Valuentum Securities, Inc. 10/1/2020 Edition 3, Volume 10

# HIGH YIELD DIVIDEND NEWSLETTER

## High Yield Dividend Income Investing in a Time of Need

***Latest Changes to High Yield Dividend Newsletter***
**Weighting Changes: 2.5% Reduction in PM and T (Reducing Weighting to 5.0% each) – July 21**
**Removed: BP and SJB – July 21 Added: 5.0% to Both CCI and CONE (5.0% each) – July 21**

## INSIDE THIS ISSUE


1 High Yield Dividend Income Investing in a Time of Need
3 Public Storage Rebounds and Its Financials Remain Strong
7 **Spotlight: *NEW* Broadcom Inc (AVGO) Carries a Stellar Cash Flow Profile and Promising Outlook**
12 CubeSmart Remains Rock-Solid
16 Our Thoughts on Chevron Buying Noble Energy
23 The High Yield Dividend Newsletter Portfolio
24 Dividend Report Page 2 – Verizon Communications (VZ)


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***"SELF-STORAGE REITS LIKE PUBLIC STORAGE AND CUBESMART GENERATE MEANINGFUL AMOUNTS OF TRADITIONAL FREE CASH FLOWS, WHICH WE REALLY APPRECIATE. WE INCLUDE BOTH PUBLIC STORAGE AND CUBESMART IN OUR HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO."***

***– CALLUM TURCAN***

*By Brian Nelson, CFA*

Please note a version of this article was emailed out to members previously on September 10th.

The skills to successfully invest for long-term capital gains or long-term dividend growth are much different than those required for generating high yield dividend income. *Income investing is a much different proposition.* However, the skills do center on a similar equity evaluation process, but one that requires an acknowledgement and heightened awareness of considerably greater downside risks.

Income investing, or high yield dividend income investing, should at times be considered among the riskiest forms of investing, as many high dividend-yielding securities tend to trade closer to the characteristics of junk-rated bonds than they do most net cash rich and free cash flow generating powerhouses that we like so much.

The dividend yield, itself, often says a lot about a company's financial health and the magnitude of risk corresponding to the ability of the company to keep paying the dividend at its existing annual rate. Let's think about this logically. In a world where CDs are yielding practically nil and the latest junk-rated debt is selling at rates under 3%, for a common equity's yield to grow north of, let's say 8%, it generally speaks more to the risk of the sustainability of the payout than any abnormally large risk-adjusted income opportunity.

Not all dividends are created equal. Just like you wouldn't expect to find $20 bills blowing around to pick up on the busy streets downtown, one shouldn't expect an 8% yielder to have the same risks to the dividend as a 2-3% dividend yielder.

The stock market is definitely not efficient (it failed to adjust rapidly to new information regarding COVID-19 in early February, as just one example), but it is not that inefficient to misprice risk to the point where investors should view that 8% yielder in any equivalent manner as a tried-and-true 2%-3% dividend yielder with substantial dividend growth prospects. The risk that the 8% yielder may cut its dividend payment, for example, could be multiple times the risk of that 2-3% yielder. Intrinsic value considerations aside, if risk were the same between the two securities, the market might price that 8% yielding equity closer to the 2-3% yield range and drive its price higher. That 8% yielder is trading at a depressed price for a reason: its risk is comparatively higher.

Let's get back to which similar equity evaluation process I noted in the first paragraph (3). You guessed it: enterprise valuation (i.e. the discounted cash flow method). Where enterprise valuation 1) helps to identify underpriced equities with strong cash-based sources of intrinsic value (i.e. net cash and future expected free cash flows) to combine with technical/momentum indicators for long-term capital appreciation potential via a heightened probability of market price to estimated fair value convergence and 2) highlights net cash rich and strong expected free cash flow payers that can comfortably cover their future dividend growth aspirations for years to come, as evidenced by their lofty Dividend Cushion ratios, it also 3) identifies the key risks associated with investing for income in the high dividend yield arena.

In most cases, and as implied thus far, high dividend-yielding stocks have substantially higher financial risk than the average company on the market. For example, many yielders north of 5%-6% tend to have large net debt positions weighing down their intrinsic value, and/or modestly cover their future expected dividend payments with future expected traditional free cash flows. The combination of a generally leveraged balance sheet and meager traditional free-cash-flow coverage of the dividend translates into a very weak Dividend Cushion ratio.

We measure the Dividend Cushion ratio by forecasting future expected free cash flows and comparing them to a company's expected dividend payments. We also consider the net balance sheet position of the equity in the calculation. All else equal, a company with a large net cash position and strong expected future free cash flows above and beyond its future dividend growth expectations has materially better dividend health than a company with a large net debt position that fails to cover its future expected dividends with traditional free cash flow.

A number of high dividend yielding equities may also be very capital-market dependent (i.e. REITs, MLPs, overleveraged cyclicals, and the like), meaning they depend heavily on the capital markets to be widely open and available to keep paying their dividends/distributions, where on the other hand, entities such as Apple (AAPL) or Microsoft (MSFT) that have huge net cash positions and strong expected future free cash flows may not care much if the markets even closed for the next 5 years. This is partly why we like net cash rich and strong free cash flow generating enterprises so much. They don't have much capital-market dependency and credit risk, the absence of which helps to support their equity prices during times of crises, as was revealed during the COVID-19 swoon. It's no surprise to us why large cap growth has dominated 2020, even on a risk-adjusted basis, as shown below.

**YTD Equity Sharpe Ratios (Through August 2020)**

| | Value | Core | Growth |
|---|---|---|---|
| **Large Cap** | -0.40 | 0.59 | 1.35 |
| **Mid Cap** | -0.45 | -0.08 | 0.29 |
| **Small Cap** | -0.53 | -0.29 | -0.03 |

*Source: WealthManagement, S&P cap/style indices*

***Image Shown:*** *The Sharpe ratio is a quantitative measure that assesses risk-adjusted returns. The higher the better.*

Where large cap growth has performed incredibly well (a large cap growth ETF is up over 23% year to date), many REITs and MLPs have suffered tremendously during the Great Financial Crisis, and even during this COVID-19 crisis, due to their capital-market dependency and credit risk. Year-to-date, for example, a broad-based REIT ETF is down nearly 12%, while a broad-based MLP ETF is down nearly 50%, relative to an S&P 500 that is up on the year.

It is often very rare to find a REIT that covers its future expected dividends with traditional free cash flow, and it is rarer still in the pipeline MLP arena. To seemingly add to investor confusion, these two groups have come up with their own industry-specific measures to communicate to investors: adjusted funds from operations (AFFO) for REITs and distributable cash flow (DCF) for pipeline MLPs, not to be confused with discounted cash flow. However, investors should be aware that, while management teams may say their entities have hefty dividend or distribution coverage on the basis of these (non-GAAP) industry-specific metrics, the astute high yield dividend income investor should always assess balance sheet health (net cash vs. net debt) and use traditional free cash flow in the evaluation process, as measured by cash flow from operations less all capital spending.

Focusing on traditional free cash flow saved Valuentum members from the impending collapse of pipeline MLP equities in 2015, and the industry has never recovered. There is truly nothing better than a focus on business model (competitive advantage) analysis, balance sheet (net cash or net debt) analysis, and future free cash flow assessments. You can consider the industry-specific information provided by management teams, but to a large degree, it can sometimes be misleading.

Searching for income within high dividend yield investments therefore isn't always easy. Almost every pipeline MLP, for example, said that its distribution was covered nicely heading into the collapse of 2015/2016. There have been dozens upon dozens of pipeline MLP cuts since then, despite such reassurances. The capital-market dependency risks of REITs are not to be overlooked either, as many have had to frequently raise equity to keep their payouts on the up and up. While we favor REITs over MLPs, all else equal, we generally prefer high dividend paying corporates over both of these business structures. We can't always find a high dividend yielding competitively advantaged corporate with substantial net cash and strong expected future free cash flows, but we want to get as close to those dynamics in our favorite high dividend-yielding income payers as possible.

Because capital-market dependency risk is so important to evaluate, we generally prefer high dividend-yielding companies that have investment-grade credit quality, as many generally won't have our preferred outsize net cash positions on the balance sheet. An investment-grade credit rating generally means that when the going gets tough, the entity will be able to raise debt at reasonable rates, if need be, to offset liquidity risk that may arise from having to pay out such a large dividend/distribution in tough times. Capital-market dependent junk-rated credits, however, may be heavily exposed to an "avalanche effect" under crisis conditions, whereupon they may be forced to raise equity capital at depressed prices, impairing intrinsic value at the same time the dividend is threatened. High yield dividend investors should pay very, very close attention to a company's corporate credit rating (BBB and above, but preferably A rated) and its equity price movements (much more so than in other investment styles), as equity is also a source of capital to preserve the payout.

After considering just how much the entity is in investment-grade territory with respect to its credit, an evaluation of the cash flow statement should come next. Hardly any pipeline MLPs cover their distributions with future expected traditional free cash flow, and perhaps only a rare few in the REIT space.

Our favorite REITs generally operate within the data center and storage arenas. Corporates, however, often have a greater capacity to generate traditional free cash flow in excess of future expected dividends paid. Let's use an example. Though a high dividend-yielding corporate such as AT&T (T) may have a hefty and ominous net debt position, it covers its future expected dividend payments nicely with expected free cash flows. AT&T also has an investment-grade balance sheet and given its competitively advantaged business model and 7% annualized dividend yield at current prices, it might make the cut for the high dividend yield income investor's portfolio. In fact, AT&T is a holding in our High Yield Dividend Newsletter portfolio.

Without a doubt, high yield dividend income investing is not easy, and it's definitely not as simple as selecting the highest dividend yielders and taking management's word that things will be okay. Investors can be blindsided by a double whammy occurring as a result of the company cutting its outsize dividend payment while having to raise equity capital at depressed prices as a result of most income investors selling hand over fist (i.e. the avalanche effect). However, a focus on a firm's business model (competitive advantages), credit rating (preferring healthy investment-grade entities), and future expected traditional free cash flow coverage of the dividend, while generally avoiding entities with considerable capital-market dependency and credit risk could lead many investors to some very nice high-yielding dividend paying equities today.

***Disclosure:*** *Brian Nelson owns shares in SPY, SCHG, DIA, QQQ, and VOT.*

## Public Storage Rebounds and Its Financials Remain Strong

***Image Shown:*** *Shares of Public Storage have recovered a considerable amount of lost ground since the pandemic-induced drop in March 2020. We continue to like Public Storage as a holding in our High Yield Dividend Newsletter and are big fans of self-storage companies with significant exposure to the US.*

*By Callum Turcan*

The self-storage real estate investment trust ('REIT') Public Storage (PSA) is included as a holding in our High Yield Dividend Newsletter portfolio. We strongly appreciate its free cash flows, which are relatively rare in the REIT industry given that the growth-related capital expenditures of most REIT's tend to be enormous. Shares of PSA have rebounded strongly off their March 2020 lows and yield ~3.6% as of this writing.

**Operations Update**

Public Storage's operations have held up relatively well during the initial stages of the ongoing coronavirus ('COVID-19') pandemic, all things considered. Its weighted average occupancy in square feet terms came in at 93.7% during the first half of 2020 (up 50 basis points year-over-year) and 94.2% during the second quarter of 2020 (up 20 basis points year-over-year). However, Public Storage's same facility net operating income dropped by single digits in both the first half and second quarter of 2020 versus the same period the prior year due to rising operating expenses and declining revenues.

The decline in revenues was primarily due to lower realized annual rental rates per occupied square feet (particularly as it relates to Public Store's second quarter performance), and reduced administration charges and late fees. Rising operating expenses were the result of the complexities arising from COVID-19 (driving payroll expenses higher) and increased marketing expenses. While this pressured Public Storage's financial performance during the first half of this year, its GAAP revenues and GAAP operating income declined by only 1% and 3% year-over-year, respectively, during this period.

**Financial Update**

During the first half of 2020, Public Storage generated $1.0 billion in net operating cash flows while spending $0.2 billion on its capital expenditures (defined here as 'capital expenditures to maintain real estate facilities' plus 'development and expansion of real estate facilities'), **allowing for $0.8 billion in free cash flows which fully covered $0.8 billion in dividend obligations** (defined as 'distributions paid to preferred shareholders, common shareholders and restricted share unitholders') during this period. Please note Public Storage also spent approximately $0.25 billion on acquisitions during the first half of 2020, activities that were funded by the balance sheet. Though an imperfect metric (as we have often noted in the past), a REIT's funds from operations ('FFO') is a way to gauge the strength of its dividend coverage and ability to push through payout increases.

We will caution that AFFO and FFO metrics do not take the REIT's balance sheet considerations and refinancing needs into account. During the first half of 2020, Public Storage saw its core FFO per share (an adjusted non-GAAP metric) drop by 3% year-over-over to $5.04 while the firm paid out $4.00 in dividends per share during this period. Public Storage's ~79% payout ratio during the first two quarters of this year (dividends per share divided by core FFO per share) is decent as we prefer payout ratios below 80%.

Pivoting to Public Storage's balance sheet, the REIT had $1.3 billion in cash and cash equivalents on hand at the end of June versus $2.5 billion in notes payable. Additionally, please note Public Storage also had $0.5 billion in preferred shares called for redemption at the end of the second quarter of 2020. Here is a brief explanation of its recent financing activities from its latest 10-Q filing:

> *On June 17, 2020, we issued 22.6 million depositary shares, each representing 0.001 of a share of our 4.625% Series L Preferred Shares, at an issuance price of $25.00 per depositary share, for a total of $565.0 million in gross proceeds, and we incurred $15.8 million in issuance costs.*
>
> *In June 2020, we called for redemption of, and on July 10, 2020, we redeemed our 5.375% Series V Preferred Shares, at par. The liquidation value (at par) of $495.0 million was reclassified as a liability at June 30, 2020… We recorded a $15.1 million allocation of income from our common shareholders to the holders of our Preferred Shares in the three and six months ended June 30, 2020 in connection with this redemption.*

At the end of June, Public Storage had ~$4.1 billion in total outstanding preferred shares by liquidation preference value. For the remainder of 2020 and throughout 2021, Public Storage has a negligible amount of debt coming due (primarily in the form of maturing mortgage debt). In 2022, $0.5 billion of Public Storage's unsecured debt matures, along with a negligible amount of mortgage debt. The weighted average effective interest rate of Public Storage's debt load was just 2.4% as of June 30, 2020 (the low effective interest rate is partially a product of its Euro-denominated debt and largely a product of its strong financial standing).

**Due to its rock solid 'A-rated' investment grade credit ratings (A/A2), Public Storage will likely retain access to debt markets at attractive rates going forward.** Considering the strength seen at shares

of PSA of late (and its recent preferred share issue), the firm will also likely retain access to equity markets at attractive rates going forward as well.

**Concluding Thoughts**

We appreciate Public Storage's ample cash on hand, strong free cash flows, and staggered debt maturity schedule (which makes refinancing activities significantly easier). As the REIT does not have a significant amount of debt coming due anytime soon, the firm has ample financial flexibility to ride out the COVID-19 pandemic with its payout intact. We continue to like the self-storage REIT industry and appreciate the resilience of Public Storage's operational and financial performance during the pandemic, all things considered. On a final note, we also continue to like CubeSmart (CUBE) as a holding in our High Yield Dividend Newsletter portfolio.

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

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

| **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: Broadcom Inc (AVGO) Carries a Stellar Cash Flow Profile and Promising Outlook

Our **High Yield Spotlight Idea for October 2020** is the semiconductor and IT infrastructure software giant Broadcom Inc (AVGO)---**3.6% yield**---which has posted strong financial and operational performance so far in the face of the ongoing coronavirus ('COVID-19') pandemic. **We are big fans of Broadcom's stellar cash flow profile, promising long-term growth runway, improving near-term outlook, and its ongoing pivot towards software sales in the IT infrastructure and cybersecurity arena.**

For starters, it is important to keep in mind that Broadcom is a serial acquirer. Back in November 2017, Broadcom closed its acquisition of Brocade through an all-cash deal worth $5.9 billion by enterprise value. For reference, Brocade sold switching and networking offerings with an eye towards data centers and cloud computing operations. A year later, Broadcom closed its all-cash $18.4 billion by enterprise value acquisition of CA Technologies in November 2018, which sold enterprise software. These two acquisitions significantly grew its software business, but Broadcom wanted to keep the momentum going.

Additionally, Broadcom completed its all-cash $10.7 billion acquisition of Symantec Corporation's 'Enterprise Security' business back in November 2019. As an aside, Symantec's remaining business was renamed NortonLifeLock Inc (NLOK). **These acquisitions (Brocade, CA Technologies, Symantec's Enterprise Security business) represent a key part of Broadcom's plan to grow its enterprise software business.** Recurring revenues, long growth runways, and relatively minimal capital expenditure requirements (to sustain a certain level of revenues) make this pivot a good fit alongside Broadcom's semiconductor business.

Demand for cybersecurity offerings is forecasted to grow significantly over the coming years and decades, with market research firm *ResearchandMarkets* estimating that the global cybersecurity market will grow from roughly $149 billion in 2019 to approximately $208 billion by 2023. Furthermore, demand for IT infrastructure offerings from data centers will likely continue to grow at a healthy clip as the transition towards cloud computing accelerated due to COVID-19. By capitalizing on secular growth tailwinds, Broadcom should be able to organically grow its revenues, operating income, and ultimately free cash flows generated by its software business. Additional acquisitions are also likely to play a big role here.

When Broadcom reported its fiscal third quarters in early-September, its 'Infrastructure software' sales represented 28% of its GAAP revenues, up from 21% in the same quarter the prior fiscal year. While Broadcom's 'Semiconductor solutions' business posted a 4% year-over-year drop in sales, its Infrastructure software business reported 41% year-over-year growth in sales, driven in large part by recent acquisitions and strong underlying demand for such offerings. As it concerns Broadcom's semiconductor business, management reported that this segment was expected to experience a significant rebound during the firm's latest earnings call aided by the rollout of 5G products and wireless networks (emphasis added):

> *"So, in summary, our semiconductor solutions segment was up 5% sequentially in Q3.* ***And given the continuing surge of demand in networking and expected 5G phone ramp in wireless, we expected a mid-teens percentage sequential increase in our fourth fiscal quarter.*** *We should know, on a year-on-year basis, Q4 will mark a return to growth for semiconductor segment overall, which we think is a key inflection point for Broadcom and which we expect to sustain into Q1.* *[Continued on next page]*

*[Continued from previous page] Now, turning to software. CA was up 6% year-on-year, flat sequentially. Bookings at our core accounts continued to grow double-digit year-on-year and has offset the expected reduction in the services business. Symantec was flat sequentially and contributed over $400 million in the quarter. Similar to CA, bookings in our Symantec core accounts are growing, offsetting the transition out of the smaller commercial accounts as we continue to rationalize the business.*

*Brocade was up 3% year-over-year, and as expected, was down significantly, sequentially.* ***Looking ahead to next quarter on a sequential basis, we expect revenues from CA to sustain and expect Symantec revenue to be up 4%. We anticipate Brocade revenue to be relatively flat on a sequential basis. And as a result, revenue from the software segment is expected to be up by low-single-digit percentage sequentially in the fourth quarter.***

***So, in summary, we expect our fourth quarter net revenue to be $6.4 billion, up 10% sequentially from Q3.*** *This reflects an approximate mid-teens percentage sequential projected revenue increase in the semiconductor solutions side and a low-single-digit percentage sequential revenue increase in infrastructure software." --- Hock Tan, CEO of Broadcom*

Broadcom's near-term outlook appears quite promising given expectations for growth on both the semiconductor and software front. The company's semiconductor business is well-positioned for the rollout of 5G telecommunications networks and 5G-connected products (smartphones, cars, and more). Back in February 2019, Broadcom announced it had completed its 5G switching portfolio that is "designed to enable the deployment of end-to-end networks that consolidate all radio and fixed-line traffic onto a standard, Ethernet-based infrastructure" to support the rollout of 5G telecommunications services.

However, Broadcom's push deeper into the software space has not been cheap. **These deals have seen Broadcom's total debt load (inclusive of short-term debt) swell to $44.0 billion at the end of the fiscal third quarter**, which weighs negatively on its dividend coverage. Broadcom's cash and cash equivalents balance sat at $8.9 billion as of the end of the fiscal third quarter, providing the firm with ample liquidity. The firm needs to retain access to capital markets to refinance debt maturities, ideally at attractive rates, which we expect will continue being the case going forward. Broadcom recently reduced its "weighted average debt maturity to approximately six years and reduce our weighted average interest rate to approximately 3%" after executing "an $8 billion bond refinancing and $3.9 billion exchange offering" according to management commentary given during Broadcom's latest earnings call.

We view Broadcom's net debt load as manageable, though we would prefer the company pare that burden down over time. Its strong cash flow profile drives its Dividend Cushion ratio. For reference, the Dividend Cushion ratio is calculated by taking the sum of the firm's forecasted free cash flows over the next five full fiscal years, factoring in balance sheet considerations (net cash is added to that sum while net debt is subtracted), and dividing that figure by the firm's estimated future dividend obligations during that period. Broadcom has a Dividend Cushion ratio of 0.9, earning the firm a "GOOD" Dividend Safety rating and please note that these metrics factor in our expectations that Broadcom will steadily push through dividend increases over the coming years.

During the first nine months of fiscal 2020 (period ended August 2, 2020), Broadcom's GAAP revenue and GAAP operating income each grew by approximately 4% year-over-year. The firm generated $8.4 billion in free cash flows and spent $4.1 billion covering its dividend obligations during this period. Additionally, Broadcom did not repurchase a significant amount of its stock during this period.

**Broadcom's financials have held up relatively well in the face of the pandemic.** During the fiscal third quarter, Broadcom's GAAP revenue and GAAP operating income were up 6% and 17% year-over-year, respectively. The uplift from its recent acquisitions played a role.

From fiscal 2017 to fiscal 2019, Broadcom generated ~$7.7 billion in annual free cash flows on average as highlighted in the upcoming graphic down below. That fully covered Broadcom's annual average dividend obligations of ~$3.0 billion during this period. In fiscal 2019, Broadcom generated $9.3 billion in free cash flow and spent $4.2 billion covering its dividend obligations, though an additional $5.4 billion was spent on its share repurchases. We caution that Broadcom's share buyback programs have historically been quite sizable and compete for capital against its dividend obligations. Broadcom's capital allocation priorities need to be monitored going forward.

**BROADCOM INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Fiscal Year Ended | | |
|---|---|---|---|
| | November 3, 2019 | November 4, 2018 | October 29, 2017 |
| | (In millions) | | |
| **Cash flows from operating activities:** | | | |
| Net income | $ 2,724 | $ 12,610 | $ 1,784 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Amortization of intangible assets | 5,239 | 3,566 | 4,286 |
| Depreciation | 569 | 515 | 451 |
| Stock-based compensation | 2,185 | 1,227 | 921 |
| Deferred taxes and other non-cash taxes | (934) | (8,270) | (173) |
| Impairment on investment | — | 106 | — |
| Non-cash portion of debt extinguishment loss | — | — | 166 |
| Non-cash restructuring, impairment and disposal charges | 133 | 21 | 71 |
| Non-cash interest expense | 90 | 24 | 24 |
| Other | (125) | 37 | 7 |
| Changes in assets and liabilities, net of acquisitions and disposals: | | | |
| Trade accounts receivable, net | 486 | (652) | (267) |
| Inventory | 250 | 417 | (39) |
| Accounts payable | (42) | (325) | (97) |
| Employee compensation and benefits | (294) | 6 | 109 |
| Contributions to defined benefit pension plans | — | (130) | (361) |
| Other current assets and current liabilities | (283) | 369 | (490) |
| Other long-term assets and long-term liabilities | (301) | (641) | 159 |
| Net cash provided by operating activities | 9,697 | 8,880 | 6,551 |
| **Cash flows from investing activities:** | | | |
| Acquisitions of businesses, net of cash acquired | (16,033) | (4,800) | (40) |
| Proceeds from sales of businesses | 957 | 773 | 10 |
| Purchases of property, plant and equipment | (432) | (635) | (1,069) |
| Proceeds from disposals of property, plant and equipment | 88 | 239 | 441 |
| Purchases of investments | (5) | (249) | (207) |
| Proceeds from sales and maturities of investments | 5 | 54 | 200 |
| Other | (2) | (56) | (9) |
| Net cash used in investing activities | (15,422) | (4,674) | (674) |
| **Cash flows from financing activities:** | | | |
| Proceeds from long-term borrowings | 28,793 | — | 17,426 |
| Repayment of debt | (16,800) | (973) | (13,668) |
| Other borrowings | 1,241 | — | — |
| Dividend and distribution payments on common stock and exchangeable limited partnership units | (4,235) | (2,998) | (1,745) |
| Repurchases of common stock - repurchase program | (5,435) | (7,258) | — |
| Shares repurchased for tax withholdings on vesting of equity awards | (972) | (56) | — |
| Issuance of preferred stock, net | 3,679 | — | — |
| Issuance of common stock | 253 | 212 | 257 |
| Other | (36) | (45) | (40) |
| Net cash provided by (used in) financing activities | 6,488 | (11,118) | 2,230 |
| Net change in cash and cash equivalents | 763 | (6,912) | 8,107 |
| Cash and cash equivalents at beginning of period | 4,292 | 11,204 | 3,097 |
| Cash and cash equivalents at end of period | $ 5,055 | $ 4,292 | $ 11,204 |

***Image Shown:*** *An overview of Broadcom's historical cash flow profile, with its net operating cash flows and capital expenditures underlined in red and its dividend obligations underlined in blue.* ***Image Source:*** *Broadcom – Fiscal 2019 Annual Report*

Broadcom has seen its margins and revenues trend in the right direction over the past several fiscal years as you can see in the upcoming graphic down below (which cites non-GAAP financial figures). Its pivot towards IT infrastructure software sales is a key reason why, given the very high-margin nature of those offerings. The company's semiconductor business is also very lucrative, giving Broadcom multiple ways to grow its free cash flows going forward.

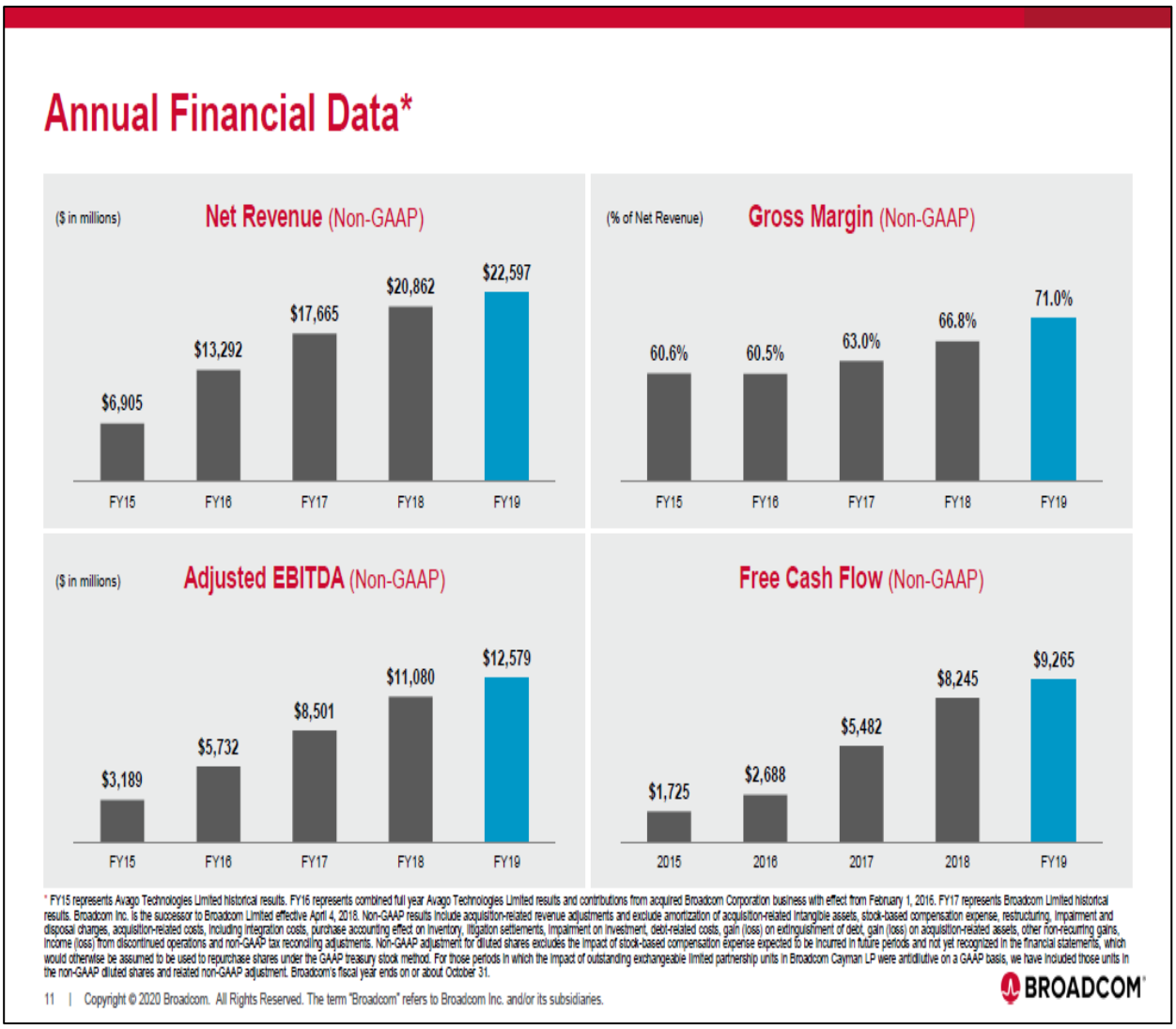


***Image Shown:*** *Broadcom's financial performance has steadily improved over the past several fiscal years.* ***Image Source:*** *Broadcom – September 2020 IR Presentation*

As Broadcom's free cash flows swelled higher, management aggressively increased the firm's per share dividend as you can see in the upcoming graphic at the top of the next page. We strongly appreciate Broadcom's commitment to rewarding shareholders and expect management will continue pushing through meaningful dividend increases over the coming years. Broadcom has a "GOOD" Dividend Growth rating.

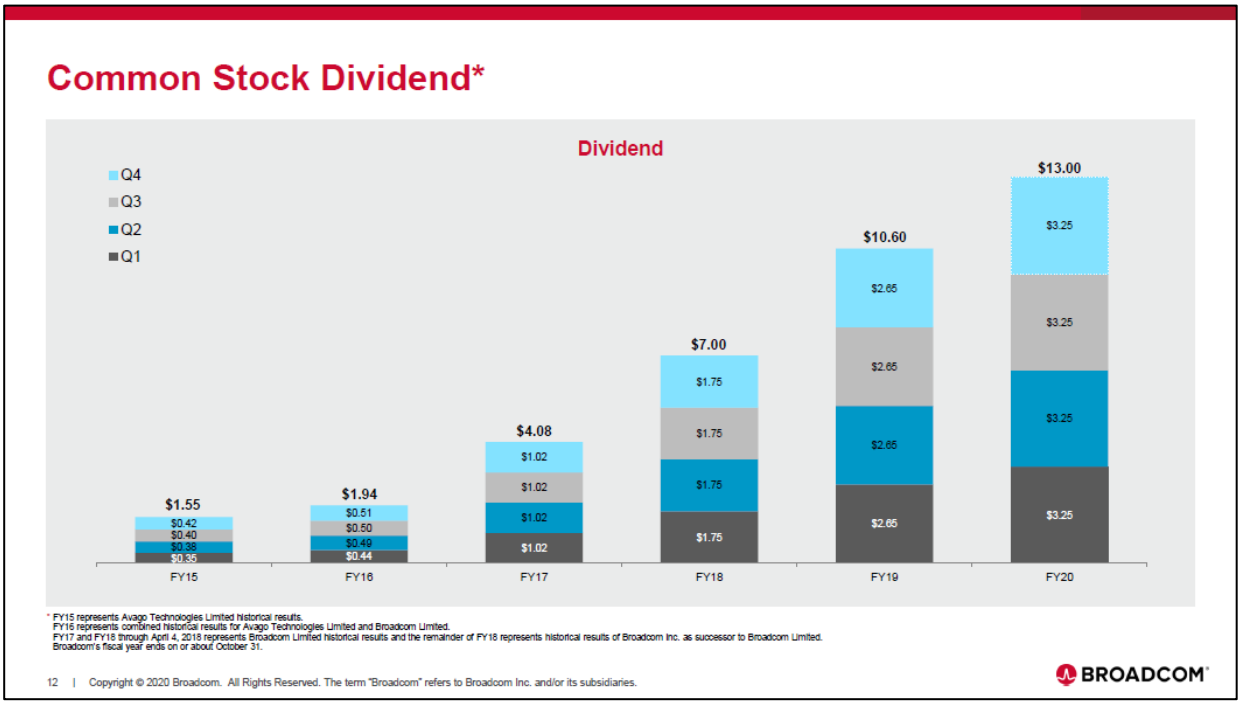


***Image Shown:*** *Broadcom has steadily grown its per share dividend over the past several fiscal years. We expect this growth trajectory will continue going forward.* ***Image Source:*** *Broadcom – September 2020 IR Presentation*

We are big fans of Broadcom's cash flow profile, outlook, and pivot towards high-margin IT infrastructure software offerings. There are concerns to keep in mind, particularly Broadcom's hefty net debt load and potential headwinds arising from COVID-19, but management appears highly confident that Broadcom's revenues are now on an upward climb. Broadcom offers a nice yield with solid dividend coverage for income seeking investors.

***Image Shown:*** *Shares of Broadcom have surged higher over the past five years.*

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

# CubeSmart Remains Rock-Solid

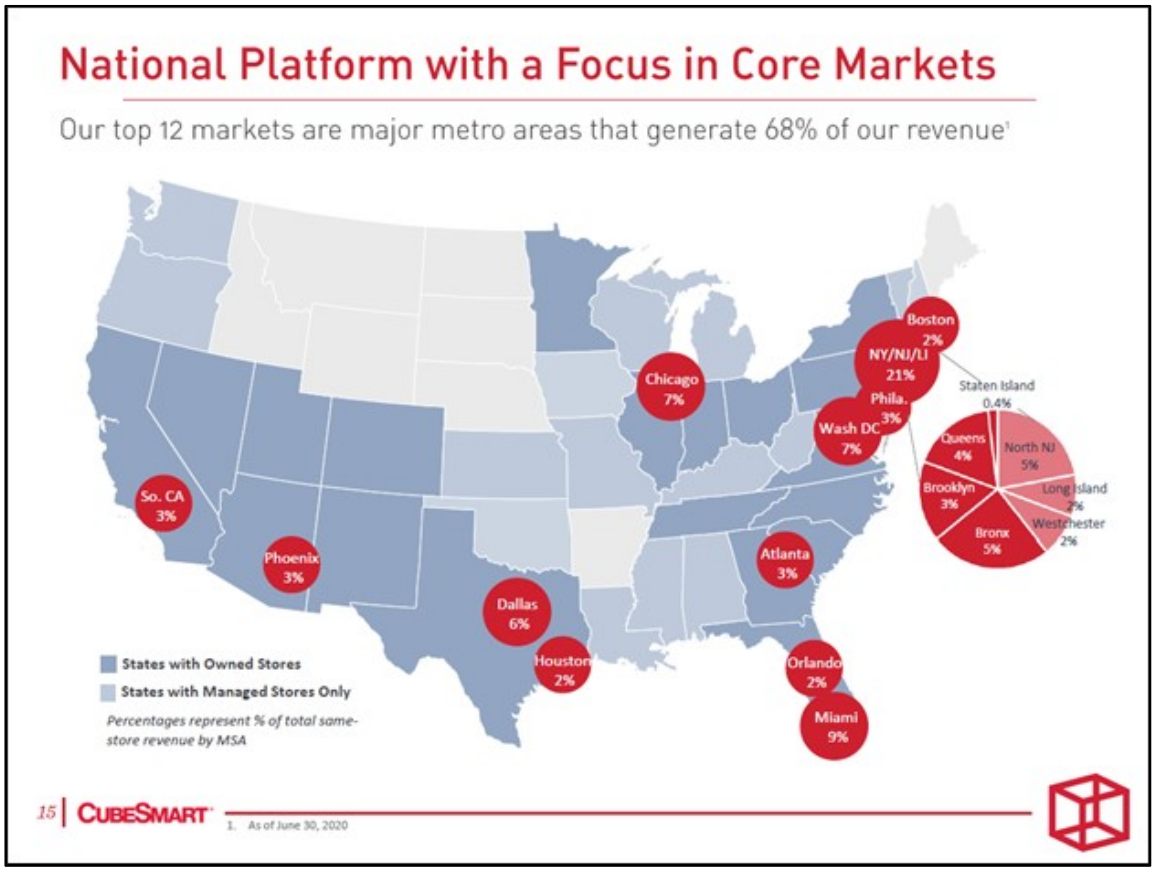


***Image Shown:*** *An overview of CubeSmart's core geographical focus. We continue to like CubeSmart as a holding in our High Yield Dividend Newsletter portfolio.* ***Image Source:*** *CubeSmart – September 2020 IR Presentation*

*By Callum Turcan*

One of our favorite industries as it relates to locating high-quality high-yielding companies with promising dividend growth runways is the self-storage real estate investment trust ('REIT') space, particularly companies with operations primarily (if not entirely) in the US. Within this industry, CubeSmart (CUBE) is one of our favorites and remains a holding in our High Yield Dividend Newsletter portfolio. Shares of CUBE yield ~4.1% as of this writing.

The self-storage REIT continued to make good on its dividend obligations during the initial stages of the coronavirus ('COVID-19') pandemic, a task made easier through CubeSmart's ability to generate meaningful free cash flows. **Unlike most other REITs, REITs operating in the self-storage space tend to be able to generate substantial free cash flows, and CubeSmart is no exception** as we cover in this note.

**Quarterly Overview**

CubeSmart's financial and operational performance held up well during the initial stages of the pandemic. When the REIT reported its second quarter 2020 earnings in August, its same-store occupancy rate averaged 93.0% during the period and ended the quarter at 94.0% Its same-store net operating income ('NOI') dropped by 4.1% year-over-year in the second quarter due to a combination of revenue declines and rising operating expenses; however, given the headwinds CubeSmart faced due to the pandemic, that performance was quite decent all things considered. By the end of August, CubeSmart's same-store occupancy rate had improved to 94.3% according to its September 2020 IR presentation.

**By the middle of 2020, CubeSmart had resumed rate increases for its existing tenants and had restarted normal delinquency processes, activities that were suspended due to the pandemic.** These factors should help significantly improve CubeSmart's near-term performance going forward.

A big part of CubeSmart's turnaround rests on its 'SmartRental' offering which is billed as a "contactless online rental process." This service was responsible for roughly a quarter of CubeSmart's rentals during the second quarter according to management commentary provided during the REIT's latest earnings call. In early September, CubeSmart launched a mobile app that could lead to better tenant retention by meaningfully improving the customer experience (the app allows customers to access their gate code and pay bills online, among other things).

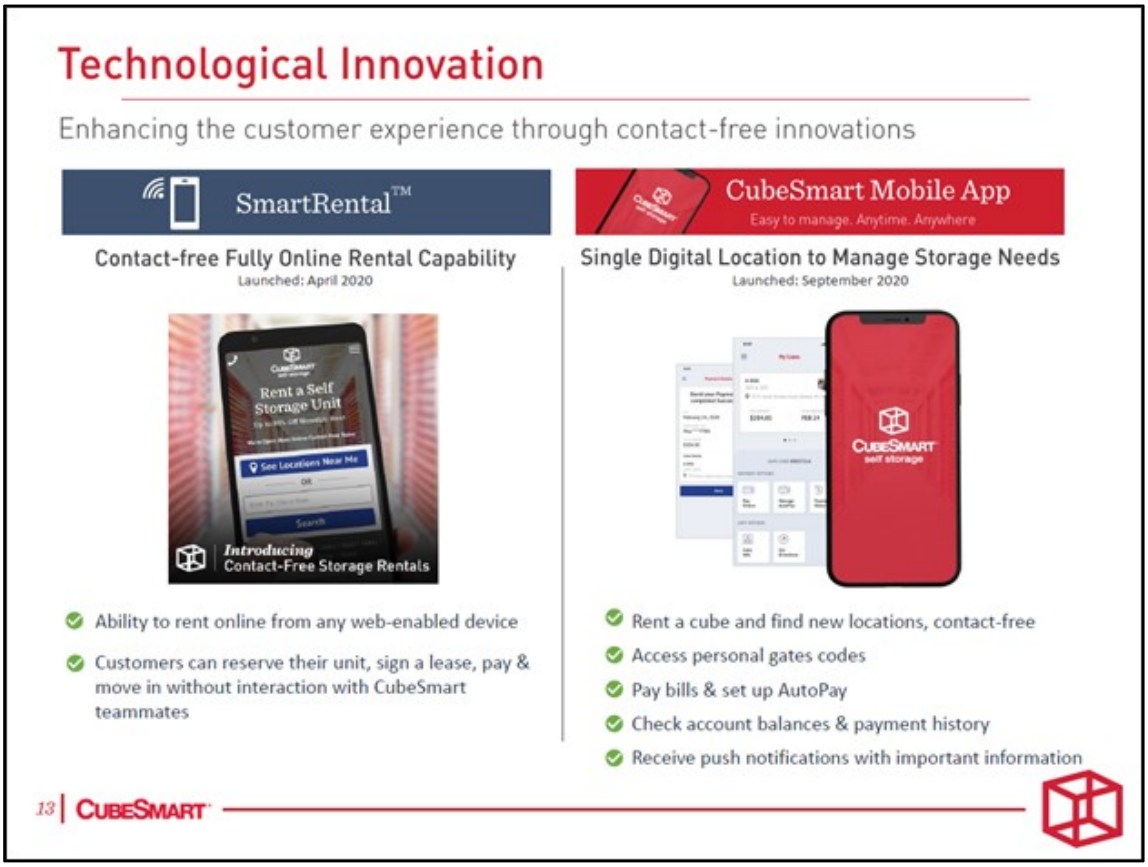


***Image Shown:*** *A look at CubeSmart's digital initiatives.* ***Image Source:*** *CubeSmart – September 2020 IR Presentation*

Here is what CubeSmart's management team had to say regarding recent events during the firm's latest earnings call (emphasis added, lightly edited):

> *"As we noted in our press release, we resume[d] more traditional pre-COVID operational processes by the end of June. During the month of July and into early August, rate increase letters were sent to all of our customers including those remaining in our portfolio for whom we had pause the process in mid-March.* ***We anticipate that the rent roll will be fully caught up with rate increases by the end of the quarter.***
>
> *We continue to innovate at a rapid pace reaping the benefits of investments we have made in our technology stack, revenue management and marketing automation.* ***SmartRental, our online contact free experience, accounted for approximately 25% of our rental volume during the quarter.*** *We remain cautiously optimistic.*
>
> *Our industry has been and remains very resilient. We are keeping a watchful eye on customer behavior in light of continuing uncertainty around government stimulus, the opening and closing of schools and segments of our economy and the varying impact the pandemic is having in each region of our country." --- Christopher Marr, President and CEO of CubeSmart*

Due to uncertainties created by the ongoing pandemic, CubeSmart did not decide to reinstate guidance for 2020 during the REIT's second quarter earnings report.

The REIT also provides services to third-party self-storage facilities through its management platform, which added 27 stores to its managed store base in the second quarter, bringing the total up to 719 stores by the end of June 2020 (up 11% versus the same period last year). **Please note that this management platform is an effective way for CubeSmart to both generate revenues and locate new properties to acquire.** CubeSmart has had a lot of success on this front recently, though this business represents just a small slice of its company-wide revenues.

**Payout Coverage**

During the first half of 2020, CubeSmart generated $0.81 per share in adjusted funds from operations ('AFFO'), down from $0.82 per share in the same period last year. Though an imperfect non-GAAP metric, FFO and AFFO per share metrics are a useful tool for gauging the ability for a REIT to keep making good on its dividend obligations in the near term (we will have more to say on this in a moment). As CubeSmart paid out $0.66 per share in dividends during the first half of this year, its dividend payout ratio (dividends per share divided by AFFO per share) came in at a little over 81% during this period. We prefer payout ratios below 80% but appreciate that CubeSmart's financials have held up relatively well during the pandemic so far. As an aside, CubeSmart's GAAP revenues grew by 5% year-over-year during the first half of 2020.

**As a capital market dependent entity, CubeSmart needs to retain constant access to debt and equity markets** to refinance its maturing debt, make good on its dividend obligations, and fund its growth ambitions. During the first half of 2020, CubeSmart generated $189 million in net operating cash flow and spent $49 million on its capital expenditures (defined here as 'additions and improvements to storage properties' plus 'development costs'), **allowing for $140 million in free cash flows. The REIT spent $128 million covering its 'distributions paid to common shareholders' during this period which were fully covered by CubeSmart's free cash flows**, though we caution that the REIT also spent $73 million on 'acquisitions of storage properties' during the first half of this year.

**Financial Update**

CubeSmart had a little over $3 million in cash and cash equivalents on hand at the end of June (not including $3 million in restricted cash on the books) versus ~$1.95 *billion* in total debt. **Its large net debt load needs to be closely monitored going forward, though we view this burden as manageable.** The REIT can use its at-the-market ('ATM') equity issuance program to raise funds. Management noted CubeSmart's debt-to-EBITDA ratio stood at 4.9x at the end of the second quarter of 2020 during the firm's latest earnings call.

The REIT has a $0.75 billion revolving credit line due June 2024 that can be tapped for funds. With CubeSmart's investment grade (Baa2/BBB) credit ratings and strong financial performance of late, it could also likely tap debt markets for funds at (ideally) attractive rates. The interest rate on its revolving credit line is relatively low at LIBOR+1.10% (as of June 30, the effective weighted average interest rate on the revolver was 1.26%). Here we would like to note that LIBOR, or the London Interbank Offered Rate, will soon be going away (regulators in the UK have indicated that they will no longer be able to guarantee the availability of LIBOR beyond the end of 2021) and the Secured Overnight Financing Rate ('SOFR') might replace it.

As of the end of June, CubeSmart had over $0.7 billion in remaining borrowing capacity on its revolving credit line. In the upcoming graphic at the top of the next page, CubeSmart highlights the various ways it could raise funds if needed (free cash flows, equity issuances, tapping its revolving credit line) along with its staggered debt maturity schedule (which we appreciate given that makes refinancing activities an easier task). CubeSmart could also likely issue out debt at attractive rates if it wanted too as noted previously, though that is not necessary at this point given its revolving credit line and sizable free cash flows.

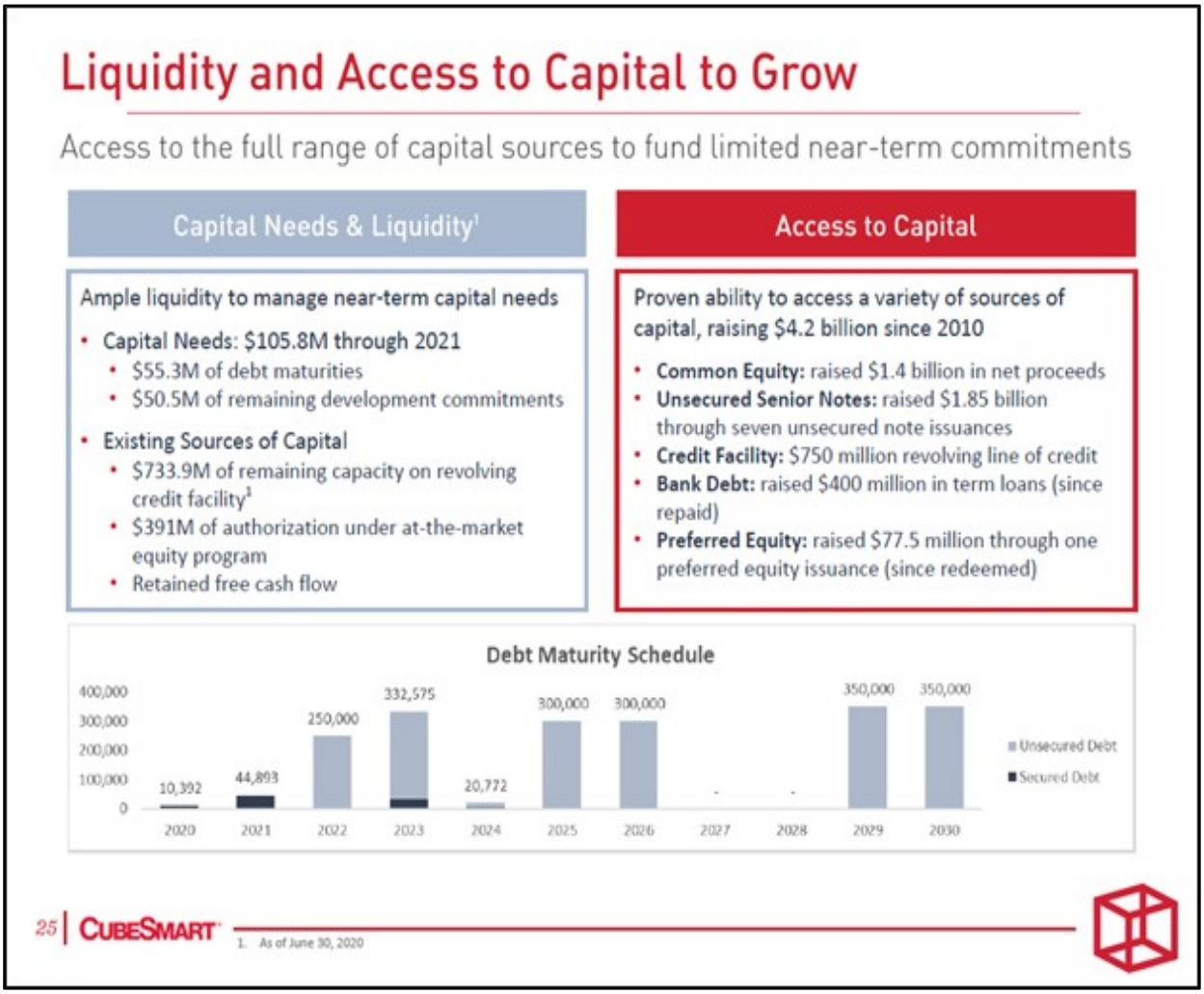


***Image Shown:*** *CubeSmart's debt maturity schedule is staggered, making refinancing activities an easier task.* ***Image Source:*** *CubeSmart – September 2020 IR Presentation*

**Concluding Thoughts**

The equity prices of self-storage REITs initially tanked earlier this year due to fears over COVID-19, though shares of CUBE have now recovered all their lost ground since March as of September. As of this writing, CubeSmart's stock price is up over 4% year-to-date, not including dividend considerations. We are confident that CubeSmart's rock-solid financial and operational performance of late indicates that its long-term growth trajectory remains intact, and investors have been steadily warming back up to the name. **We expect CubeSmart will be able to continue meeting its dividend obligations going forward**, keeping pandemic-related headwinds in mind. On a final note, we continue to like Public Storage (PSA) as a holding in our High Yield Dividend Newsletter portfolio as well.

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

# Our Thoughts on Chevron Buying Noble Energy

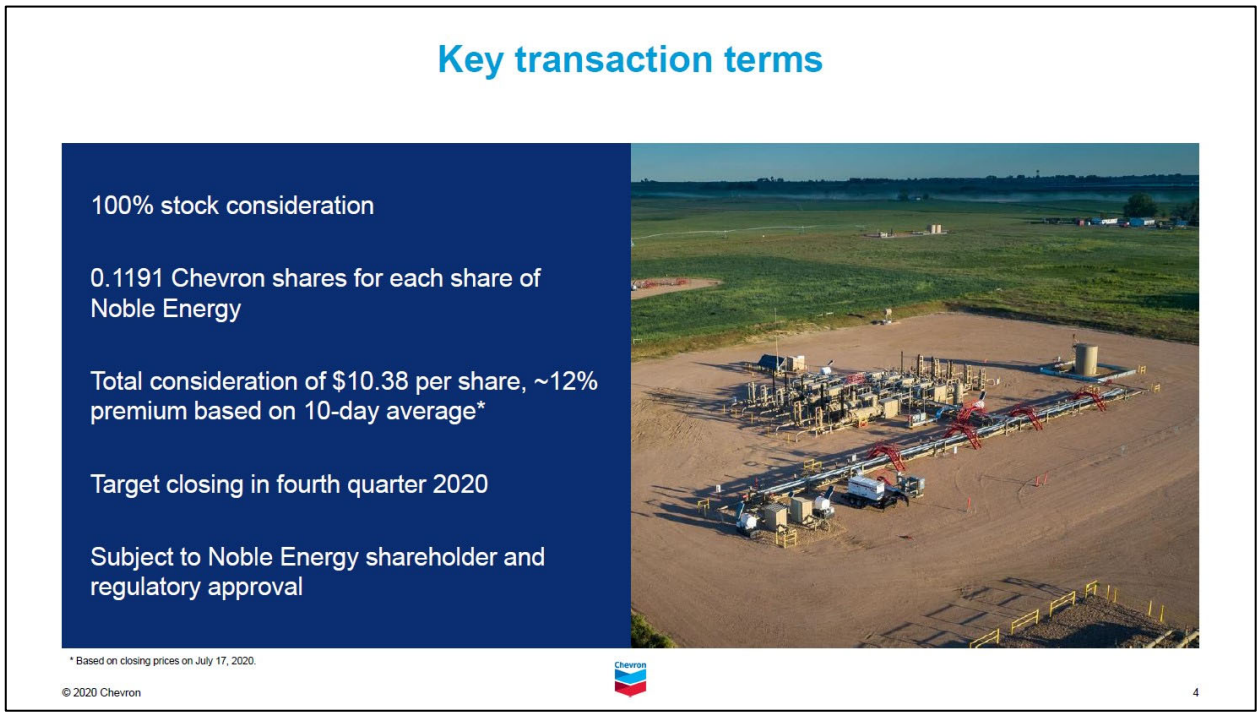


***Image Shown:*** *An overview of Chevron Corporation's all-stock acquisition of Noble Energy Inc that was announced in July 2020.* ***Image Source:*** *Chevron Corporation – July 2020 Noble Energy Acquisition Presentation*

*By Callum Turcan*

On July 20, Chevron Corporation (CVX) announced it was acquiring Noble Energy Inc (NBL) through a $5.0 billion all-stock transaction, or $13.0 billion when factoring in net debt and the book value of non-controlling interests. Shareholders of Noble Energy will receive approximately 0.12 share of Chevron for each share of Noble Energy. At the time the deal was announced, shareholders of NBL were receiving a ~12% premium based on the ten-day average closing stock prices. Chevron intends to issue ~58 million shares to cover the deal, keeping in mind the firm had approximately 1.85 *billion* shares outstanding on a weighted-average diluted basis as of the second quarter 2020. The deal is expected to close during the fourth quarter of this year and is forecasted to generate $0.3 billion in annualized run-rate cost synergies one year after closing.

**Eye Towards East Mediterranean**

In our view, **this deal was entirely about Chevron gaining access to Noble Energy's Mediterranean assets**, which are primarily upstream operations supported by third-party midstream assets. For reference, upstream operations focus on discovering and extracting raw energy resources (oil, natural gas, natural gas liquids) from the ground, ideally in an economical manner though low prices of late have made that a tricky task. Midstream operations, in the oil & gas industry, include energy infrastructure assets such as pipelines and storage facilities among other things.

Noble Energy owns a significant working interest in the offshore Tamar and Leviathan natural gas fields in Israel. With the Leviathan field now operational (came online near the end of 2019), Noble Energy's net production in the region is quite sizable even for a firm as large as Chevron, and its output should steadily ramp up in the region in the medium-term as production from the Leviathan field ramps up. For reference, production from the Tamar field came online back in 2013. Supplies from these two offshore natural gas fields are meeting regional demand, which we will cover later on in this article. Combined, both fields contain tens of trillions of cubic feet of potentially recoverable natural gas resources.

**There remains an enormous amount of room for upside in this region that could be unlocked by expanding the output capacity at producing fields and by developing other offshore gas fields in the area** (like the Aphrodite and Dalit discoveries, which are not producing fields as things stand today). In the upcoming graphic down below, Noble Energy highlights its asset base and near-term goals in the area.

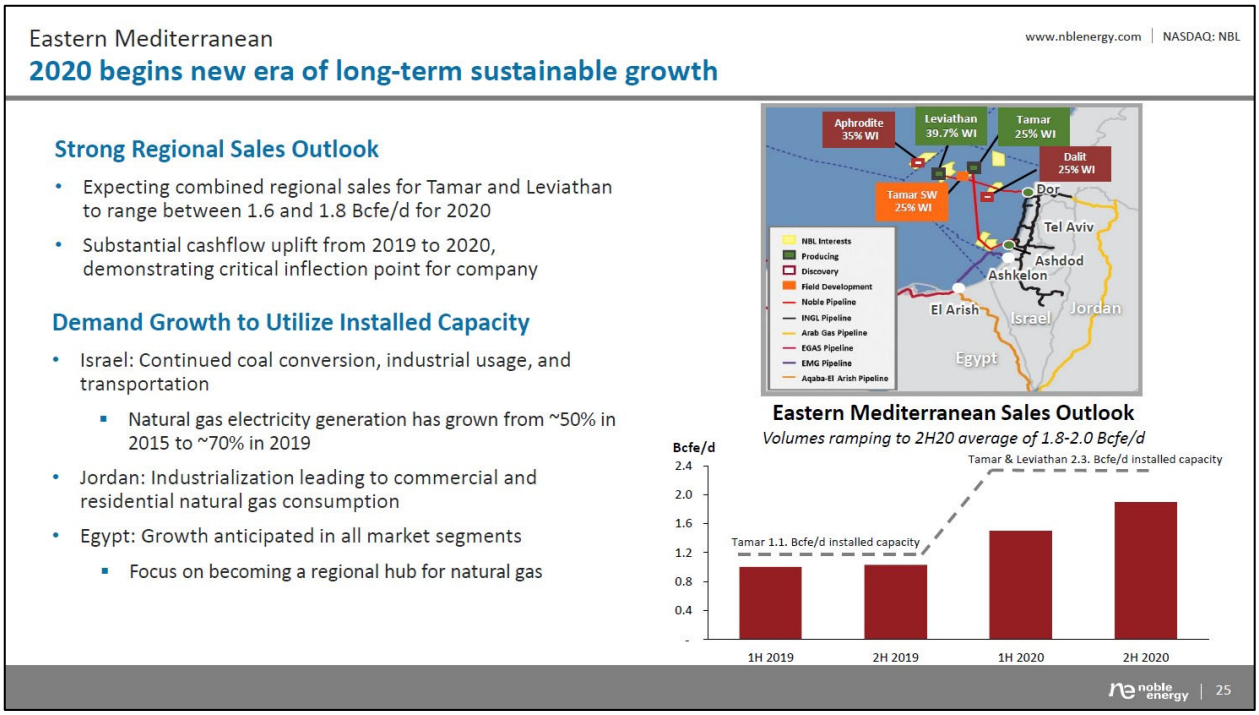


***Image Shown:*** *An overview of Noble Energy's Mediterranean operations and its near-term production outlook in the East Mediterranean region.* ***Image Source:*** *Noble Energy – March 2020 Investor Handout*

Please note that there are serious geopolitical considerations, especially for resources in Cypriot waters (such as the Aphrodite discovery), as Turkey and Cyprus are at odds over resource development in this region (due to a longstanding territorial dispute). Additionally, Turkey and Greece are at odds over offshore resource development in the region as well (relating to the dispute between Cyprus and Turkey, with Cyprus and Greece being close allies). In response to Turkey very recently sending over a seismic research vessel into contested waters supported by warships, France is beefing up its military presence in the Eastern Mediterranean region to help out Greece, which scrambled its own navy to rebuff Turkey's incursion into its and Cyprus' territory according to the *WSJ* (France explicitly called out Turkey and intends on supporting Greece's sovereignty).

The Tamar and Leviathan fields are home to vast amounts of low-cost natural gas supplies and the financial performance of these assets are well suited to ride out the storm. Israel, Jordan, and Egypt are the three main markets Noble Energy and its partners have focused on as it relates to finding end natural gas demand, and that will likely stay the same when Chevron takes over. Please note Noble Energy owns a ~40% working interest in the Leviathan field and a 25% working interest in the Tamar field, as Israeli regulations forced the company to sell down its stake in these assets to reduce potential anti-competitive threats to the Israeli economy (that process was completed a couple of years ago). Israel's Energy Minister Yuval Steinitz has recently signaled that he supports Chevron taking over Noble Energy's local assets.

Natural gas produced from the offshore Tamar and Leviathan fields are sold under long-term contracts and delivered by pipelines, including the Arab Gas Pipeline and the EMG Pipeline, which deliver natural gas supplies to customers in Egypt and Jordan. Customers in Israel receive natural gas supplies through the Israel Natural Gas Lines ('INGL') Network. For reference, a network of subsea pipelines connects the offshore production facilities with onshore transmission and distribution pipeline networks. Please note Noble Energy acquired an equity stake in the Eastern Mediterranean Gas Company S.A.E that owns the EMG Pipeline back in November 2019 to support its growth efforts in the region.

Natural gas sales to Egypt and Jordan from the two producing offshore fields have already begun, though we would like to stress that should geopolitical tensions flare up between Israel and its neighbors, it is possible things well beyond Noble Energy's (and soon Chevron's) control will prevent those sales from occurring. However, everything has been moving in the right direction (more or less) as it relates to regional economic ties and the development of these offshore natural gas resources over the past few years.

On August 13, Israel and the United Arab Emirates announced the initiation of formal diplomatic relations between the two countries, marking a historic turning point in Israeli-Gulf Arab state relations. Going forward, it appears there could be greater geopolitical risk to Chevron's future assets in the area from tensions between Turkey and Greece/Cyprus (the aforementioned offshore resource development disputes) than from other geopolitical dynamics in the region (particularly the state of relations between Gulf Arab states and Israel given recent events). Israel currently has formal diplomatic relations with Jordan and Egypt as well.

As you can see in the upcoming graphic down below, Chevron and Noble Energy both have offshore exploration blocks in Egypt. When the deal closes, **Chevron may allocate significantly more resources towards exploring for additional raw energy resources in the East Mediterranean region given its enlarged footprint.** Several major energy companies including Italy's Eni SpA (E), which discovered the massive offshore Zohr natural gas field, have located meaningful raw energy resources off the Egypt's Mediterranean coast in recent years indicating there is reason to be optimistic as it concerns future exploration endeavors in the region. BP plc (BP) has also struck it big in Egypt's offshore natural gas space in recent years.

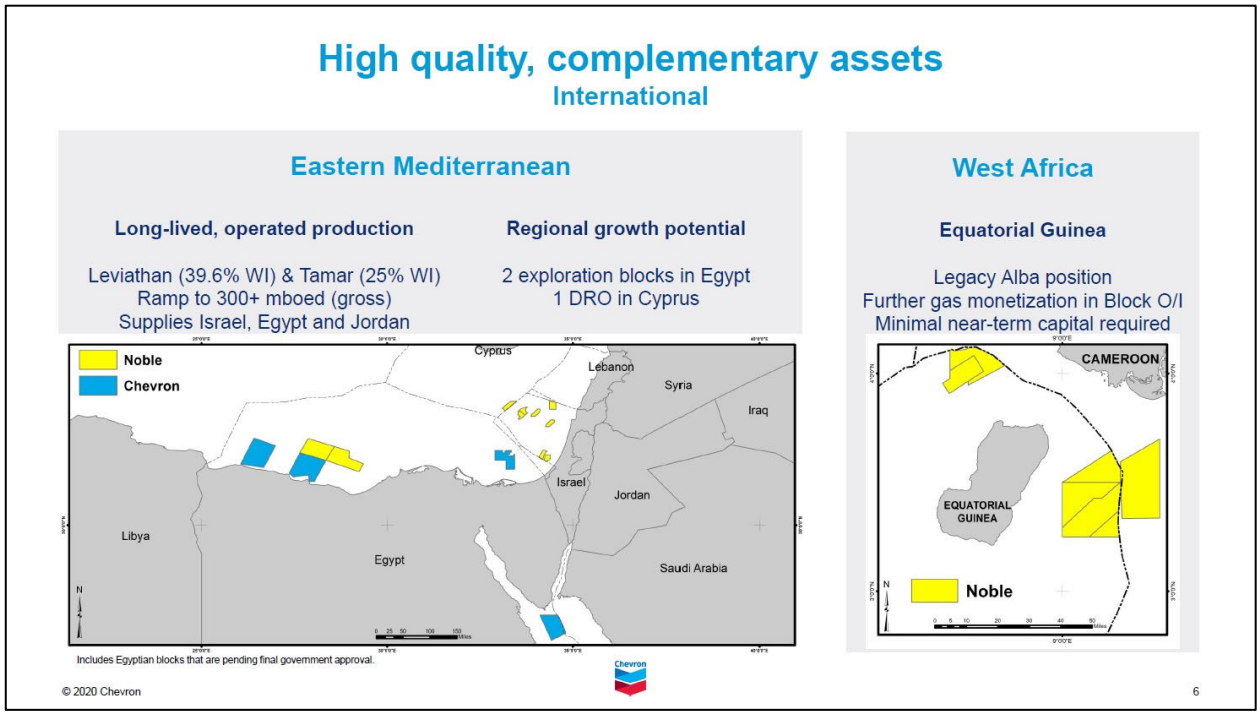


***Image Shown:*** *An overview of Noble Energy's East Mediterranean and West African operations.* ***Image Source:*** *Chevron – July 2020 Noble Energy Acquisition Presentation*

As an aside, Chevron is also acquiring Noble Energy's assets in Equatorial Guinea which includes upstream and some downstream operations (such as an equity stake in a methanol plant). These are not growth assets, but they are meaningful cash flow generators and in the short-term, do not require significant capital investment. It is likely Chevron will retain Noble Energy's West African operations for the time being, though Chevron's asset base in the region is centered around Nigeria. There might be room for some synergies here, particularly as it relates to exporting activities. Additionally, Noble Energy owns various other international assets, such as exploration blocks in Colombia and in Cameron (near Equatorial Guinea).

**US Asset Overview**

Noble Energy also operates in the Permian Basin which stretches across Southeastern New Mexico and West Texas. In this region, hydraulic fracturing and horizontal drilling techniques (known as "fracking") are utilized during upstream operations to unlock vast amounts of raw energy resources from shale, sandstone, and other geological formations deep underground. **Chevron has been aggressively developing its Permian Basin position over the past few years**, though more recently it has reduced development activity in the region due to the ongoing coronavirus ('COVID-19') pandemic weighing negatively on raw energy resources pricing.

As you can see in the upcoming graphic down below, Noble Energy's acreage position in the Permian Basin (in Reeves County, Texas) is located either near or adjacent to Chevron's existing position. The bolt-on nature of the acreage makes it ideal for Chevron due to the numerous operational synergies (centralized development plans, centralized midstream infrastructure) **Chevron will likely want to retain and eventually develop these assets as the Permian Basin represents a core part of its upstream strategy.** However, Noble Energy's position in the Denver-Julesburg Basin ('DJ Basin') in Colorado and its position in the Eagle Ford in South Texas does not really fit in with its long-term upstream strategy, and those assets are less likely to get developed (in a meaningful way) in the medium-term.

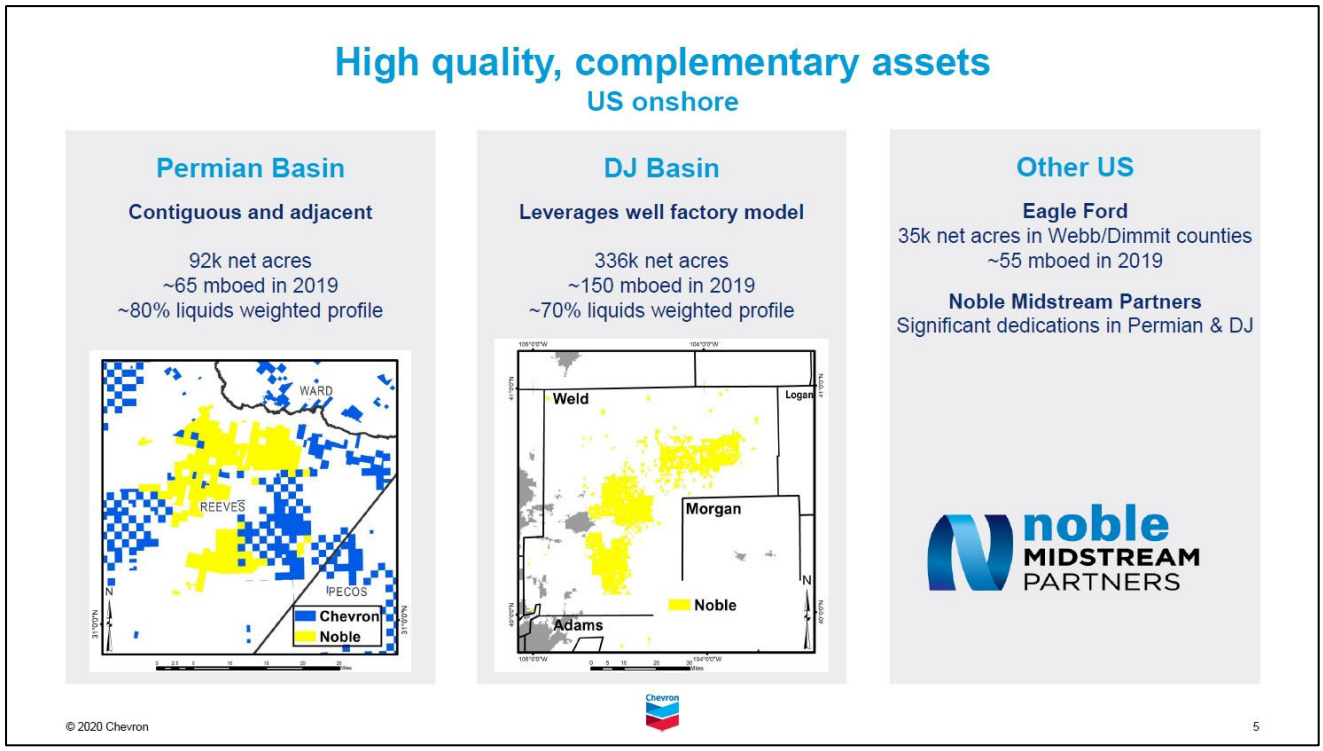


***Image Shown:*** *A look at the domestic onshore upstream assets Chevron will take on by buying Noble Energy.* ***Image Source:*** *Chevron – July 2020 Noble Energy Acquisition Presentation*

In the upcoming graphic at the top of the next page, Chevron highlights the significant upstream production growth it has generated in the Permian Basin since 2015-2016, a product of the large capital expenditure budgets Chevron allocated to the region. Due to the pandemic-related downturn in raw energy resources pricing, Chevron is scaling back and that included cutting its 2020 capital expenditure budget significantly (bringing it down to as low as $14.0 billion as of May 2020, though that target may change going forward given that it has changed at least twice so far this year). Due to the steep production decline rates seen at fracked wells (~50-80% in the first year alone), **Chevron's upstream Permian Basin output is expected to move lower in the medium-term as less drilled but uncompleted ('DUC') well locations are turned online.**

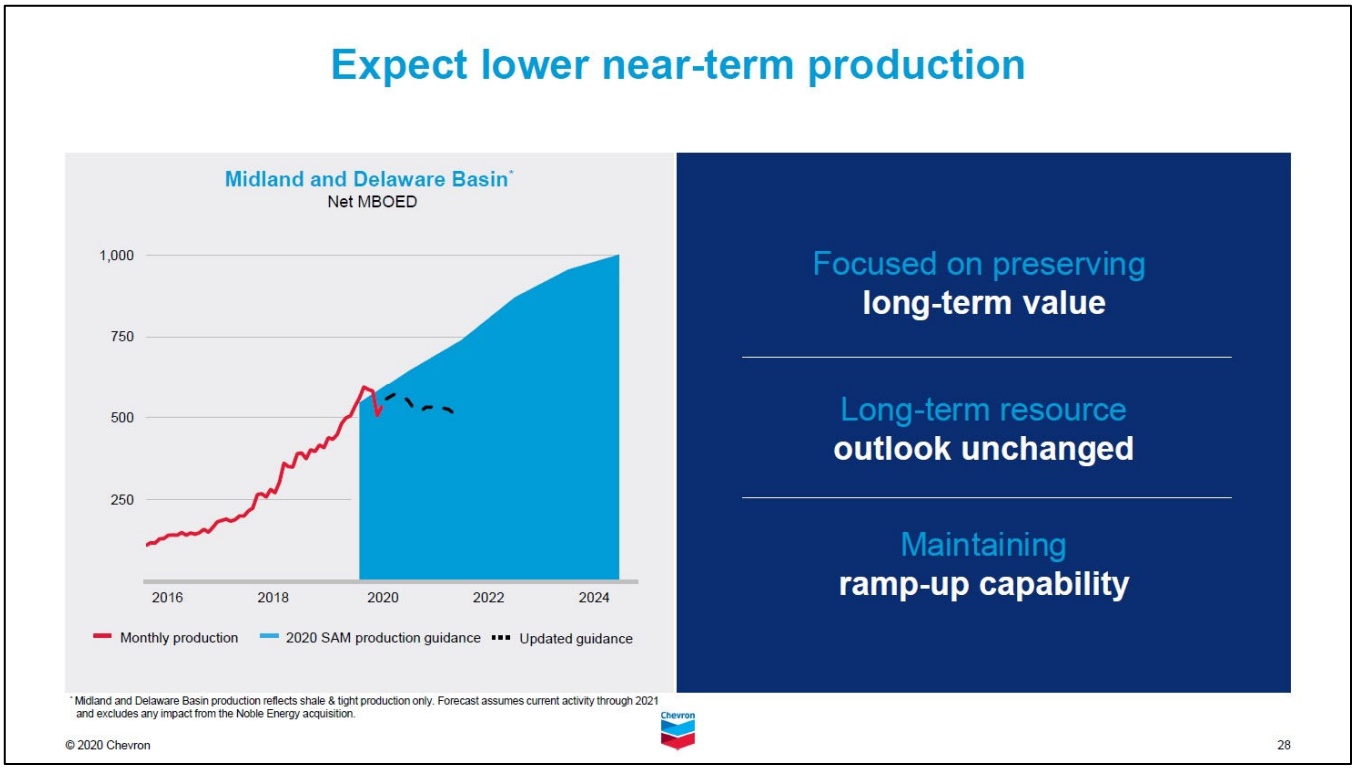


***Image Shown:*** *Though Chevron is reducing its upstream development activity in the Permian Basin in the medium-term, the region remains a key part of its long-term upstream strategy.* ***Image Source:*** *Chevron – July 2020 Investor Presentation*

As it relates to the other onshore assets in the US Chevron is acquiring from Noble Energy, we would not be surprised to sell those operations get sold off in the next few years. Regulatory hurdles have been steadily growing in Colorado for years, and the Eagle Ford is considered a "mature" unconventional upstream play, meaning many of the best well locations have likely already been developed.

Chevron also acquired Noble Energy's stake in its midstream spinoff, Noble Midstream Partners LP (NBLX). This midstream spinoff operates in the DJ Basin and the Permian Basin within the US. As of November 2019, Noble Energy owned 63% of Noble Midstream Partners' outstanding equity, and through a transaction completed last year, Noble Midstream Partners eliminated its incentive distribution rights ('IDRs'). What Chevron intends to do with its stake in Noble Midstream is far from clear. Chevron will also own Noble Midstream Partners' general partner and will be in complete operational control of the company.

There is a small chance Chevron could rollup Noble Midstream Partners by acquiring the remaining outstanding equity once the deal closes, though that is far from likely given the cash requirements of doing so (and the net debt Chevron would take on, though please note Chevron will likely consolidate its financials with Noble Midstream Partners when the deal closes given the controlling stake it will have in the company). Many analysts see Chevron possibly attempting to sell off that stake (and remove the net debt recourse to the midstream spinoff from its balance sheet), though attempts to do similar transactions at Chevron's peers have not been successful. For reference, Noble Midstream Partners had $1.6 billion in net debt at the end of June 2020.

Divesting Chevron's stake in Noble Midstream Partners (at a decent price) would be no easy task. As Occidental Petroleum Corporation (OXY) found out with its interest in Western Midstream Partners LP (WES) (another midstream spinoff) acquired through its purchase of Anadarko Petroleum last year, there are not many buyers out there. Occidental Petroleum has accepted it will need to slowly sell off its stake in Western Midstream, likely at subdued prices given the weak technical performance of shares of WES since late-2019. Chevron may simply choose to hold onto its equity stake in Noble Midstream Partners for now, along with the general partnership.

## Concluding Thoughts

Shareholders of Noble Energy are not receiving a large premium from this deal, though there are not many buyers in the oil & gas industry right now and that is likely to remain the case for some time. Given Noble Energy's existing net debt load, Chevron opted to use equity to buy into the Eastern Mediterranean region to limit the amount of leverage taken on by pursuing this deal. For Chevron, the cost savings combined with the potential exploration and production upside (particularly in the Mediterranean) makes this a favorable deal from its perspective, though for Noble Energy, the deal offers little relief to long-term shareholders given the precipitous drop in Noble Energy's stock price since the start of 2020.

***Image Shown:*** *Shares of Noble Energy have simply gotten crushed over the past five years due to the downturn in crude oil and other raw energy resources prices that started in late-2014.*

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

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***Disclosure:*** *Brian Nelson and Callum Turcan 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 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. The newsletter portfolio is pretty well-diversified, and we've started to identify some pretty good individual equity ideas of late. That said, **high yield investing is inherently risky.**

In many respects, 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** | | | |
| PowerShares Senior Loan Portfolio | BKLN | 5.0% | 4.00% |
| iShares MSCI Australia ETF | EWA | 5.0% | 3.75% |
| ProShares High Yield—Interest Rate Hedged | HYHG | 5.0% | 5.76% |
| iShares International Select Dividend ETF | IDV | 5.0% | 7.14% |
| iShares U.S. Preferred Stock ETF | PFF | 5.0% | 5.27% |
| Global X SuperDividend ETF | SDIV* | 5.0% | 11.25% |
| Global X SuperIncome Preferred ETF | SPFF | 10.0% | 6.12% |
| Vanguard Consumer Staples ETF | VDC | 5.0% | 2.13% |
| Vanguard Real Estate ETF | VNQ | 10.0% | 2.99% |
| Utilities Select Sector SPDR | XLU | 5.0% | 3.36% |
| **EQUITY** | | | |
| AT&T | T | 5.0% | 7.30% |
| Crown Castle | CCI | 5.0% | 1.53% |
| CyrusOne Inc. | CONE | 5.0% | 2.91% |
| CubeSmart | CUBE | 5.0% | 4.09% |
| Digital Realty Trust | DLR | 5.0% | 3.05% |
| Enterprise Products Partners | EPD | 2.5% | 11.27% |
| Magellan Midstream Partners | MMP | 2.5% | 12.02% |
| Philip Morris | PM | 5.0% | 6.40% |
| Public Storage | PSA | 5.0% | 3.59% |
| Cash** | - | 0.0% | 0.00% |
| | | *100.0%* | **5.07%** |

*This is not a real money portfolio. Inception 1/1/2018. Data as of 10/1/2020. Est. Div. Yield information retrieved from Seeking Alpha.*

*** Reflects federal funds target rate range*

# DIVIDEND REPORT PAGE 2 – VERIZON COMMUNICATIONS (VZ)



## Verizon VZ FAIRLY VALUED

Buying Index™ 7 Value Rating

| Economic Castle | Stock Fair Value Range | Dividend Track Record | Dividend Safety / Cushion™ | Div Growth Potential | Dividend Yield |
|---|---|---|---|---|---|
| Attractive | $48.00 - $72.00 | HEALTHY | VERY POOR / 0 | VERY POOR | 4.20% |

### Assessment of Company Dividend Strategy

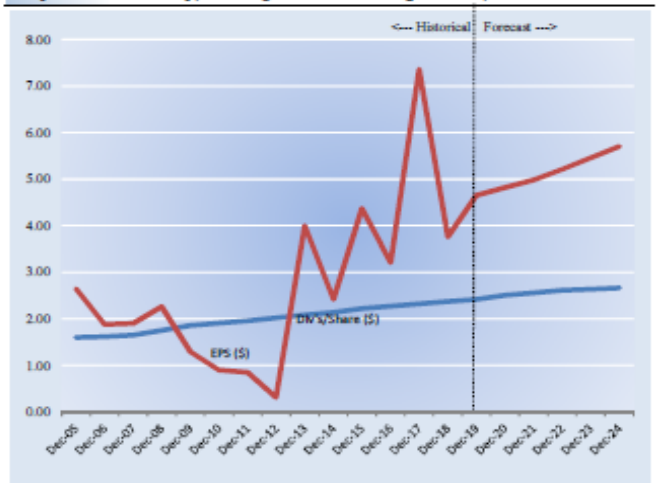
**Key Strengths**

Verizon is one of the most well-known telecommunications companies in our coverage universe. In 2019, Verizon generated $16.9 billion in free cash flow and spent $5.1 billion covering its dividend obligations. While Verizon's net debt load is enormous, its free cash flows are sizable though we caution refinancing activities are required to roll over its debt. Verizon acquired the remaining portion of Verizon Wireless from Vodafone back in 2014, a move we liked from an operational standpoint. As with many companies in the telecommunications industry, Verizon's capital expenditure requirements are sizeable as the firm rolls out its 5G service in the US.

**Potential Weaknesses**

As of the end of June 2020, Verizon had $6.7 billion in short-term debt and $106.2 billion in long-term debt on the books versus $7.9 billion in cash and cash equivalents on hand. Verizon's enormous net debt load and sizable capital expenditure requirements weigh negatively on its Dividend Cushion ratio. However, its free cash flows remain sizable. The company's revenues are facing significant headwinds due to COVID-19, though management has been able to offset some of those pressures via operating expense reductions. We are keeping a close eye on Verizon's net debt load as the firm continues to spend heavily on its 5G wireless infrastructure.

### Graphical Relationship, Earnings and Dividends (per share)

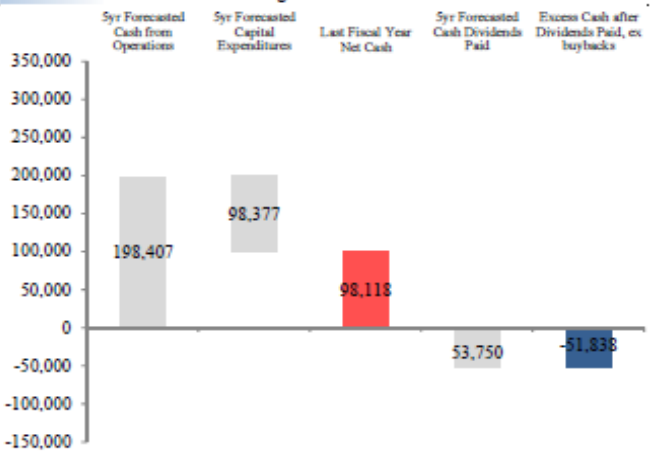



The graph above shows the relationship between a firm's earnings per share and its dividends per share.

### 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. Verizon'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

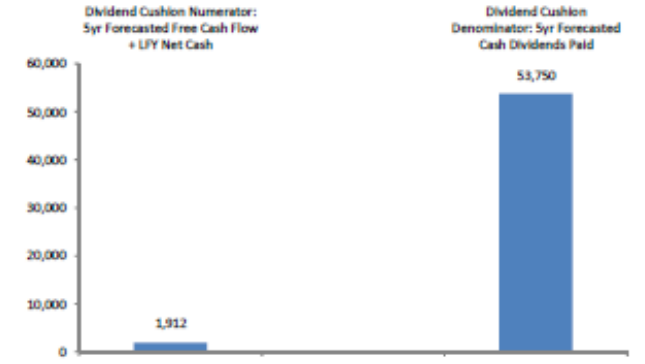



Source: Company Filings, Valuentum Projections

### 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, Verizon'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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