01
QUALCOMM	QCOM	3.0%	Very Attractive	6.00
Insperity	NSP	1.4%	Neutral	5.96
Royal Dutch Shell	RDS	6.7%	Neutral	5.94

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 that are dealing with a secular shift toward digital consumption or navigating changing consumer preferences as millennials seek 'experiences' not 'things' (e.g. fashion). These may not be the best dividend growth stocks to consider. The Dividend Cushion is only one factor that we use in assessing the overall health of a company's dividend.

DIVIDEND REPORT PAGE 2 – MOLSON COORS BEVERAGE CO (TAP)

Molson Coors TAP FAIRLY VALUED

Buying Index™ 7 Value Rating

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Unattractive	$46.00 - $68.00	HEALTHY	VERY POOR / -0.9	VERY POOR	3.95%

Assessment of Company Dividend Strategy

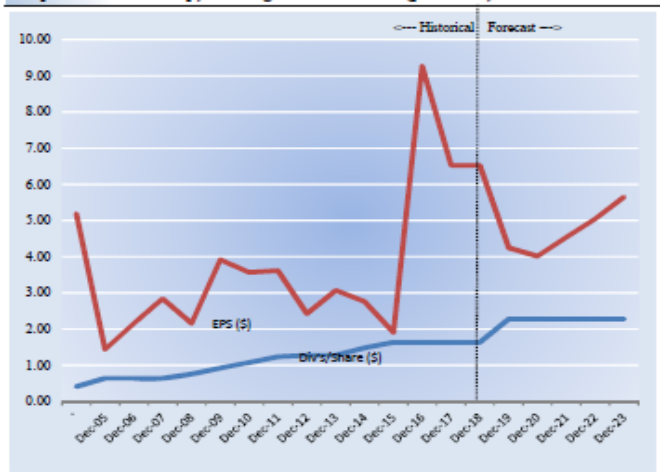
Key Strengths

Molson Coors is now the sole owner of the MillerCoors portfolio of brands, and the firm's dividend potential should benefit from the ~$200 million in annual cost synergies expected to be extracted from the $12 billion deal. This has given it incremental economic interest in a broad range of brands of drinks across the quality spectrum, from economy to premium to craft. Though it dipped in 2015, free cash flow generation (averaging over $830 million from 2015-2017) has been more than double average annual run rate cash dividend obligations of just over ~$353 million in recent years. Dividend growth had been strong at the company prior to the MillerCoors deal, as the payout has grown from $0.64 in 2006 to current levels.

Potential Weaknesses

Molson Coors' balance sheet has been impacted by the issuance of new debt as part of its acquisition of full ownership of its MillerCoors joint venture. Its net debt load is large. Management expects to aggressively pay down debt, which has the potential to significantly eat into capital that may have been otherwise allocated towards dividend hikes. If annual cost synergy targets are achieved, we view the deal as a long-term positive for the company, but near-term income-oriented investors must be aware of the impact it could have on dividend growth potential in coming years. We wouldn't be surprised to see management put dividend growth on the back burner for some time.

Graphical Relationship, Earnings and Dividends (per share)

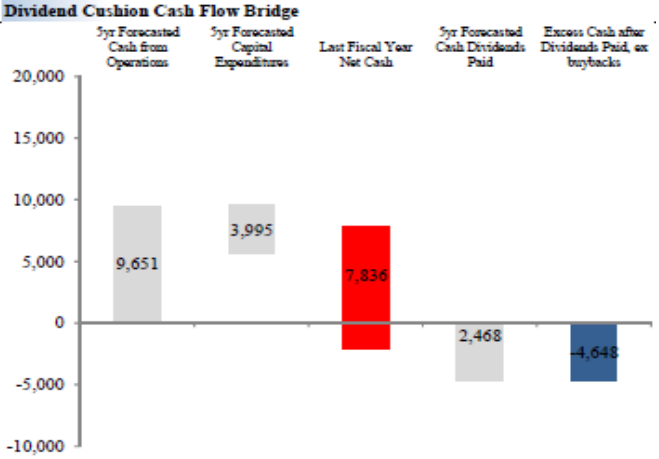


The graph above shows the relationship between a firm's earnings per share and its dividends per share.

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

Dividend Cushion Cash Flow Bridge

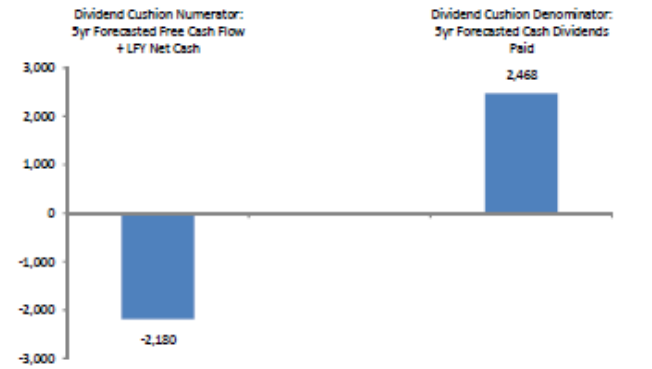


Source: Company Filings, Valuentum Projections

Dividend Cushion Ratio Evaluation

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

Dividend Cushion Ratio Deconstruction



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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