Valuentum Securities, Inc. 4/1/2021 Edition 4, Volume 4

HIGH YIELD DIVIDEND NEWSLETTER

AT&T'S VIDEO STREAMING GROWTH IS STARTING TO TAKE FLIGHT

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

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"THE YIELD ON 10-YEAR US TREASURIES HAS SURGED SINCE OCTOBER 2020 IN LARGE PART DUE TO GROWING EXPECTATIONS THAT INFLATION RATES WILL PICK UP ON THE BACK OF MASSIVE SUPPORT PROVIDED TO THE DOMESTIC ECONOMY BY RECENT FISCAL STIMULUS MEASURES. WE VIEW THE HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO AS WELL-POSITIONED TO NAVIGATE THE MACROECONOMIC LANDSCAPE GOING FORWARD."

– CALLUM TURCAN

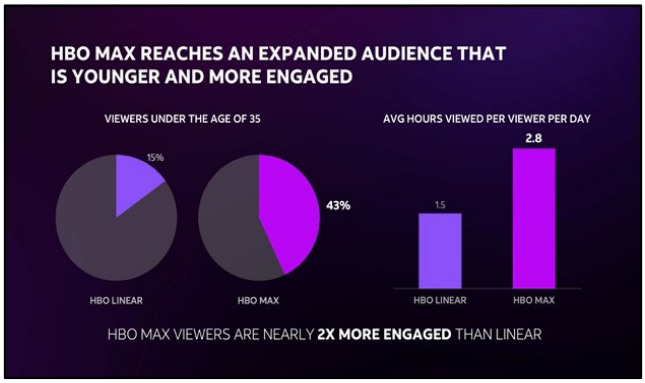

Image Source: *AT&T Inc – 2021 Investor & Analyst Day Presentation*

By Callum Turcan

On March 12, AT&T Inc (T) hosted its 2021 Analyst & Investor Day event. In conjunction with the event, AT&T issued long-term financial and operational guidance which included a substantial upward revision in its expected HBO/HBO Max subscriber growth over the coming years. We continue to be big fans of AT&T and include the company as an idea in our High Yield Dividend Newsletter portfolio. **As of this writing, shares of AT&T yield ~6.8%.**

Background Information

In June 2018, AT&T completed its acquisition of Time Warner which gave AT&T the keys to Home Box Office ('HBO'). **A pillar of AT&T's long-term growth strategy involves building out a vast video streaming business around the HBO brand** (specifically its new HBO Max offering).

However, AT&T struggled initially with getting its streaming ambitions off the ground due in part to an unnecessarily complex branding strategy. We covered this situation in our December 2020 article, *AT&T's Outlook Is Getting Brighter,* and in that piece we noted:

> Back in May 2020, AT&T launched HBO Max at the same price (more or less) as its traditional HBO offering, largely to encourage existing subscribers (including traditional cable subscribers) to transition to the new video streaming service (which has a significantly larger content library). Many existing HBO subscribers, at the time, received access to the new service at no additional cost.
>
> However, AT&T's initial branding strategy for HBO Max was confusing as there were several HBO offerings on the market which had similar names including HBO Now, HBO Go, and HBO. Since then, HBO Go has been retired and HBO Now has been rebranded to HBO to simplify the branding strategy, which we appreciate. Additionally, AT&T is bundling certain wireless packages with HBO Max to help get the nascent video streaming service off the ground.

When AT&T launched HBO Max, it faced another problem as well. The company had launched the video streaming service before securing distribution deals with several major TV platforms. Since then, AT&T has secured deals with Amazon Inc (AMZN), Roku Inc (ROKU), Comcast Corporation (CMCSA), and privately-held Cox Communications to enable HBO Max to be distributed easily through their TV platforms and related hardware. In our view, these agreements will go a long way in supporting future subscriber growth at HBO Max, and we appreciate AT&T getting these deals done.

To keep the momentum going, AT&T committed to adding every movie release this year from its Time Warner segment to its HBO Max service (for a limited time) free of charge. Subscribers that already have the video streaming service do not need to pay extra to view these new movie releases (which are available on HBO Max for about a month before getting removed so movie theaters can have a period of exclusivity with those titles). In December 2020, AT&T first attempted this strategy by adding the movie *Wonder Woman 1984* to its HBO Max service for free for a month. The company launched *Zack Snyder's Justice League* on HBO Max in March 2021, which has been well-received by critics and the general audience. Most importantly, these big title launches have drummed up a lot of interest in HBO Max.

Major Positive Revision

Putting this all together, AT&T now views its video streaming growth trajectory much more favorably than it did back in 2019. According to guidance put out during the March 12 investor event, **AT&T expects to have 120-150 million HBO/HBO Max subscribers worldwide by the end of 2025.** Back in October 2019, AT&T forecasted it would have 75-90 million HBO/HBO Max subscribers by the end of 2025, indicating recent operational changes have positively impacted the subscriber growth trajectory of the company's video streaming business in a big way. This strategy reportedly involved a major corporate restructuring at WarnerMedia and HBO along with the aforementioned changes.

By 2025, AT&T forecasts that HBO will generate approximately $15.0 billion in annual revenue, up from roughly $6.8 billion in 2020. The company plans to make enormous investments in original content for HBO Max over the coming years to capitalize on the vast growth opportunity. Please note these investments are expected to weigh on HBO's medium-term profitability as AT&T expects its HBO segment will not reach breakeven status by 2025, as one can see in the upcoming graphic down below. In our view, AT&T made the right move by committing to these investments given that its HBO/HBO Max streaming business could eventually become an enormous cash flow cow as greater economies of scale are achieved.

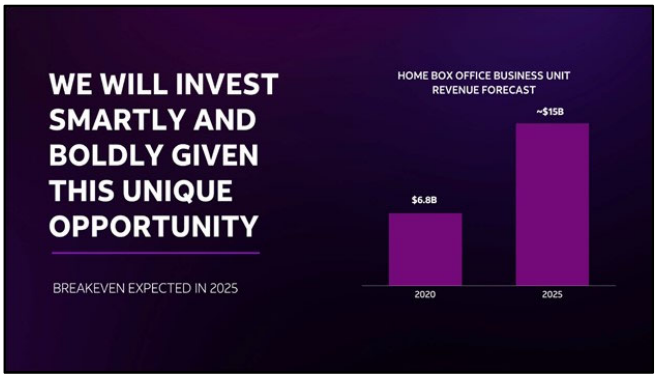

Image Shown: *AT&T expects its HBO business will more than double its annual revenues by 2025 versus 2020 levels.* ***Image Source:*** *AT&T – 2021 Investor & Analyst Day Presentation*

According to management commentary given during AT&T's second quarter of 2020 earnings call, the company had 34.6 million domestic HBO subscribers at the end of 2019. Previously, the goal was to grow that figure to 50 million by the end of 2025 according to management commentary given back in December 2020. In our view, that target was quite modest.

With this in mind, please note HBO/HBO Max had only 38 million domestic subscribers by the end of 2020's third quarter and 57 million subscribers worldwide. From the end of 2019 to the end of September 2020, the launch of HBO Max had added less than 4 million net paying customers to its HBO/HBO Max subscriber base (AT&T's reported HBO/HBO Max domestic subscriber figures do not include subscribers on free trials).

Put another way, by the Fall of 2020 AT&T's video streaming growth strategy was still off to a slow start. In the fourth quarter of 2020, AT&T had over 41 million domestic paying HBO/HBO Max subscribers and almost 61 million international HBO/HBO Max subscribers, **indicating its subscriber growth trajectory was starting to pick up pace by the end of 2020.**

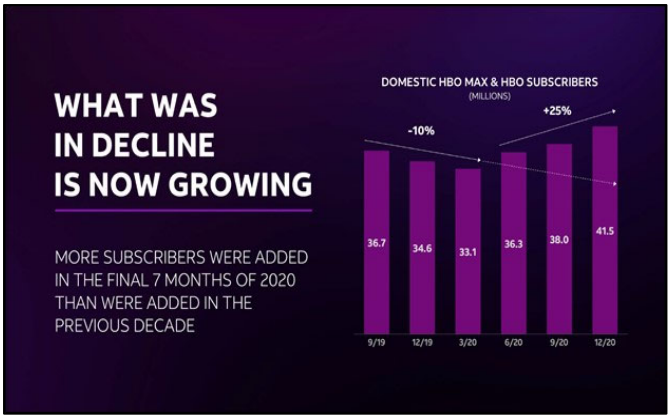

Image Shown: *AT&T's domestic HBO/HBO Max subscriber base has been moving in the right direction of late after subscriber growth at HBO Max got off to a slow start.* ***Image Source:*** *AT&T – 2021 Investor & Analyst Day Presentation*

Growth Strategy

Management has a strategy in place to build on AT&T's recent momentum in the video streaming world. During the presentation, AT&T noted that about one quarter of HBO Max's subscribers came from AT&T, indicating the company is starting to realize serious operational synergies between its wireless business and its media and entertainment business. The ongoing adoption of 5G technology and related wireless plans by consumers in the US should provide a nice tailwind on this front going forward.

Looking ahead, AT&T plans to launch HBO Max in 60 international markets this year. That includes plans to roll out the service in 39 Latin American "territories" and 21 "territories" in Europe during 2021 (starting in late June, though additional expansions are expected during the second half of this year).

Additionally, AT&T intends to launch an advertising-supported video on demand ('AVOD') version of HBO Max in the US this upcoming June. These moves, combined with the recent acceleration in its subscriber growth, underpin management's confidence in AT&T's video streaming strategy.

One of the reasons why it took AT&T some time to secure distribution deals covering HBO Max with companies such as Amazon and Roku were due to AT&T's desire to keep operational control of the HBO Max app (instead of having HBO Max included as an additional service on a platform that is managed by a different company).

Management wanted to keep operational control of the HBO Max app so AT&T could launch an effective AVOD version of the video streaming service. This in turn is expected to enable AT&T to offer HBO Max at a lower monthly price point, which in theory expands the base of potential HBO Max subscribers without sacrificing a significant amount or any revenue due to the incremental sales generated by digital advertising activities, positively impacting AT&T's long-term growth runway.

Going forward, AT&T plans to steadily grow its average revenue per user ('ARPU') at its domestic HBO Max service as one can see in the upcoming graphic down below. That could be achieved via pricing increases and by building out a successful digital advertising business. Internationally, AT&T will eventually focus on ARPU growth, though the company's first goal will likely be to build out as large of a paying subscriber base as possible at a reasonable price point (before considering substantial pricing increases).

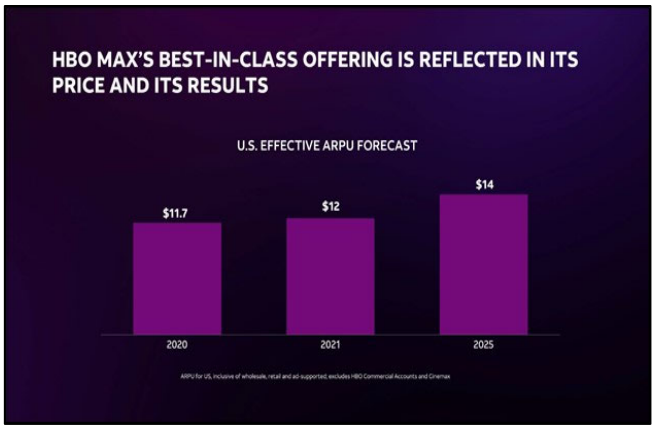

Image Shown: *AT&T plans to steadily grow its ARPU at its domestic HBO Max service over the coming years. Price increases and establishing a successful digital advertising business represent two ways AT&T could accomplish this goal.* ***Image Source:*** *AT&T – 2021 Investor & Analyst Day Presentation*

Other Considerations

Now that AT&T's video streaming growth story is starting to gain some real momentum, the company's decision to invest sizable sums towards developing original content for the business in the coming years is starting to look like a smart decision. When the firm decided to launch movies from its Time Warner segment simultaneously at physical movie theaters (where available) and on its HBO Max streaming service, that effectively removed a major source of revenue generation (box office sales) in return for an opportunity to build up sizable recurring revenues (i.e., a larger paying subscriber base at HBO Max). Box office ticket sales remain subdued, as evidenced by the domestic and international performance of Time Warner's new *Tom & Jerry* movie, leaving movie producers with few options.

Companies in the movie making business that also have substantial video streaming services were better positioned to navigate headwinds arising from the COVID-19 pandemic due to the ability to make a bet on their future recurring revenue streams. Another one of our favorite companies, The Walt Disney Company (DIS), has had tremendous success growing its numerous video streaming services businesses of late.

In certain instances, Disney has added new movie launches to its Disney+ service that traditionally would have been released exclusively at physical movie theaters for a few months before potentially ending up on those video streaming services. Some of those movies were available at no extra charge on Disney+ and others required an additional payment on top of the subscription, as video streaming companies are still attempting to figure out the right economic balance.

As an aside, as with AT&T Disney also recently restructured the corporate umbrella that overseas its video streaming businesses. These restructurings appear to have yielded positive results as both companies have sharply increased their long-term video streaming subscriber growth targets since making these changes (Disney sharply increased its long-term video streaming subscriber growth guidance back in December 2020 during its Investor Day update).

While Netflix Inc (NFLX) continues to be a leader in the video streaming business, Disney is hot on Netflix's heels, and now even AT&T is starting to become a contender. Please note, we forecast Netflix will become a free cash flow generating machine as ever-greater economies of scale are achieved.

Concluding Thoughts

We continue to like exposure to AT&T and view the company's cash flow growth outlook quite favorably. During the March 12 event, AT&T noted it expected to generate around $26.0 billion in free cash flow this year and that its dividend payout ratio would be in the high 50s percent range this year (dividend obligations divided by free cash flows). AT&T intends to continue paring down its hefty net debt load going forward, which we appreciate.

On a final note, AT&T finally found a partner willing to take a stake in DirecTV at an acceptable price. Private investment firm TPG intends to take a 30% equity stake in a new entity which will include the DirecTV, AT&T TV, and U-verse video services through a deal announced in February 2021. The new entity (dubbed "New DIRECTV") will have an enterprise value of ~$16.25 billion, and AT&T will retain the remaining 70% equity stake. This deal is expected to close in the second half of 2021, and AT&T expects to receive $7.8 billion in net cash from the deal ($7.6 billion in cash from New DIRECTV plus the assumption of $0.2 billion in existing DirecTV debt). We like the move as it will better enable AT&T to pivot towards its 5G wireless, fiber optic, and video streaming service operations which have promising growth outlooks. AT&T expects to use the proceeds from this deal to further pare down its net debt load.

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

ViacomCBS Makes Big Bet on Streaming

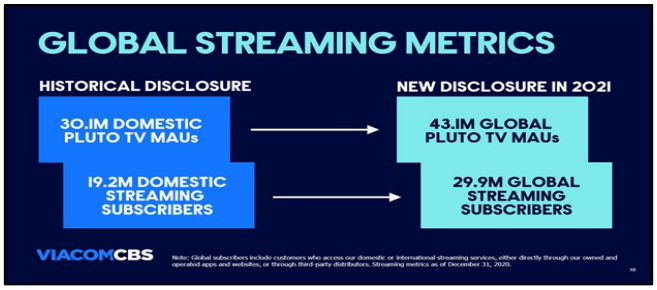

Image Source: *ViacomCBS Inc – Fourth Quarter of 2020 IR Earnings Presentation*

By Callum Turcan

After Viacom and CBS were reunited in December 2019, the new entity ViacomCBS Inc (VICAC) had finally started to gain some traction on the video streaming front.

The service CBS All Access, which has since been rebranded as Paramount+, was largely a dud and did not gain the level of attention that Walt Disney Company's (DIS) Disney+ service, AT&T Inc's (T) HBO Max service (AT&T's video streaming growth strategy is picking up steam) or Netflix Inc's (NFLX) namesake service were able to generate.

For background, ViacomCBS's operations include various TV network and cable TV assets, TV and movie studios, various streaming services, and a book publisher. That includes various CBS networks (CBS, CBS Sports, CBS News), CBS studios, MTV, Comedy Central, Paramount, Nickelodeon, Pluto TV (another video streaming service that is free and ad-supported), BET, CMT, POP TV, half of CW (AT&T owns the remaining 50%), COLORS (focused on India), telefe (focused on Spanish-speaking content), SHOWTIME, and the book publisher Simon & Schuster.

As an aside, shares of VIAC have seen some wild trading activity of late which reportedly was driven by the forced liquidation of the hedge fund Archegos Capital Management's positions in various media names, including ViacomCBS. We are monitoring these events closely. **Shares of VIAC yield ~2.1% as of this writing.**

Content is King

In March 2021, ViacomCBS launched Paramount+ in the US and various Latin American markets. The service now has a larger slate of content than CBS All Access and is supported by ViacomCBS' vast library (and most importantly, ViacomCBS has plans to produce dozens of original series for Paramount+ going forward). Paramount+ is leaning on properties such as *Star Trek* and *SpongeBob SquarePants* along with reboots of shows like *iCarly* to create engaging original content.

Content is king. The combination of Viacom and CBS helped address that issue and provided the new entity with the scale required to be competitive in this business. All the big players in this space, such as Disney, AT&T, Netflix and others, have pledged to aggressively increase their original content investments over the coming years. ViacomCBS will need to spend heavily to keep up.

Please note, this comes on top of the hefty investments made in the recent past. Comcast Corporation's (CMCSA) Peacock service and Discovery Communications Inc's (DISCA) Discovery+ service represent two relatively new contenders in the video streaming space and HBO Max was only launched by AT&T last year, though there were other iterations of HBO streaming services available before then.

According to a March 4 press release, Paramount+ launched with "a slate of new originals" which includes (the bolded and italicized text was formatted that way in the press release):

> …***The SpongeBob Movie: Sponge on the Run***, the first-ever all CGI SpongeBob motion picture event; ***Kamp Koral: SpongeBob's Under Years***, a prequel series and the first-ever spinoff of *SpongeBob SquarePants*; MTV Documentary Films ***76 Days***, the Oscar Shortlisted documentary that looks at life in the earliest days of the COVID-19 crisis in Wuhan, China; ***For Heaven's Sake***, a docuseries blending comedy and crime for a unique take on uncovering the truth; ***The Real World Homecoming: New York***, a reunion special with the original New York cast in the iconic NYC loft; ***60 Minutes+***, a new form of the flagship series that reveals the stories behind the news through original reporting and captivating interviews; and ***Stephen Colbert Presents Tooning out the News***, the second season of the animated daily news satire series. These titles join a growing slate of originals currently on the service exclusively, including ***The Good Fight***, ***Why Women Kill***, ***The Stand***, ***Star Trek: Lower Decks***, ***No Activity***, ***Coyote*** and more.

Live Sports

Paramount+ includes live sports offerings and given the relatively low monthly cost of the service ($9.99 per month in the US for the ad-free version, and in June a $4.99 per month ad-supported version of the service will launch), we see room for the service to gain some ground (annual subscriptions are also available). Comcast's Peacock service also has some live sports offerings, as does Disney's EPSN+ service, though most video streaming services tend to either not have such offerings or require a substantially larger monthly bill to view such offerings.

FuboTV Inc (FUBO) focuses on live sports offerings (as part of a broader package similar to traditional pay-TV packages), though its cheapest offering starts at $64.99 per month (please note there are also tax and other considerations). Hulu, which is owned by Disney and Comcast, also offers packages similar to traditional pay-TV offerings that start at a similar price as FuboTV's. Traditional pay-TV packages such as those offering by Comcast, AT&T's DirecTV, and Dish Network Corporation (DISH) tend to be priced at or above that range.

With all of this in mind, Paramount+ includes several sporting events, such as every UEFA Champions League and UEFA Europa League match (soccer), the 2021 NCAA Division I Men's Basketball Championship, and CBS Sports' coverage of The Masters golfing tournament. On March 18, ViacomCBS announced that it had secured a major 11-year deal with the NFL that will run through the 2033 season (please note ViacomCBS has an existing agreement with the NFL). This was part of a broader deal the NFL reached with ViacomCBS, Comcast (via its ownership of NBCUniversal), Fox Corp (FOXA) (FOX), Amazon Inc (AMZN), and Disney (via its ownership of ABC and majority ownership of EPSN) that could be worth north of $100.0 billion in total.

Here is what ViacomCBS's related press release had to say (lightly edited, emphasis added):

> The new agreement, which begins with the 2023 season, allows for CBS Sports to broadcast and stream more Sunday afternoon games than ever before and also includes an expanded schedule of games featuring teams from the National Football Conference (NFC). In addition, the schedule is highlighted by 10 CBS doubleheaders, including the NFL's most-watched window Sundays at 4:25 PM ET, eight singleheaders and the annual Thanksgiving Day game. **CBS Sports will broadcast three Super Bowls over the length of the deal**, including the first in the new agreement, Super Bowl LVIII in 2024, as well as Super Bowl LXII in 2028 and Super Bowl LXVI in 2032.
>
> **The CBS Television Network and Paramount+ will also present a full slate of playoff games each season**, featuring the AFC Championship game, one Divisional game and one Wild Card game. A second Wild Card game will be added to the CBS Sports lineup during the 2024, 2029 and 2033 seasons…
>
> **Paramount+ has been granted new and expanded rights for the streaming service**, allowing for the flexibility to distribute NFL games on both the premium tier at $9.99 and the new $4.99 ad-supported tier that will debut in June. **The rights begin with the 2021 season and extend throughout the length of the new deal to 2033.**

ViacomCBS is making some interesting choices by combining live sports with video on demand offerings, and we are intrigued by the upside this combo could have. Paramount+ also includes breaking news offerings.

When ViacomCBS reported its fourth quarter earnings for 2020 in late February, the firm touted the momentum it had gained on the video streaming front from its Pluto TV, Showtime, and CBS All Access (now Paramount+) offerings. Additionally, ViacomCBS's BET+ video streaming service has been performing well of late according to management commentary given during the related earnings call.

Recent Updates

The company's Pluto TV offering has seen its user base grow nicely of late with the company noting it had 43 global million monthly active users ('MAUs') in the final quarter of 2020 (up 80% year-over-year). ViacomCBS recently expanded the service into Brazil and Spain. It noted in its earnings press release that "Pluto TV's domestic MAUs increased to 30.1M, up 34% year-over-year, and more than doubled its advertising revenue in the quarter" which we appreciate.

However, **the market is likely most interested to see if ViacomCBS can replicate the success of Netflix and Disney with its rebranded Paramount+ service given the highly desirable nature of growing recurring revenue streams** (provides for higher quality cash flow profiles given the highly visible nature of those sales).

ViacomCBS generated $2.0 billion in free cash flow in 2020 and spent $0.6 billion covering its dividend obligations along with less than $0.1 billion on its share buybacks during this period. The firm exited 2020 with a little over $16.7 billion in net debt (inclusive of its marginal short-term debt position), which limits its flexibility to a degree, though ViacomCBS has the capacity to step up its original content investment going forward given its current free cash flow generating abilities. During the company's fourth quarter of 2020 earnings call, here is what management had to say regarding ViacomCBS' streaming strategy (emphasis added):

> *"ViacomCBS has been and remains a consistent hit maker across genres, across demographics, across formats and across platforms. Across our studios, we're one of the biggest suppliers of premium original content in the industry today,* ***with nearly 900 shows in production this year.***
>
> *In addition to hits on our own networks around the world, every major streaming service has had a monster hit from one of our studios.* *[Continued on next page]*

[Continued from previous page] We have made or licensed for third parties some of the most watched shows and movies of the streaming era, including 13 Reasons Why, Emily in Paris, Dead to Me, Jack Ryan, Avatar, The Haunting of Bly Manor and many others.

The original shows we've made for others, is proof of the power of our content in the streaming era. And we also know that if we direct that same great content engine back to our own streaming service and unleash that same knack for producing original hits to attract our own subscribers, we can be successful. And that's exactly, what we're setting out to do.

A year ago, I said we were going to super-size CBS All Access, but we've done much more than that. We've transformed CBS All Access into Paramount+. ***Paramount+ will be one of the only streaming services to combine live sports, breaking news and a mountain of entertainment, a mountain of entertainment built on a portfolio of world-renowned brands.*** *It's all your favorites, all in one place.*

Going forward, the combined creative firepower, franchises and IP of Paramount, CBS, MTV, Nickelodeon, Comedy Central, BET and the Smithsonian Channel will be focused on creating original hits for Paramount+. And Paramount+ will also be home to their massive libraries." --- Bob Bakish, President and CEO of ViacomCBS

We are intrigued, though please note these are still very early days and the video steaming services space remains highly competitive. There is room for multiple winners, but there will be plenty of losers as well.

Concluding Thoughts

ViacomCBS is still playing catch up in the video streaming space, though things are increasingly starting to fall in the right place. **When ViacomCBS reports its first quarter earnings report for 2021, all eyes will be on its initial Paramount+ paid subscriber figures.** Going forward, we intend to continue monitoring the video steaming services space given its promising long-term growth outlook and the potential for these assets to become free cash flow cows.

Please note our favorite video streaming play is Disney, and we continue to like AT&T as a high-yield opportunity. **We are currently looking at ViacomCBS' shares within the context of an options idea and expect to raise our fair value estimate materially upon the next update.** For long only investors, we prefer Disney and AT&T as the better ideas at this time, respectively.

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

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

HIGH YIELD SPOTLIGHT

International Paper is Pursuing a Strategic Spinoff That Should Unlock Substantial Upside

Our **High Yield Spotlight for April 2021** is International Paper Company (IP)---**3.7% yield**---**due to its impressive free cash flow generating abilities and a pending strategic transaction that should significantly improve the company's cost structure going forward.** International Paper operates pulp, paper and packaging mills, recycling facilities, converting and packaging plants, and bag facilities all over the world. The company also operates a printing and packaging products distribution business focused on Asia. Additionally, International Paper has sizable economic interests in forestlands in Brazil and Russia. In 2007, International Paper formed a 50/50 joint-venture with Ilim Holding known as Ilim Group (the 'JV'). The JV has exclusive harvesting rights on timberland and forest areas in Russia, and also operates paper and pulp mills along with corrugated box plants in the country.

International Paper has three core business operating segments: 'Industrial Packaging,' 'Global Cellulose Fibers' and 'Printing Papers.' **In December 2020, International Paper announced it was separating off its Printing Papers business segment from the rest of its business.** The new entity, SpinCo, will be publicly traded and spun off to shareholders in a tax effective manner though International Paper will retain up 19.99% of SpinCo's outstanding shares at the time of the spinoff with the goal being to monetize that stake when opportune. According to the press release announcing the move, when SpinCo is separated from International Paper "SpinCo intends to raise debt in order to pay a dividend to International Paper, which will be used to pay down outstanding debt" at International Paper. As you can see in the upcoming graphic down below, this strategic transaction is expected to generate substantial synergies within a few years.

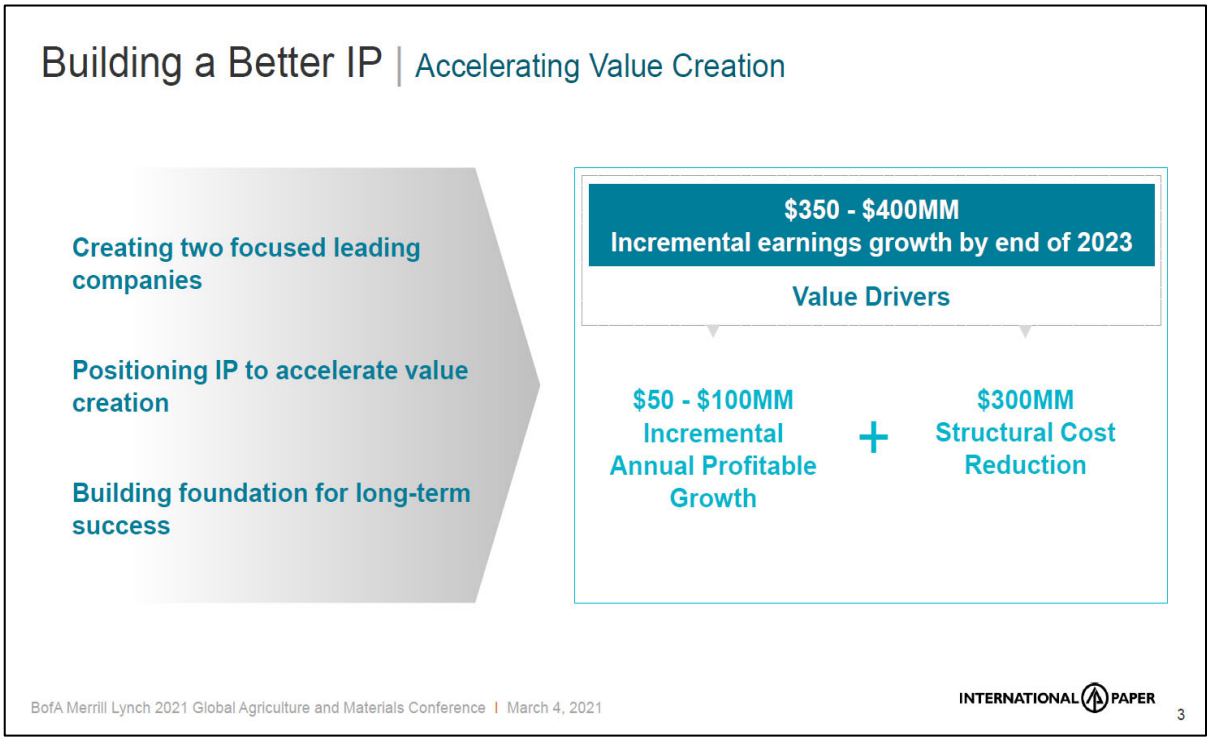

Image Source: *International Paper – March 2021 IR Presentation*

The deal is expected to unlock $300 million in annualized cost savings and $50-$100 million in new earnings opportunities by the end of 2023, and the separation is expected to be completed in the third quarter of 2021, subject to shareholder and regulatory approval. In our view, this strategic transaction is a good idea and one that should unlock substantial upside over time for International Paper as it pivots towards its business segments with stronger outlooks while taking advantage of the expected improvements in its cost structure and in its balance sheet, assuming its monetization efforts go as planned.

Here we would like to caution that due to the size of the strategic transaction, International Paper intends to reduce its dividend by 15%-20% to right-size its payout relative to its free cash flows excluding its Printing Papers business. Given the size of the strategic transaction, we do not view this move as a sign of underlying weakness in International Paper's ability to cover its dividend obligations. The parent company, International Paper, will have approximately $17.0 billion in annual sales on a pro forma basis (~85% from its Industrial Packaging segment, ~15% from its Global Cellulose Fiber segment) and the SpinCo will have approximately ~$4.0 billion in annual sales on a pro forma basis.

International Paper faced sizable headwinds from the coronavirus ('COVID-19') pandemic last year as its GAAP net sales were down 8% year-over-year and its GAAP gross margin fell by ~160 basis points year-over-year in 2020. **However, its cash flow generating abilities held up quite well as International Paper generated $2.3 billion in free cash flow in 2020**, aided by a material reduction in its capital expenditures. International Paper spent $0.8 billion covering its dividend obligations and less than $0.1 billion buying back its stock in 2020. **During the 2018-2020 period, International Paper's annual free cash flows averaged approximately $2.1 billion.**

At the end of 2020, International Paper had $7.5 billion in net debt (inclusive of short-term debt). We view its net debt load as manageable given its stellar free cash flow generating abilities and ample liquidity on hand (the firm exited 2020 with $0.6 billion in cash and cash equivalents on the books). The company has done a stellar job improving its balance sheet over the past several years as you can see in the upcoming graphic down below.

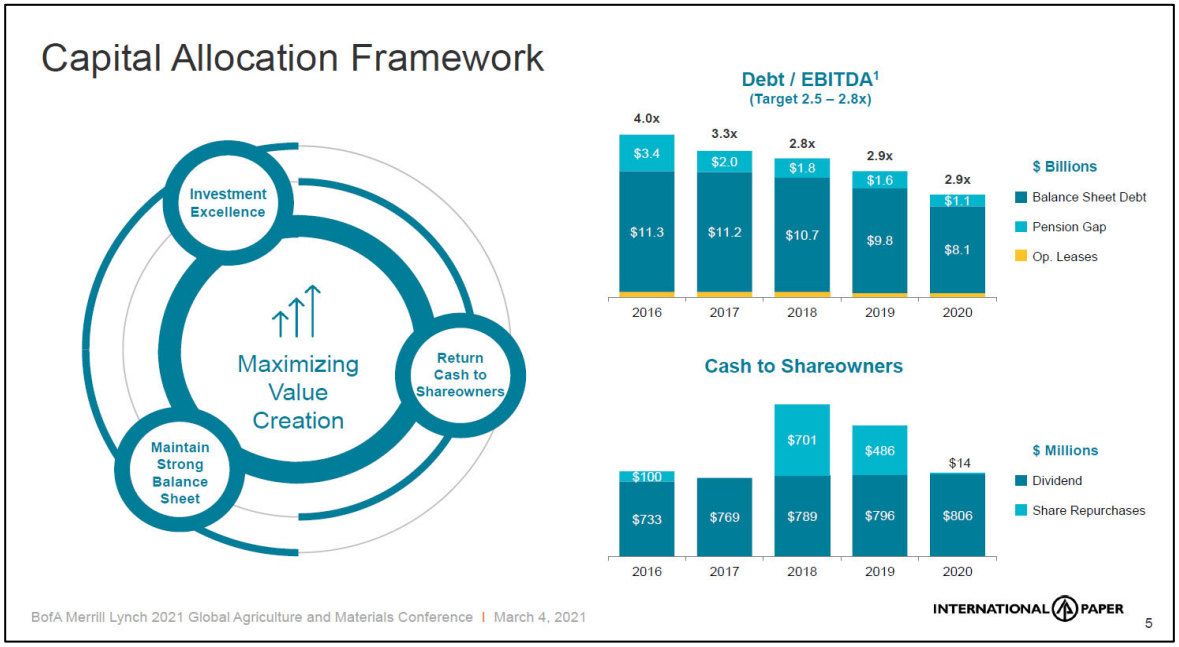

Image Source: *International Paper – March 2021 IR Presentation*

Please note International Paper had $4.2 billion in 'current nonrecourse financial liabilities of variable interest entities' and $2.1 billion in 'long-term nonrecourse financial liabilities of variable interest entities' on the books at the end of 2020, which was offset by $4.9 billion in 'current financial assets of variable interest entities' and $2.3 billion in 'long-term financial assets of variable interest entities' at the end of this period. These line-items and variable interest entities ('VIEs') were created through past transactions that involved International Paper monetizing the sale of some of its forestland holdings.

After International Paper announced the aforementioned spinoff in December 2020, Moody's Corporation (MCO) put out a press release that reaffirmed International Paper's investment grade Baa2 senior unsecured credit rating with a stable outlook. International Paper's financial position is quite strong and should improve going forward as the world emerges from the COVID-19 pandemic.

During the company's fourth quarter of 2020 earnings call, management provided an overview of how International Paper navigated the COVID-19 pandemic. In particular, the company noted that at steep drop-off in demand seen at its Printing Papers business was partially offset by strong volume performance at its Industrial Packaging business and solid cost control performance. Here is what management had to say during that earnings call (emphasis added, lightly edited):

> *"Our 2020 results reflect strong execution and effective cost management to mitigate the impact of market disruptions associated with COVID-19…* ***Volume was a drag on earnings due to the unprecedented decline in demand for printing papers. The impact was partly offset by strong volume in our packaging business, driven by higher demand across most consumer segments.***
>
> *We managed operations and cost well in a challenging environment with no material operational disruptions due to COVID-19. Our teams performed in a high level under a reconfigured work systems to protect our employees and contractors.* ***We did experience higher operating and distribution cost in the latter part of the year as we flexed our systems to meet very strong packaging demand."*** *--- Tim Nicholls, CFO of International Paper*

E-commerce is a source of long-term upside for International Paper, as is the growing middle class and rising consumer purchasing power worldwide. During the final quarter of last year, International Paper saw "broad based demand strength across all of our channels including boxes, sheets and containerboard. Just about every consumer segment accelerated in the fourth quarter, we continue to see strong double-digit growth in e-commerce and we believe the vast majority of e-commerce adoption is permanent" according to recent management commentary.

In our view (and the view of International Paper), the recent surge in e-commerce demand has long legs. For instance, households that began to order groceries and other consumer staples products online during the COVID-19 pandemic are likely to continue to utilize such services, in at least some capacity, even when the public health crisis comes to an eventual end (made possible by ongoing vaccine distribution efforts).

Management also recently noted that demand for export containerboard was robust during the final quarter of 2020, though food service categories were laggards as activities concerning restaurants and the travel industry remain subdued in the wake of the COVID-19 pandemic. International Paper's backlog in the realm of freight board and containerboard, particularly in North America, remains strong according to management. We appreciate International Paper's ability to adeptly navigate the pandemic (as best as a company in its industry can) as the firm proved effective at pivoting towards categories experiencing stronger demand and at pursuing meaningful cost control efforts.

We appreciate that International Paper was experiencing strong demand at its Industrial Packaging business segment during the latter part of last year, which will represent the bulk of the parent company's pro forma business once the aforementioned separation is completed. Management sees the company's strong performance at the end of last year carrying on into 2021 as you can see in the upcoming graphic down below.

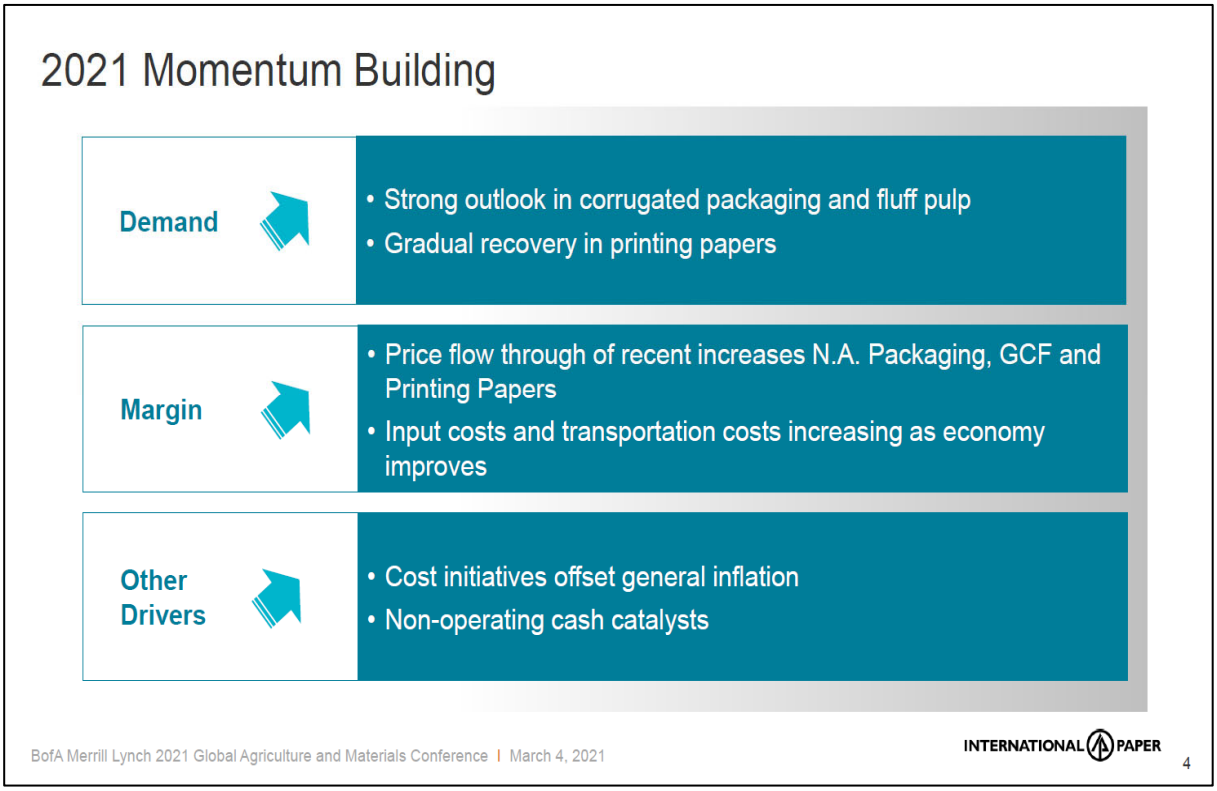

Image Source: *International Paper – March 2021 IR Presentation*

There are downside risks to be aware of here, such as a slowdown in e-commerce growth at a time when restaurants, hotels, and other sources of food service demand continue to face sizable headwinds. Additionally, any complications arising from the strategic spin-off could create problems for International Paper. In our view, the company entered 2021 on a nice upward trajectory and synergies from the strategic spinoff combined with the eventual end of the COVID-19 pandemic (as vaccine distribution efforts continue to pick up steam) supports International Paper's cash flow outlook.

As noted previously, International Paper intends to right-size its dividend policy once it completes the spinoff of its Printing Papers business, though we will stress once again that this is not due to underlying weakness in its business and is entirely about the size of the spinoff. Expected cash proceeds from the monetization of its stake in the pending publicly-traded entity, on top of the cash dividend International Paper expects to receive from SpinCo, should help maintain the parent company's (International Paper) balance sheet strength. The company's free cash flow generating abilities are impressive and expected synergies will help further improve its cash flow profile. **We like International Paper as our April 2021 High Yield Spotlight.**

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

General Mills Prepares for Cost Inflation, Pet Business Growing Rapidly

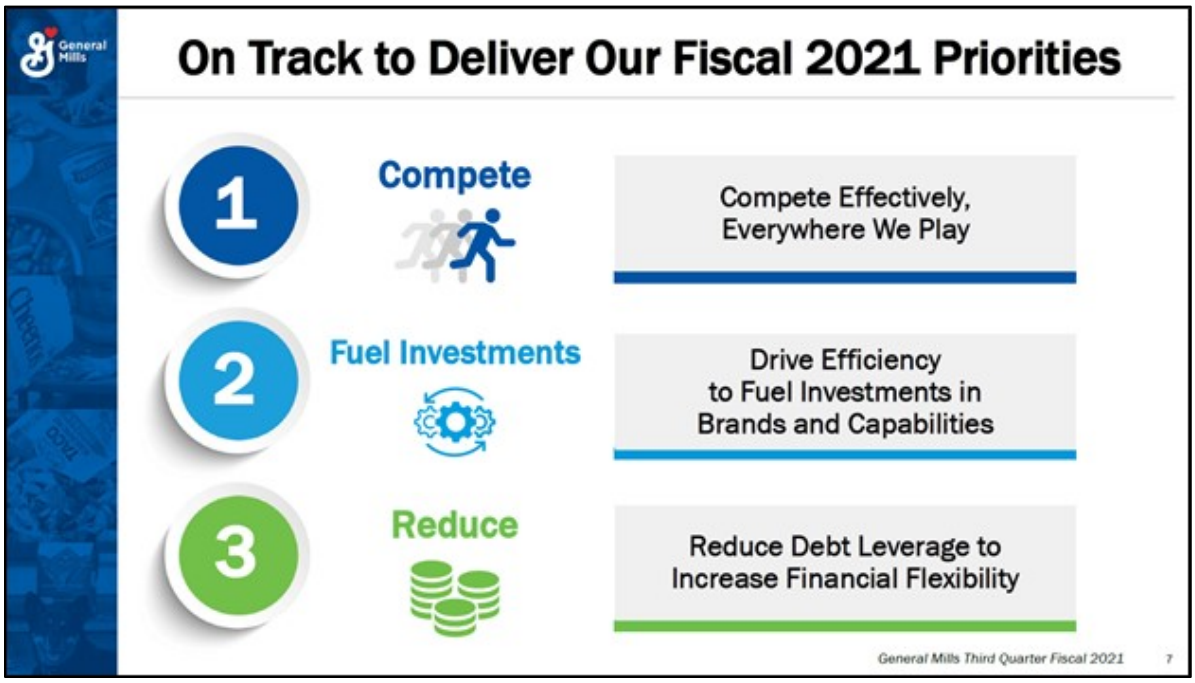

Image Source: *General Mills Inc – Third Quarter of Fiscal 2021 IR Earnings Presentation*

By Callum Turcan

On March 24, General Mills Inc (GIS) posted third quarter earnings for fiscal 2021 (period ended February 28, 2021) that beat consensus top- and bottom-line estimates on a GAAP basis, though its adjusted non-GAAP bottom-line performance missed consensus estimates. General Mills has seen demand surge higher for its products in the wake of the coronavirus ('COVID-19') pandemic as households stockpiled goods and started eating at home more often. **The company posted a solid fiscal third quarter earnings report, though its outlook is facing headwinds as General Mills is contending with cost inflation concerns.** Shares of GIS yield ~3.3% and are trading just above our fair value estimate as of this writing, after selling off in the wake of its latest earnings report.

Earnings and Near-Term Outlook Update

General Mills reported 8% year-over-year GAAP revenue growth in the fiscal third quarter on the back of a modest foreign currency tailwind and organic (non-GAAP) net sales growth of 7% on a year-over-year basis. Its GAAP operating income surged higher 27% year-over-year last fiscal quarter, aided by General Mills posting an ~80 basis point expansion in its GAAP gross margin and due to its operating expenses shifting lower during this period. General Mills' GAAP diluted EPS hit $0.96 last fiscal quarter, up 30% versus year-ago levels.

In the fiscal third quarter, organic net sales growth was driven by solid performance at almost all of General Mills' core business operating segments: 'North America Retail' (up 9% year-over-year due to volume growth), 'Pet' (up 14% year-over-year with volume growth offsetting unfavorable pricing/mix), 'Europe & Australia' (up 7% year-over-year supported by volume growth and favorable pricing/mix effects) and 'Asia & Latin America' (up 14% year-over-year due to a combination of volume growth and favorable pricing/mix effects). General Mills reported that its 'Convenience Stores & Foodservice' business operating segment saw a 10% year-over-year decline in organic net sales in the fiscal third quarter due to a reduction in volumes and unfavorable pricing/mix effects. Headwinds from the COVID-19 pandemic continue to weigh negatively on this segment's performance.

Looking ahead, General Mills expects demand for consumer staples products will remain elevated though cost inflation concerns are building. Please note that the firm's organic net sales performance is facing a very tough comparison this fiscal quarter on a year-over-year basis as General Mills benefited during this same period last year from pandemic-induced stockpiling. Here is what the firm had to say regarding its near-term outlook in latest earnings press release (emphasis added):

> General Mills expects that the COVID-19 pandemic will drive continued elevated consumer demand for food at home, relative to pre-pandemic levels, through the remainder of fiscal 2021. **The company expects full-year organic net sales to increase approximately 3.5 percent, reflecting strong year-to-date growth, partially offset by a difficult comparison in the fourth quarter** reflecting the initial pandemic-driven surge in at-home food demand as well as the extra month of results in the Pet segment.
>
> **On the bottom line, better-than-expected first-half adjusted operating profit margin results are now expected to be offset by higher input cost inflation and higher logistics costs in the second half.** As a result, full-year fiscal 2021 adjusted operating profit margin is expected to be approximately in line with fiscal 2020 levels, consistent with the guidance the company outlined at the beginning of the year.

Cost Inflation Concerns

During General Mills' fiscal third quarter earnings call, management was asked a question about cost inflation, a theme that is becoming increasingly common. Raw materials and energy prices are on the rise and that is coinciding with various logistical hurdles seen of late (such as ongoing US West Coast port delays and high shipping container rates, the winter storm that hit Texas and other parts of the US particularly hard this past February, and a massive container ship getting stuck in the Suez Canal starting in late March).

Management noted during the earnings call that when General Mills first issued guidance (for what appears to be fiscal 2021) regarding its cost inflation expectations the company was "rounding up to about 3%, and we are in a position now where we will be rounding down to about 3% inflation." **That indicates General Mills expects this year's cost inflation headwinds to be larger than initially forecasted.** Additionally, General Mills has been positioning itself "in anticipation of higher inflation as we step into [fiscal 2022]" according to recent management commentary. Pricing strength can be used to offset these headwinds, at least to a degree, though there are limits to what General Mills can do given the competitive environment the company operates in.

Financial Update

During the nine-month period that concluded at the end of February 2021, General Mills generated $1.9 billion in free cash flow and spent $0.9 billion covering its dividend obligations along with a negligible amount buying back its stock. **Here we would like to highlight that General Mills has done a stellar job paring down to leverage ratio over the past several fiscal years** (defined as net debt to adjusted EBITDA over a trailing twelve-month period), **aided by its strong free cash flow generating abilities.**

In February 2018, General Mills announced it was acquiring pet food maker Blue Buffalo in an all-cash deal worth about $8.0 billion by enterprise value, which closed in April 2018. This deal significantly grew General Mills' net debt load and resulted in a pro forma leverage ratio of ~4.2x in fiscal 2018. However, by the third quarter of fiscal 2021, General Mills had brought its leverage ratio down to ~2.8x. As of the end of February 2021, General Mills had $11.1 billion in net debt on the books (inclusive of short-term debt) though its $2.8 billion cash and cash equivalents position combined with its strong cash flow profile provides the firm with the means to manage that burden going forward, in our view.

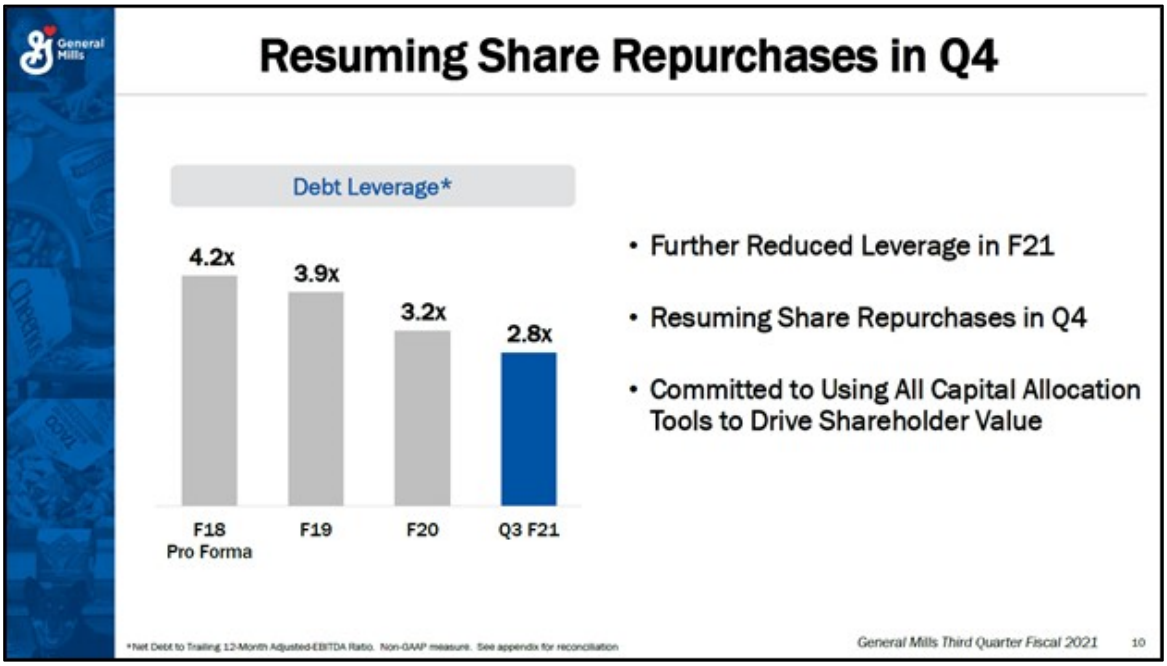

Image Shown: *General Mills has steadily improved its leverage ratio over the past few fiscal years.* ***Image Source:*** *General Mills – Third Quarter of Fiscal 2021 IR Earnings Presentation*

Keeping this in mind, General Mills announced that it was resuming its share repurchase program (likely meaning the resumption of substantial share buybacks) in conjunction with its latest earnings update. As shares of GIS are trading near our fair value estimate as of this writing, in our view it would be wise for General Mills to continue paring down its leverage ratio instead of buying back its stock. Though its leverage ratio has come down considerably over the past few fiscal years, General Mills still has ample (net) debt on the books which limits its financial flexibility considerably.

Though General Mills has a Dividend Cushion ratio of 0.6, we still view its forward-looking dividend coverage favorably given the company's apparent ability to tap capital markets at attractive rates for refinancing needs and its strong cash flow profile. General Mills has a "GOOD" Dividend Safety rating though we caution that this rating could change if it were to make another major acquisition. We are not changing our Dividend Safety rating in light of the announcement that General Mills is shaking up its capital allocation priorities, though we are keeping a close eye on the firm. The company noted it was considering bolt-on acquisitions during its latest earnings report.

Pet Update

General Mills was seeking a growth engine with long legs when it acquired Blue Buffalo. The "humanization of pets" trend seen in the US and elsewhere supports the outlook for pet food sales and other pet-related product sales over the long haul, providing General Mills a way to capitalize on a secular tailwind. Recent growth rates at several of General Mills' business operating segments are unlikely over the coming fiscal years to be sustained given the nature of the consumer staples business, though its Pet segment is well-positioned to continue growing at a brisk clip going forward. In prepared remarks, General Mills' management team had this to say on the acquisition and recent trends during the company's latest earnings report (moderately edited, emphasis added):

> *"When General Mills acquired Blue Buffalo, we highlighted five compelling strategic and financial benefits: the business operated in an attractive growth category; BLUE was a leading brand with a loyal consumer base that we believed was still in its early stages of growth; it had proven to be successful in both existing and emerging channels; it was a scaled platform with strong growth and operational efficiency; and it would contribute meaningfully to General Mills' growth and margin profile… [Continued on next page]*

[Continued from previous page] ***The shift to high-quality, natural food also accelerated during the pandemic. Average pet food spend per household was up 6% as pet parents traded up and switched to more premium foods like BLUE.*** *We also saw shopping patterns shift. BLUE's strong presence across channels allowed us to be available wherever pet parents wanted to shop. Together, these trends drove strong, profitable growth for BLUE, with organic net sales up 13% so far in Fiscal '21 and broad-based market share growth across key segments and retail channels.*

Looking forward, BLUE is well positioned for continued growth. Pet food is a great category, BLUE leads in the most attractive segment, and we have a clear plan for growth. ***Since we acquired Blue Buffalo, the U.S. pet food category has grown about 4% a year, and recent trends point to continued mid-single-digit growth for the category going forward. Natural pet food, which represents around 30% of total pet food sales today, has led the category with 9% growth in calendar 2020.*** *Because we know pet parents want natural, high-quality ingredients for their pets, we expect the Natural segment to continue to drive category growth in the years ahead." --- Bethany Quam, Group President of General Mills' Pet division*

Blue Buffalo operates in what could be considered the "premium" side of the pet food industry. Given that this part of the industry is growing at a faster rate than the pet food industry overall in the US, General Mills views its Blue Buffalo operation as uniquely well-positioned to capitalize on secular tailwinds going forward. The upcoming graphic down below highlights how General Mills was incredibly effective at expanding the reach of its Blue Buffalo business since acquiring the firm a few years ago. **We appreciate that Blue Buffalo is gaining market share in the pet food space.**

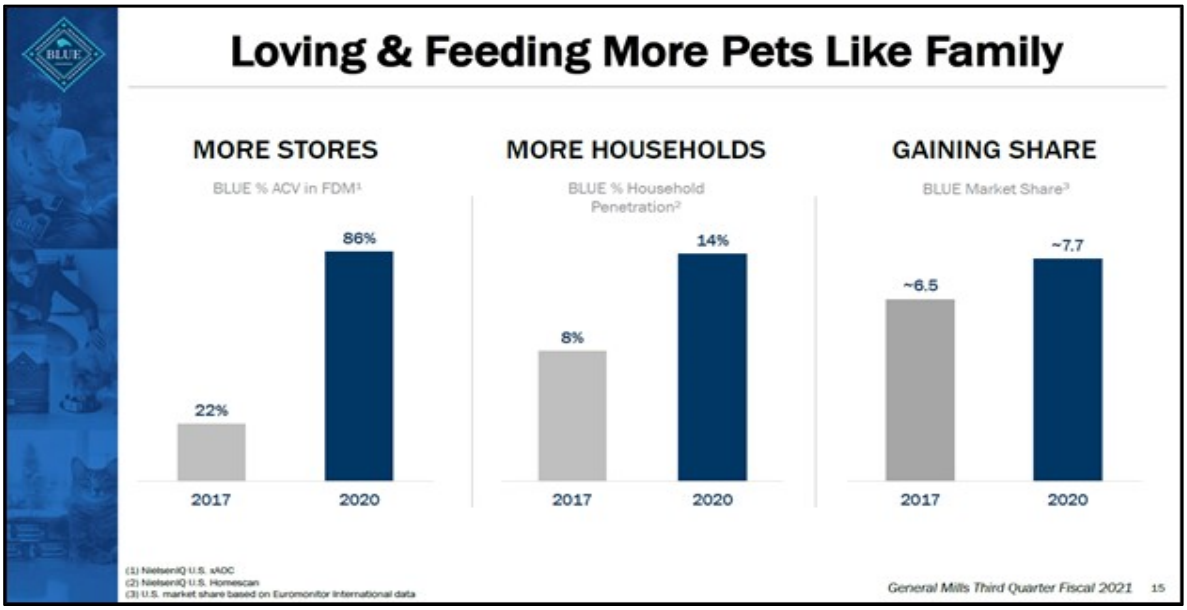

Image Shown: *General Mills views the growth trajectory of its Pet segment quite favorably.* ***Image Source:*** *General Mills – Third Quarter of Fiscal 2021 IR Earnings Presentation*

Portfolio Optimization Update

Most consumer staples firms tend to be continuously engaged in acquisition and divestment activities as management teams aim to capitalize on growing and lucrative parts of the sector while shedding assets in terminal decline. A day before publishing its latest earnings report, General Mills announced that it had agreed to sell its 51% controlling stake in Yoplait S.A.S to the French dairy cooperative Sodiaal in return for full ownership of the Canadian Yoplait business and a reduction in the royalty rate regarding the use of the Yoplait and Liberté brands in the United States and Canada (General Mills would be able to distribute these products in the US and Canada on a royalty-free basis according to the press release). This deal is expected to close by the end of this calendar year.

Generally speaking, simplifying corporate structures is a good move as it enables firms to remove unnecessary complexities and potentially enables improvements in cost structures over the long haul. This deal will see General Mills acquire Sodiaal's 49% stake in Yoplait Canada Holding Co, making that entity a wholly-owned subsidiary of General Mills. In the press release, General Mills noted that "this transaction improves our growth profile, enhances our margins, and creates value for our shareholders. Additionally, it increases our focus on the brand platforms that have the greatest growth potential." We are intrigued by the move.

Concluding Thoughts

General Mills is a solid company though we are not interested in adding the company to any of the newsletter portfolios at this time. As of this writing, shares of GIS appear to be fairly valued. In the High Yield Dividend Newsletter portfolio, we include Vanguard Consumer Staples Index Fund ETF (VDC) as an idea to gain broad exposure to the consumer staples sector.

Image Shown: *Shares of General Mills are on an upward climb though they remain well below levels seen a few years ago.*

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

Two Railroad Operators to Join Forces, Creating the First Fully Integrated Canada-US-Mexico Railroad Network

Image Source: *Canadian Pacific Railway Ltd, Kansas City Southern – March 2021 Acquisition Presentation*

By Callum Turcan

On March 21, Canadian Pacific Railway Ltd (CP) announced it was acquiring Kansas City Southern (KSU) through a cash-and-stock deal worth ~$29.0 billion by enterprise value (factoring in assumed debt). **The combination will create the first fully integrated Canada-US-Mexico railroad operator with ~$780 million in annualized synergies expected within three years of the deal closing.** Once this two-part transaction is complete, the new entity will have a US Class 1 railroad network that spans ~20,000 miles with ~20,000 employees supporting its operations. **The pro forma company will be renamed Canadian Pacific Kansas City ('CPKC').**

According to the acquisition press release:

> Calgary will be the global headquarters of CPKC, and Kansas City, Mo. will be designated as the U.S. headquarters. The Mexico headquarters will remain in Mexico City and Monterrey. CP's current U.S. headquarters in Minneapolis-St. Paul will remain an important base of operations. Four KCS Directors will join CP's expanded Board at the appropriate time, bringing their experience and expertise in overseeing KCS' multinational operations.

Over time, it is possible that the pro forma company's corporate footprint will be consolidated to eliminate redundancies and to provide for a more streamlined corporate structure. However, cost synergies only represent a modest slice of the targeted annualized synergies, indicating that this acquisition is primarily about growing the pro forma company's total addressable market ('TAM'). We will cover this in detail later.

Regulatory Concerns

As it relates to whether this deal could pass regulatory scrutiny (with an eye towards anti-trust concerns), it is worth comparing the size of the pro forma firm to some of the big companies in the North American railroad operator space. Union Pacific Corporation (UNP) operates a US Class 1 railroad network that runs for ~32,300 miles across 23 US states (primarily in the Western US region). Berkshire Hathaway Inc (BRK.A) (BRK.B) owns BNSF, another US Class 1 railroad operator with ~32,500 miles of track across 28 US states and three Canadian provinces.

It appears that the tie up between Canadian Pacific and Kansas City Southern has a strong chance of securing regulatory approval given that the combination will create an entity that is still significantly smaller than the biggest players in this arena. Management noted in the acquisition press release that the pro forma entity would still be "the smallest of six U.S. Class 1 railroads by revenue" in an apparent bid to highlight the chances of this deal passing regulatory muster. However, nothing is for certain on this front.

Deal Overview

When the first part of the Canadian Pacific-Kansas City Southern deal closes, KSU shareholders will receive $90 in cash and 0.489 share of CP for each share of KSU they own (which represented a nice pre-announcement premium for KSU shareholders). Canadian Pacific will issue roughly 44.5 million new shares and approximately $8.6 billion in new debt to help fund the cost of the acquisition. The goal is for the pro forma entity to maintain an investment grade credit rating over the long haul. Canadian Pacific suspended its share buyback program in conjunction with the announcement of this acquisition to help make that possible.

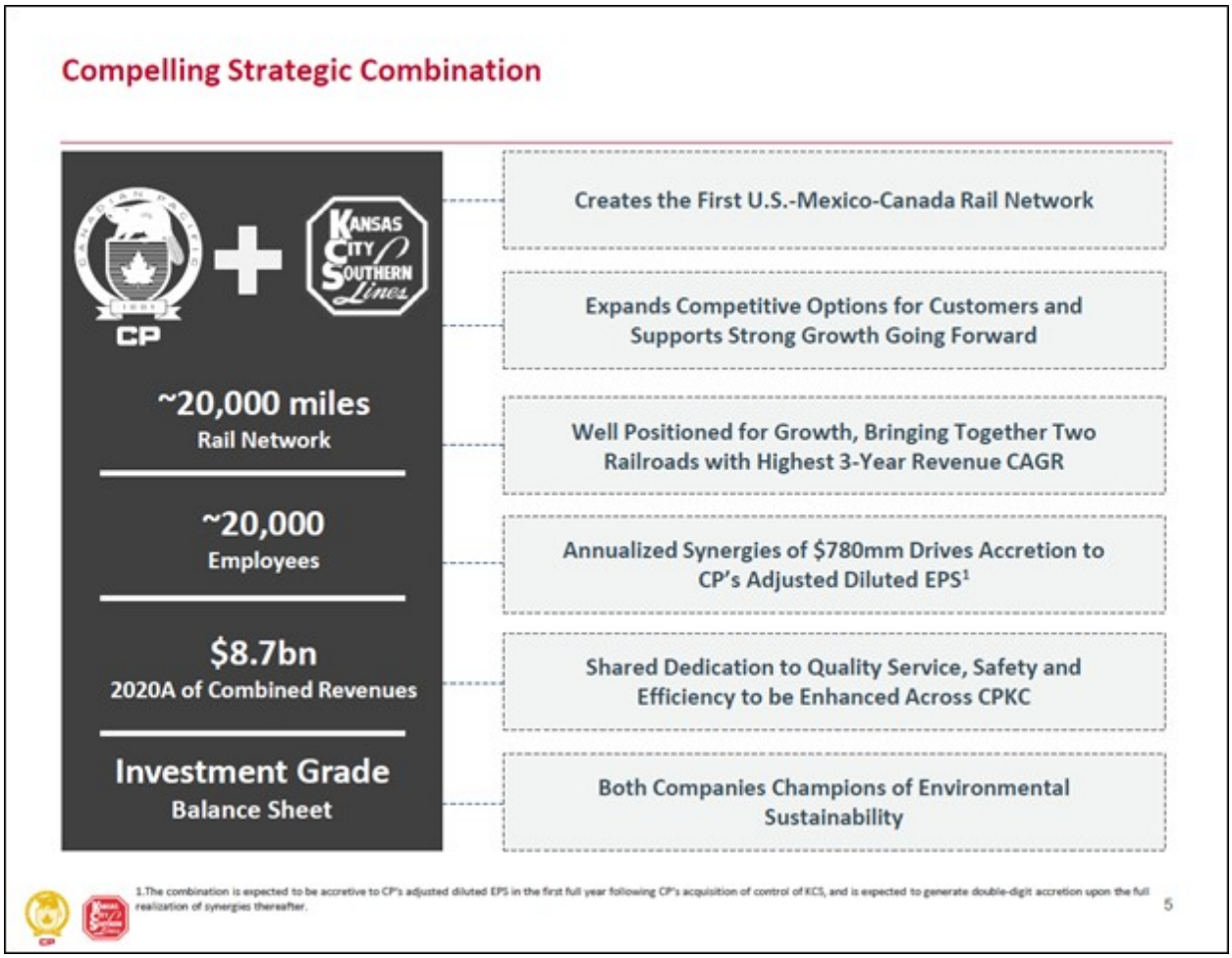

Image Shown: *Canadian Pacific and Kansas City Southern are joining forces.* ***Image Source:*** *Canadian Pacific, Kansas City Southern – March 2021 Acquisition Presentation*

Canadian Pacific sees the deal being accretive on an adjusted (non-GAAP) diluted EPS basis within the first year of the deal closing, though getting regulatory approval from the federal US Surface Transportation Board ('STB') will be required before the transaction can go forward. Beforehand, an independent trust owned by Canadian Pacific will acquire the outstanding shares of Kansas City Southern, once receiving the necessarily shareholder approvals. The independent trust will operate Kansas City Southern as a separate entity from Canadian Pacific's operations and will continue to pursue Kansas City Southern's current strategic priorities. In the upcoming graphic below, the railroad operators lay out how the two-part transaction is expected to unfold.

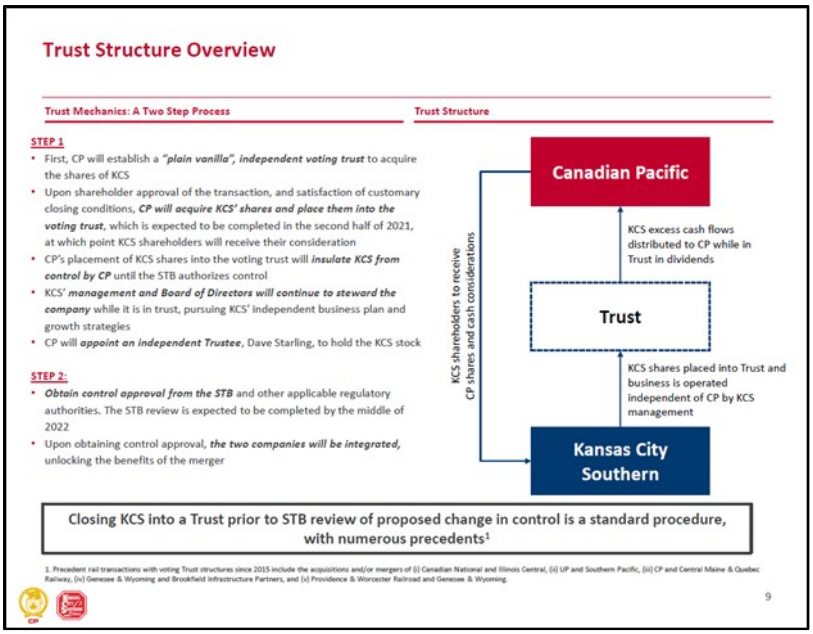

Image Shown: *An overview of the two-part transaction that will see Canadian Pacific take over Kansas City Southern, should the deal receive the necessary shareholder and regulatory approvals.* ***Image Source:*** *Canadian Pacific, Kansas City Southern – March 2021 Acquisition Presentation*

The first half of this transaction involves Kansas City Southern shareholders receiving their cash-and-stock consideration. On a pro forma basis, Kansas City Southern shareholders will own approximately 25% of Canadian Pacific's stock when the deal closes, and this phase of the transaction is expected to be completed in the second half of 2021. Approval from the US STB is expected to be completed by the middle of 2022, which will allow integration efforts to commence, highlighting the relatively long amount of time it will take for this deal to be finalized and longer still for meaningful operational synergies to be realized. **However, the tie up makes sense in our view, given the operational overlap and ability to capitalize on the highly integrated and growing nature of North America's three big economies (i.e., Canada, the US, and Mexico).**

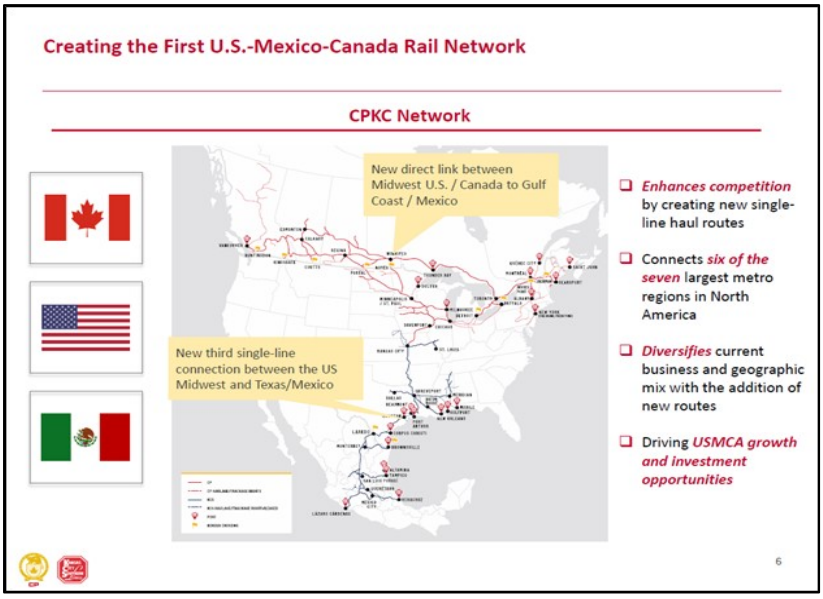

Image Shown: *Should the deal go through as envisioned, the combination of Canadian Pacific and Kansas City Southern would create a fully-integrated Canada-US-Mexico railroad network, the first of its kind. In theory, this is expected to generate meaningful new market opportunities that the pro forma entity intends to swiftly capitalize on.* ***Image Source:*** *Canadian Pacific, Kansas City Southern – March 2021 Acquisition Presentation*

Keith Creel, currently President and CEO of Canadian Pacific, will take over as CPKC's CEO when the deal is finalized. Also on March 21, Canadian Pacific announced it had amended its contract with Mr. Creel to extend his employment agreement until at least early-2026. Mr. Creel has a long history of working in the railroad industry.

Sizable Synergies

Roughly $180 million of the ~$780 million in targeted annualized synergies are expected to come from cost savings and efficiency gains (such as better fuel efficiency, reduced corporate overhead and IT expenses, rationalizing its facility footprint, better rates on equipment rentals, reduced licensing costs as it concerns securing right-of-way and land use rights). **The remaining ~$600 million in targeted annualized synergies will come from new market opportunities the tie up between Canadian Pacific and Kansas City Southern is expected to generate.**

As mentioned previously, this pro forma entity will be the first to operate a fully integrated Canada-US-Mexico railroad. **This is expected to create numerous new single-line railroad transportation opportunities** involving various commodities and semi-finished/finished products including grains, energy products, chemicals/petrochemicals, plastics, and automotive shipments. Single-line railroad tracks involve trains moving in both direction on the same track. This strategy has its advantages as is it much easier and cheaper to maintain and build a single-track compared to a multi-track system, though there are disadvantages as well (such as the potential for significant shipment delays).

In the acquisition press release, the railroad operators had this to say on the issue:

> The combined network's new single-line offerings will deliver dramatically expanded market reach for customers served by CP and KCS [Kansas City Southern], provide new competitive transportation service options, and support North American economic growth. The transaction is also expected to create jobs across the combined network. Additionally, efficiency and service improvements are expected to achieve meaningful environmental benefits.

Here is an example of how this strategy could play out: CPKC could ship grain volumes from Canada and the Upper US Midwest down to the Southern US and Mexico along a single-line track. After unloading the grain shipment, those trains could then load up on energy, chemical, and plastics products (which are plentiful in this region in the wake of the North American energy production boom and related boom in petrochemical and plastic products production) and those products could be shipped up north. CPKC's pro forma railroad network would also tie together North America's major automotive and auto parts production hubs in the Great Lakes region in Canada, the US Midwest, and Mexico. We see room for the pro forma firm to significantly grow its total addressable market (TAM) via integration efforts and future capital investment programs.

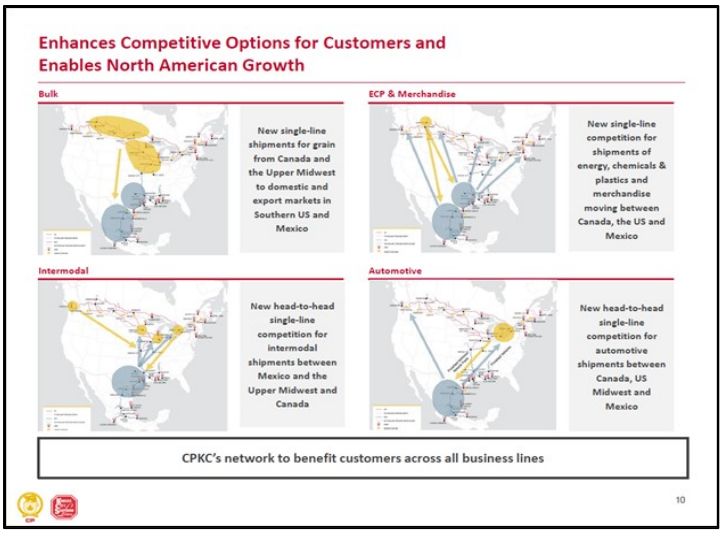

Image Shown: *An overview of the new market opportunities CPKC intends to capitalize on as an enlarged entity.* ***Image Source:*** *Canadian Pacific, Kansas City Southern – March 2021 Acquisition Presentation*

Railroad operators have, generally speaking, been running longer trains and fewer trips in a bid to reduce their operating ratios (operating expenses dividend by revenues over a given period). **For reference, the lower the operating ratio the better.** In the final quarter of 2020, Canadian Pacific had a record-low operating ratio of 53.9% and Kansas City Southern had an operating ratio of 62.2%, though please note that the latter faced sizable headwinds that quarter due to a service interruption stemming from a protest (according to the company). Please note that Kansas City Southern expects its operating ratio to improve going forward, hitting a forecasted ~57.5% in 2021 and 55.0%-56.0% in 2022.

Financial Considerations

This deal will cause the pro forma entity to have a bloated balance sheet, though Canadian Pacific is committed to utilizing its strong free cash flow generating abilities to pare down its pro forma (net) debt load over the coming years. As noted previously, the company has suspended its share buyback program to help keep a lid on its leverage ratio. Management expects the pro forma entity will have a leverage ratio of ~4.0x in 2021 which is forecasted to fall to ~2.5x by 2023. Note that Canadian Pacific's leverage ratio is defined as its adjusted net debt to adjusted EBITDA ratio. Canadian Pacific and Kansas City Sothern pledged to not change their dividend policies in conjunction with the acquisition announcement, and please note that both railroad operators have relatively modest payout obligations.

At the end of 2020, Canadian Pacific had ~$9.4 billion in net debt (inclusive of short-term debt and long-term investments) and Kansas City Southern had ~$3.5 billion in net debt (inclusive of short-term debt and long-term investments) on the books. Furthermore, both firms have substantial operating lease and pension plan liabilities. Canadian Pacific noted in the acquisition press release that it expects it would "produce approximately $7 billion of levered free cash flow (after interest and taxes) over the next three years" which will help the firm stay on top of its financial commitments. **Shares of CP and KSU yield ~0.5% and ~0.8%, respectively, as of this writing.**

Concluding Thoughts

We see this railroad operator combination as one that should benefit all parties over the long haul. Shares of CP sold off and shares of KSU rose sharply during normal trading hours Monday, March 22, the first business day after the deal was announced. However, the targeted cost savings and new market opportunities that the pro forma entity intends to capitalize on appear reasonable, in our view. The long-term economic outlook for the North American economy remains bright, and it is quite likely that integration between the big three economies (i.e., Canada, the US, and Mexico) will continue in the coming years and decades, aided by the United States-Mexico-Canada Agreement ('USMCA'). That free trade pact officially entered into force in July 2020 after getting ratified by the three signatories. We are keeping an eye on the railroad operator space, and our favorite way to gain exposure to the industry is indirectly via Berkshire Hathaway Class B shares.

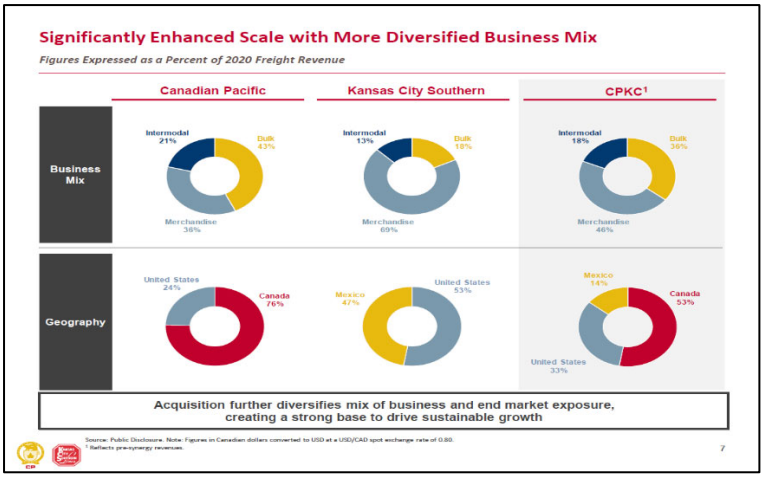

Image Source: *Canadian Pacific, Kansas City Southern – March 2021 Acquisition Presentation*

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%	3.34%
iShares MSCI Australia ETF	EWA	5.0%	1.62%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	4.98%
iShares International Select Dividend ETF	IDV	5.0%	4.03%
iShares U.S. Preferred Stock ETF	PFF	5.0%	4.74%
Global X SuperDividend ETF	SDIV	5.0%	6.86%
Global X SuperIncome Preferred ETF	SPFF	10.0%	5.70%
Vanguard Consumer Staples ETF	VDC	5.0%	2.63%
Vanguard Real Estate ETF	VNQ	10.0%	3.49%
Utilities Select Sector SPDR	XLU	5.0%	3.06%
EQUITY			
AT&T	T	5.0%	6.87%
Crown Castle	CCI	5.0%	3.09%
CyrusOne Inc.	CONE	5.0%	3.01%
CubeSmart	CUBE	5.0%	3.60%
Digital Realty Trust	DLR	5.0%	3.29%
Enterprise Products Partners	EPD	2.5%	8.17%
Magellan Midstream Partners	MMP	2.5%	9.48%
Philip Morris	PM	5.0%	5.41%
Public Storage	PSA	5.0%	3.24%
Cash*	-	0.0%	0.00%
		100.0%	**4.35%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 4/1/2021. Est. Div. Yield information retrieved from SeekingAlpha, YF.

** Reflects federal funds target rate range*

Valuentum's Stock Dividend Research | Visit us at www.valuentum.com | Ratings as of 22-Mar-2021 | Data as of 22-Mar-2021

Public Storage PSA FAIRLY VALUED

Buying Index™ 6 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$191.00 - $319.00	HEALTHY	GOOD / 1.6	GOOD	3.39%

Assessment of Company Dividend Strategy

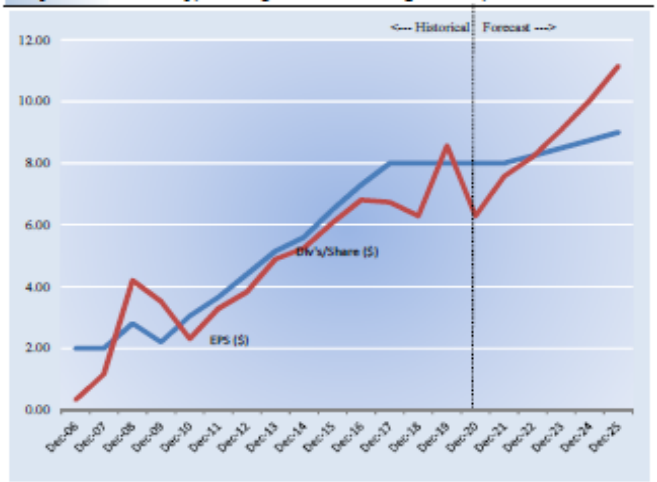
Key Strengths

Public Storage's ability to generate free cash flows is impressive. In 2020, Public Storage generated ~$1.7 billion in free cash flow and spent ~$1.6 billion covering its payout obligations. The REIT's 'A-rated' investment grade credit rating and the well-staggered nature of its debt maturity schedule provides it with some financial flexibility, though Public Storage has a sizable net debt load. The long-term outlook for the self-storage property space is favorable and supported by rising housing prices in minor and major metropolitan markets combined with the desire for households to find affordable ways to maximize their living space.

Potential Weaknesses

Real estate investment trusts pay out 90% of annual taxable income and therefore are unable to meaningfully reinvest internally-generated funds, resulting in external capital-market dependence. The weak internal cash-flow retention of most REITs translates into poor raw, unadjusted Dividend Cushion ratios, which could become severe during the depths of the real estate cycle. Even though a REIT's operating cash flow may be robust, the lack of cash accumulation on the balance sheet and the massive debt needed to purchase/develop new properties can become restrictive. The adjusted Dividend Cushion ratio, accounts for expectations of continued access to the capital markets, which while "normal," cannot be guaranteed in times of tight credit.

Graphical Relationship, Earnings and Dividends (per share)

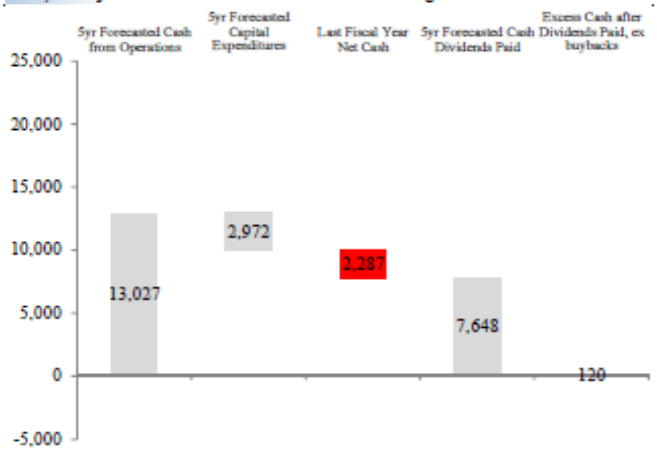


The graph above shows the relationship between a firm's earnings per share and its dividends per share.

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

Raw, Unadjusted Dividend Cushion Cash Flow Bridge - Raw

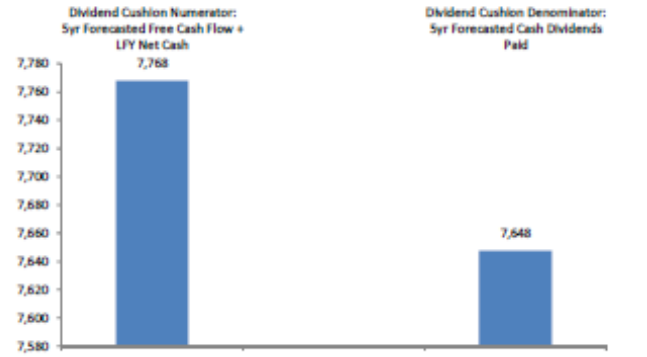


Source: Company Filings, Valuentum Projections

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, Public Storage's numerator is larger than its denominator suggesting strong dividend coverage in the future. The Dividend Cushion Ratio Deconstruction image puts sources of free cash in the context of financial obligations next to expected cash dividend payments over the next 5 years on a side-by-side comparison. Because the Dividend Cushion ratio and many of its components are forward-looking, our dividend evaluation may change upon subsequent updates as future forecasts are altered to reflect new information.

Raw, Unadjusted Dividend Cushion Ratio Deconstruction - Raw



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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