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HIGH YIELD DIVIDEND NEWSLETTER

HIGH-YIELDING AT&T REMAINS FREE CASH FLOW COW

Latest Changes to High Yield Dividend Newsletter
Removed: EWA – April 27 Added: SPYD – April 27

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"WE ARE IMPRESSED WITH THE LATEST EARNINGS UPDATES FROM SEVERAL OF THE IDEAS INCLUDED IN THE HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO. AT&T REMAINS A FREE CASH FLOW COW, PHILIP MORRIS' TRANSFORMATION STORY CONTINUES, AND BOTH OUR FAVORITE MIDSTREAM MLPS, ENTERPRISE PRODUCTS AND MAGELLAN MIDSTREAM, PERFORMED QUITE WELL."

– CALLUM TURCAN

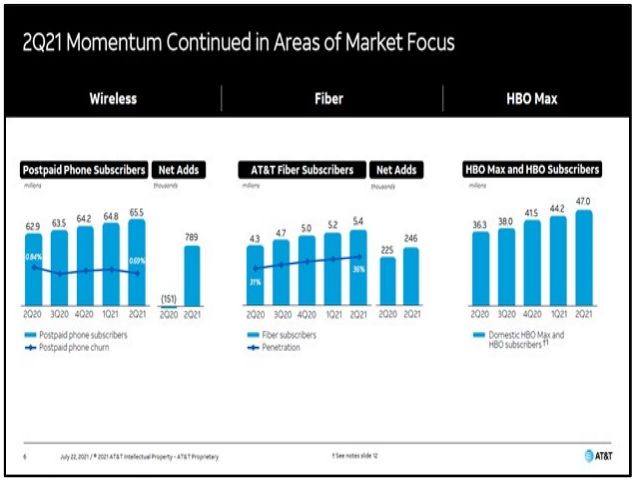


Image Shown: *AT&T Inc's core businesses in the wireless and fiber arenas continue to gain subscribers at a rapid pace, while its HBO/HBO Max offerings are also growing at a nice clip.* ***Image Source:*** *AT&T Inc – Second Quarter of 2021 IR Earnings Presentation*

By Callum Turcan

On July 22, AT&T Inc (T) reported second quarter 2021 earnings that beat both consensus top- and bottom-line estimates. **The company added 1,156,000 net postpaid customers to its core 'Mobility' business including 789,000 net postpaid phone customers, aided by its lowest churn rates ever at just below 0.7%.**

AT&T also added 174,000 net prepaid phone customers while its AT&T Fiber business added 246,000 net customers last quarter. We include shares of AT&T as an idea in the High Yield Dividend Newsletter portfolio and **shares of T yield ~7.4% as of this writing.**

Transformative Deals

Over the past several months, AT&T has made some big announcements including agreeing to spin off a 30% stake in its US video business to TPG (includes its DIRECTV, AT&T TV, and U-verse assets), merge WarnerMedia with Discovery Inc (DISCA), and sell its mobile games studio Playdemic to Electronic Arts Inc (EA for $1.4 billion in cash.

Furthermore, on July 21, AT&T announced it was selling its Vrio business (its Latin American video services provider) to Grupo Werthein, a private holding company, though no sales price was included in the press release. The *WSJ* reports that according to an AT&T spokesman, the deal carries an enterprise value of ~$0.5 billion. AT&T recorded a large $4.6 billion impairment charge associated with the sale of its Vrio business, which is expected to close in early-2022.

These moves are expected to significantly improve AT&T's balance sheet going forward, though management has communicated that AT&T's dividend will be right-sized in the process. After the transformative transaction with Discovery is complete, AT&T expects to generate $20+ billion in free cash flow and aims to have a dividend payout ratio of ~40%-43% (equal to ~$8-$9 billion in annual dividend obligations). The company aims to step up its capital investments towards its 5G and fiber operations going forward to support its long-term growth trajectory, a move we support given AT&T's success on these fronts of late.

As an aside, AT&T expects its HBO/HBO Max offerings will exit 2021 with 70-73 million subscribers worldwide (keeping in mind its HBO/HBO Max businesses will soon be separated from AT&T).

In conjunction with its latest earnings report, AT&T raised its full-year guidance for 2021 and now expects (excluding the impact of its DIRECTV/TPG transaction) to generate ~$27 billion in free cash flow this year, up from ~$26 billion according to its first quarter guidance. At its new free cash flow forecast, AT&T forecasts that its dividend payout ratio will come in the high 50s% range this year (expected dividend obligations divided by forecasted free cash flows).

By the end of 2023, AT&T aims to bring its net debt-to-adjusted EBITDA ratio down below 2.5x once its deal with Discovery is in the rearview mirror. Please note that the timing of other spinoffs and divestments, and the potential for additional activities on this front, will play a leading role here.

Additionally, its free cash flow forecast for 2021 will be impacted by the pending spinoff of its US video services unit, though we appreciate the guidance boost as that speaks quite favorably to the performance of its core operations going forward.

Earnings Update

AT&T's GAAP revenues grew by 8% year-over-year in the second quarter of 2021, though its GAAP operating income moved lower year-over-year due to its large impairment charges. However, AT&T's non-GAAP adjusted operating income also moved lower year-over-year last quarter as it continues to face sizable headwinds from the coronavirus ('COVID-19') pandemic. **AT&T generated $12.8 billion in free cash flow during the first half of 2021.**

The company's net debt load stood at $167.9 billion at the end of June 2021 according to AT&T (a balance sheet statement was not provided in its latest earnings update). Though manageable considering its impressive free cash flow generating abilities and pending transactions, AT&T's balance sheet remains bloated. Management has committed to paring that burden down over the coming years. AT&T exited the second quarter with a net debt-to-adjusted EBITDA ratio of approximately 3.15x.

Operational Updates

During AT&T's latest earnings call, management had this to say about the firm's fiber and legacy businesses (emphasis added):

> *"Our fiber growth continues to be solid. We added 246,000 fiber customers in the quarter. Broadband ARPU grew by 6.1% year-over-year. Our aggregate Fiber penetration rate is now more than 36% up from about 31% a year ago.*
>
> ***And nearly 80% of net ads are new AT&T broadband customers. We've reached a major inflection point in our consumer wireline business. Broadband revenue growth now surpasses legacy declines.*** *This help drive consumer wireline revenues up 2.9%. We expect broadband revenues to continue to outpace legacy decline." --- Pascal Desroches, Executive Vice President and CFO of AT&T*

As it concerns AT&T's 'Communications' business segment which includes its 'Mobility' operations, the company signed a major deal with DISH Network Corp (DISH) in July 2021.

Here is what the press release had to say about the deal:

> Through this agreement, DISH will provide current and future customers of its retail wireless brands, including Boost Mobile, Ting Mobile and Republic Wireless, access to best-in-class coverage and connectivity on AT&T's wireless network, in addition to the new DISH 5G network. The agreement accelerates DISH's expansion of retail wireless distribution to rural markets where DISH provides satellite TV services. AT&T is also providing transport and roaming services as part of the agreement, to support DISH's 5G network.

Dish Network is a relative newcomer in the wireless space after acquiring Boost Mobile last year, and aims to steadily become a much bigger player in this arena. AT&T is effectively replacing T-Mobile US Inc (TMUS) as DISH Network's strategic partner on this front, and AT&T's management team noted during its latest earnings call that "we expect our recent agreement with Dish to provide a boost to wireless service revenues in 2022." In our view, this deal is a win-win considering T-Mobile's acquisition of Sprint was given the go-ahead by regulators with the understanding that Dish Network was going to enter the industry. The wireless market in the US is reasonably competitive, and AT&T has been firing on all cylinders on this front of late in the wake of its rollout of nationwide 5G services.

Concluding Thoughts

AT&T's core businesses are performing quite well while the company begins to jettison its other operations. The firm has made several big U-turns over the past few years, and it appears AT&T is finally on a path that management can stick with, which we appreciate. **We expect AT&T's dividend will remain competitive after its deal with Discovery is complete as its core businesses, providing wireless and fiber services to customers in the US, remain major cash flow cows with promising long-term growth outlooks.**

In our view, there is a decent chance AT&T will eventually completely divest its stake in its US video services business. On a final note, *Axios* reports that AT&T is actively looking to divest its advertising tech business Xandr and is in discussions with an Indian ad tech giant. We like the move as AT&T needs to get back to its roots.

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

Answering Some Questions from Our Members

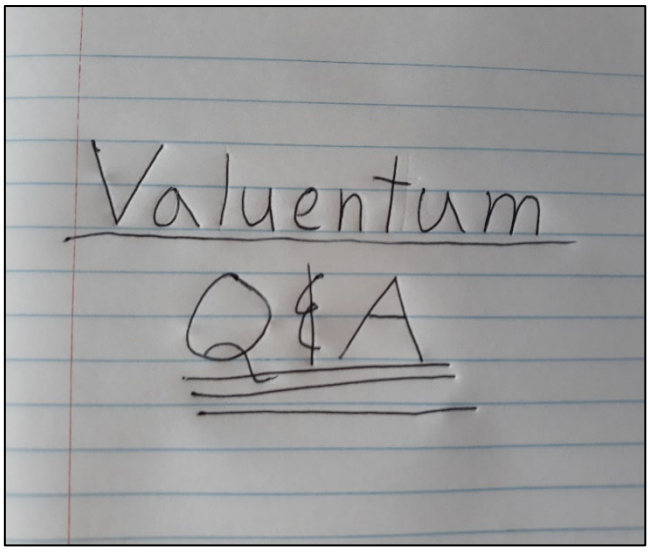


Image Source: *Valuentum Analysts*

By Callum Turcan and Brian Nelson, CFA

Let's answer some questions we received recently from our members. Please note that the wording of some of the questions was modified somewhat for clarity.

Question: What do you think about Moderna (MRNA), as their mRNA technology can be used for far more than just Covid-19 vaccines?

Answer: We are simply amazed at how fast the pharmaceutical industry, in conjunction with various partners and government programs (Operation Warp Speed and others), discovered a safe and viable vaccine for the coronavirus ('COVID-19'). Moderna was key to making that possible after its COVID-19 vaccine received emergency approval from the US FDA in December 2020. With a vaccine efficacy of 94.1%, Moderna really was able to showcase the power of mRNA technology.

Looking ahead, Moderna's vaccine pipeline (built upon its expertise in the realm of mRNA) is quite robust as you can see in the upcoming graphic at the top of the next page on the left, and we are particularly interested in its oncology and seasonal flu vaccine candidates (given the commercial potential in this area, and there is a very real societal need for improvements in battling the scourge that is cancer). Moderna's outlook is fantastic, though with only one commercialized vaccine offering (for COVID-19), its fair value estimate range is rather wide.

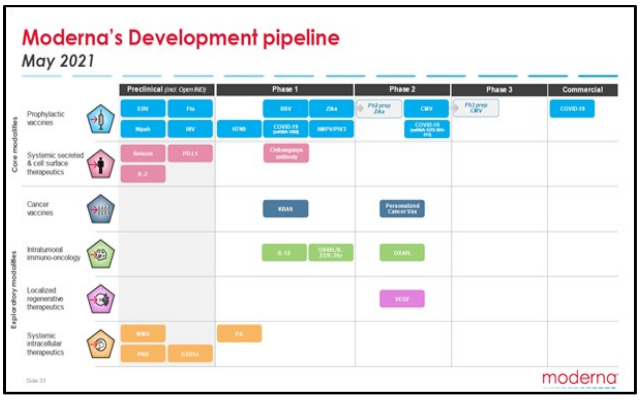


Image Shown: *Moderna's vaccine pipeline is robust and covers a lot of ground, underpinned by its cutting-edge mRNA technology.* ***Image Source:*** *Moderna – May 2021 IR Presentation*

Question: First of all, thank you for the excellent work- it is a pleasure to follow your team's ideas and how they work out! I read increasingly about the proposed changes in global corporate taxation and the implications this will have on big tech e.g., Alphabet (GOOG) (GOOGL), Microsoft (MSFT), Apple (AAPL), Facebook (FB). It will be probably interesting for your subscriber base to know your thoughts on that considering the weighting of these names in the sample portfolios.

Answer: Thank you for the warm thoughts, we appreciate it!

As it concerns the estimated cash tax rate for companies, through the enterprise cash flow analysis process we can stress test our models by adjusting the estimated corporate income tax rate to gauge the changes in fair value. Looking at the proposed minimum global corporate tax rate that has the backing of ~130 countries, at 15% that is unlikely to have a seriously deleterious effect on the major tech giant's future forecasted free cash flows (it will impact their fair value estimates in a marginal to modest way).

Pivoting to the potential changes in the US corporate income tax rate, in our view, our base case is that there is a decent chance it gets raised up to 25% (up from 21% currently) rather than President Biden's 28% proposal (not a guaranteed thing) given the opposition to a larger tax increase from some key Democratic senators.

In any event, we are waiting for greater details on these situations and will update our cash flow models accordingly (with an eye towards the estimated future corporate cash income tax rate), but we continue to be huge fans of firms with net cash positions and strong free cash flow generating abilities whose outlooks are supported by secular growth tailwinds.

Large cap tech and payment processing firms, like PayPal (PYPL) and Visa (V), fit the bill.

Question: Regarding PPL Corp (PPL), is your VBI rating of 9 correct?

Answer: The utility PPL is quite an interesting firm given its transformative deal with National Grid plc (NGG) which we covered in our *Utility PPL Is Pursuing a Major Transformation and Has a VBI Rating of 9* article. In our view, investors are looking for greater clarity on what PPL intends to do with its large net cash infusion (the sale of its UK operations has been completed and now PPL is a pure play US utility) once its deal to acquire Rhode Island's leading utility is complete (which is forecasted to occur by March 2022).

Debt reduction efforts are already underway, and the acquisition is going through the regulatory process, but investors likely want to know whether share buybacks, dividends and/or capital expenditures are going to be prioritized going forward (in other words, what are PPL's core capital allocation priorities post-transformation). We are keeping an eye on the situation, and expect that during its upcoming earnings, PPL will provide some additional color here.

Note that we do not add all stocks that register high ratings on the Valuentum Buying Index (VBI) to the newsletter portfolios. Please see the last question in this Q&A roundup for further detail.

Question: Is there any news regarding the sale of Korn Ferry (KFY) top officers selling some of their stock?

Answer: While we always want to see executives have as much "skin in the game" as feasibly possible, insider stock buying and selling activity has only a modest impact on our outlook towards companies.

The enterprise cash flow analysis model is built around the company's future forecasted financial performance, and unless insider stock buying and selling activity indicates there may be trouble afoot (such as an accounting scandal, for example), executives cashing in some of their stock does not change our fair value estimate or view towards a firm.

There is a long list of reasons why an executive would want to sell their stock. With shares of Korn Ferry trading near their all-time highs, some selling activity is to be expected from time to time. We continue to be big fans of Korn Ferry and like the firm as an idea in the Best Ideas Newsletter portfolio.

Question: What is a fair value estimate?

Answer: The fair value estimate is our best estimate of the true intrinsic value of the stock and rests as the highest point on the probability distribution of the fair value estimate range (as shown below), which itself represents a broader fair value estimate of the equity. The fair value estimate is derived by a three-stage discounted cash flow model (enterprise valuation), while the fair value range uses the fair value estimate as a midpoint to ascribe what we think would be a fair market price for the stock to trade within.

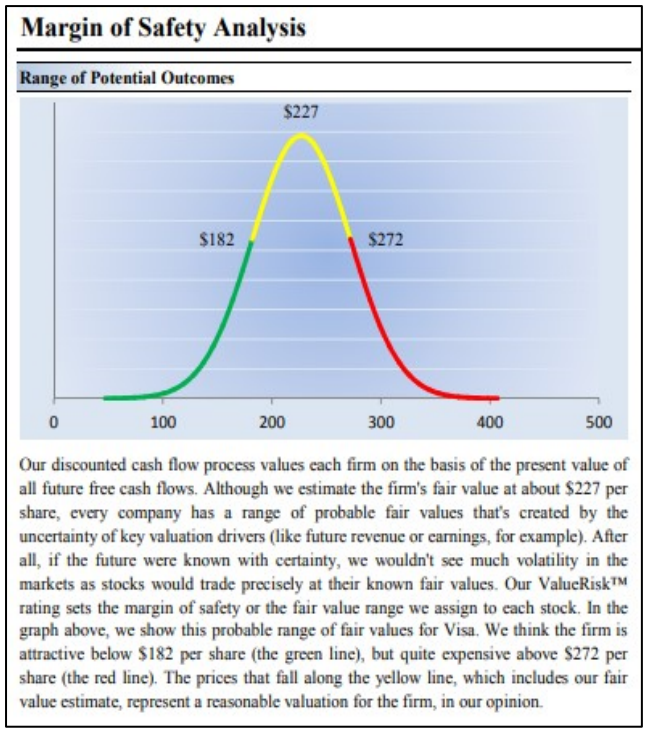


Image Shown: *Visa's fair value estimate range.* ***Image Source:*** *Valuentum's 16-page stock report of Visa.*

Let's use Visa (V) as an example. Based on our discounted cash-flow process, we value shares of Visa at $227 per share. The stock trades at ~$248 per share at the time of this writing, so its price-to-fair value (P/FV) estimate stands at ~1.05. The low end of our fair value estimate range is $182 per share, while the high end of our fair value estimate range is $272. In other words, we could see shares of Visa rise to as much as $272 per share before we would grow concerned about its underlying valuation.

If Visa's shares dropped below $182 per share and carved out a nice bottom/base (meaning that the market was supporting the equity on a technical basis through strong relative strength and/or share-price momentum), it would register one of the highest ratings on the Valuentum Buying Index.

If that were to occur, we would view Visa as one of the most attractively positioned stocks on the market, along with Facebook – which had been (and continues to be) severely underpriced while showing continued strong share-price momentum; hence, Facebook's high rating on the Valuentum Buying Index.

Importantly, the fair value estimate, the price-to-fair value (P/FV) ratio, the fair value estimate range, and the Valuentum Buying Index are only a handful of metrics on our website to use to evaluate new ideas. The rating is not absolute within the investment-decision making process, meaning that there are other factors beyond the rating that we consider before a company is added to the newsletter portfolios, the most important of which is approval from the Valuentum team (a precursor to adding the company to the newsletter portfolios). Our research indicates that the VBI rating is highly effective across large sample sets, but we prioritize a qualitative overlay when running the concentrated newsletter portfolios which target 15-20 holdings.

The simulated newsletter portfolios help surface our favorite ideas in the construction of diversified equity portfolios, as in the case of the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio (the High Yield Dividend Newsletter portfolio offers even more diversified exposure). When adding or removing companies from the newsletter portfolios, we also consider market conditions and diversification parameters, so it's critical to reiterate that no metric should ever be used by itself.

Question: When I look at the company vitals information on the left side of the first part of each stock page, are the 'Est. Normal Diluted EPS' and 'P/E on Est. Normal Diluted EPS' essentially the same as 12-month forward EPS and 12-month forward P/E I see from other data sources (just worded differently and based on your estimates rather than "consensus figures")? It seems like this would be the case, but I wanted to double check. Do you all back out the company's net cash position when looking at this metric?

Answer: Our normalized P/E ratios and EV/EBITDA ratios consider the companies' current price relative to the average earnings or average EBITDA over a reasonable forward-looking cycle, generally five years. For example, the 'Est. Normal Diluted EPS' will take the price at the time of the report and divide that by the average annual EPS over the next five years. The same process occurs with respect to the current price of EV (market cap plus book value of debt, preferred) divided by the average of annual EBITDA over the next five years.

The normalized measures are unique as they take into consideration our forecasts over the next five years within the context of our enterprise discounted cash flow process. The net cash position is not backed out of the 'Est. Normal Diluted EPS.' The net cash position is considered in our fair value estimate, namely the price-to-fair value (P/FV) ratio as well as in the context of enterprise value (EV), applied within the EV/EBITDA multiple, for example.

Question: Please explain the difference between the raw, unadjusted Dividend Cushion ratio and the adjusted Dividend Cushion ratio, and what is considered a good score for the unadjusted Dividend Cushion ratio, what is an excellent score, what is neutral and what is poor? Also, how much relative importance should I give to each score?

Answer: The raw, unadjusted Dividend Cushion ratio adds a firm's net cash position to the sum of its future free cash flows (cash flow from operations less all capital spending) over the next five years and takes that sum and divides it by the sum of the company's expected cash dividends paid and growth in them over the next five years.

The Dividend Cushion ratio is essentially a coverage ratio -- the higher the ratio above 1, the better able the company will be able to cover dividend payments in the future, in our view. For most of our coverage and for most corporates, the qualitative ratings for safety and growth are a function of the raw, unadjusted Dividend Cushion ratio, as shown below.

The Dividend Cushion Ratio Helps Income Investors

$$\frac{\sum_{t=1}^{5}[A(t) - B(t)] + C(0) - D(0)}{\sum_{t=1}^{5} E(t)}$$

A = cash flow from operations (from the operating section of the cash flow statement),
B = capital expenditures or additions to property plant and equipment (from the investing section of the cash flow statement),
C = cash and cash equivalents (from the balance sheet),
D = long-term debt (from the balance sheet), and
E = cash dividends paid (from the financing section of the cash flow statement).

"All else equal, a firm with billions of net cash on the balance sheet is better positioned to keep paying a dividend than a firm with billions of net debt on the balance sheet. More cash on the books relative to debt reveals significantly more financial flexibility. The dividend payout ratio ignores this important concept, while the Dividend Cushion ratio embraces it." – Valuentum's Brian Nelson, CFA

For MLPs, REITs, and some utilities, however, we make modifications to the raw, unadjusted Dividend Cushion ratio in deriving the adjusted Dividend Cushion ratio. For example, with MLPs, we add back future equity issuance to the numerator and mitigate the company's debt load to a degree on account of assuming ongoing refinancing capacity for such entities. These adjustments result in a sharp upward revision to the raw, unadjusted Dividend Cushion ratio. For MLPs, REITs, and some utilities, we base the qualitative rating on this enhanced adjusted Dividend Cushion ratio, but we also disclose the raw, unadjusted Dividend Cushion ratio in each case.

In short, we believe both the raw, unadjusted Dividend Cushion ratio and the adjusted Dividend Cushion ratio offer insights.

The former reveals the capital-market-dependency risks inherent to MLPs, for example, while the latter acknowledges that under benign market conditions, continued funding of the distribution/dividend would ensue. We place greater emphasis on the raw, unadjusted Dividend Cushion ratio because it is more of a pure risk measure than the adjusted one, which considers a variety of incremental funding sources, which cannot be guaranteed during difficult credit conditions.

Though we may make qualitative adjustments to the ratings themselves on account of other factors, the assigned breakpoints are as follows for both measures (they can be found on the definitions page in the Dividend report in the back): *Dividend Safety. We measure the safety of a firm's dividend by adding its net cash to our forecast of its future cash flows and divide that sum by our forecast of its future dividend payments. This process results in a ratio called the Dividend Cushion™. Scale: Above 2.75 = EXCELLENT; Between 1.25 and 2.75 = GOOD; Between 0.5 and 1.25 = POOR; Below 0.5 = VERY POOR.*

Concluding Thoughts

We appreciate the feedback and questions from our members and look forward to answering any questions in the future. Stocks for the long run!

Disclosure: *Brian Nelson owns shares in SPY, SCHG, QQQ, DIA, VOT, and IWM. Brian Nelson's household owns shares in HON, DIS, HAS. Callum Turcan does not own shares in any of the securities mentioned above.*

ConocoPhillips is a High Yielding Energy Giant That Just Completed a Major Transformation

Our **High Yield Spotlight for August 2021** is ConocoPhillips (COP)---**3.1% yield**---which is often referred to as the "super-independent" energy giant. An independent oil and gas company is one that is focused solely on the extraction of raw energy resources (oil, natural gas, natural gas liquids) from the ground, which is known as the upstream part of the industry. Back in 2012, ConocoPhillips and Phillips 66 (PSX), its former downstream division (refineries and petrochemical plants), separated and that separation also included ConocoPhillips jettisoning a large chunk of its midstream operations (energy infrastructure such as pipelines) as well, though ConocoPhillips retained some midstream assets that directly support its upstream operations.

ConocoPhillips exited the deepwater exploration space a few years ago in the wake of the oil pricing crash that started back in late-2014 and lasted for several years. Deepwater exploration is generally defined as opportunities that involve drilling through 7,500+ feet of water and then thousands more feet of ground to reach potentially extractable raw energy resources, expensive endeavors that do not always pan out. ConocoPhillips kept only its most promising deepwater opportunities in its portfolio and divested the rest (or let its acreage leaseholds and/or drilling rights expire). **By doing so, the company significantly improved its cost structure and raised some cash proceeds in the process via divestment activity** (including a significant divestment in Senegal), though the firm did not stop there.

Back in 2017, **ConocoPhillips divested most of its higher cost oil sands operations** to Cenovus Energy Inc (CVE) for ~$13.3 billion in a large cash-and-stock deal. This move significantly improved ConocoPhillips' balance sheet strength and further improved its cost structure. However, please note ConocoPhillips retained its most lucrative oil sands position, the Surmont steam-assisted gravity drainage ('SAGD') joint-venture which uses heat to move viscous heavy sour oil barrels to the surface. ConocoPhillips owns 50% of the Surmont JV and France's TotalEnergies SE (TTE) owns the rest.

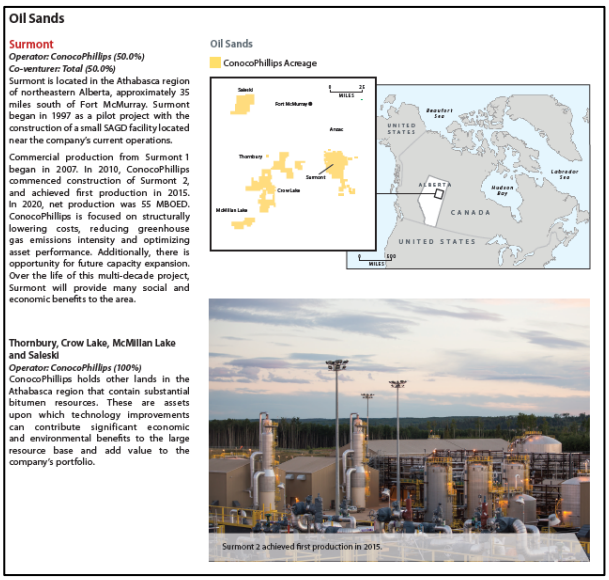


Image Shown: *An overview of ConocoPhillips' remaining oil sands operations in Canada. Its Surmont JV is a top tier asset in this arena.* ***Image Source:*** *ConocoPhillips – Canada Fact Sheet March 2021*

This portfolio "high-grading" process resulted in ConocoPhillips' net debt load (inclusive of short-term debt) **dropping from ~$22.2 billion at the end of 2015** (one year into the oil pricing crash) **to ~$11.5 billion at the end of March 2021** (inclusive of short-term debt, short-term investments, and its equity position in Cenovus Energy which is not a strategic asset by any means). **Now ConocoPhillips is a more profitable enterprise, albeit a smaller one, with a much stronger balance sheet.**

Here we would like to highlight that ConocoPhillips' management team stated during the firm's first quarter 2021 earnings call that the company was going **to sell down its equity stake in Cenovus Energy** and use the proceeds to repurchase ConocoPhillips' stock. Furthermore, **management also committed to reducing ConocoPhillips' total debt by ~$5.0 billion over the next five years**, a move we really appreciate. **The company's capital allocation priorities and broader strategy is rock-solid**, in our view. Here is a moderately edited excerpt from that earnings call highlighting ConocoPhillips' strategy (emphasis added):

> *"…[W]e view our balance sheet as a strategic asset… And given that our borrowing costs exceed the returns on our cash,* ***we plan to put some of that incremental cash to work along with future free cash flow to reduce gross debt by $5 billion over the next five years.*** *This will reduce our ongoing interest expense, lower our ongoing free cash flow break-even price, improve return and create greater flexibility on our overall debt structure, all while maintaining our strong leverage position. As part of our program, we may refinance some of our high coupon debt to take advantage of historically low interest rates and facilitate the total quantum of our debt reduction over time.*
>
> *…As a reminder,* ***we own approximately 10% of Cenovus****… The shares were received as part of the consideration for our sale of Canadian assets to Cenovus in 2017, and we've always stated that we did not intend to be a long-term strategic owner of Cenovus shares…*
>
> ***We intend to begin selling our Cenovus shares in the open market in the second quarter, while simultaneously tendering the proceeds in the ConocoPhillips shares.*** *We will be thoughtful and measured with our sales program, as you would expect, with an intention to fully dispose of our Cenovus position by the end of 2022." --- Bill Bullock, Executive Vice President and CFO of ConocoPhillips*

In January 2021, ConocoPhillips completed its all-stock acquisition of Concho Resources, which significantly grew its position in the Permian Basin while enabling ConocoPhillips to retain its financial strength. At the time of the announcement in October 2020, the all-stock transaction was valued at ~$9.7 billion. **ConocoPhillips now views the deal unlocking $1.0+ billion in annual cost and capital savings by 2022 (more than double its previous guidance)** with savings coming from corporate consolidation and efficiency gains in the realm of exploration and development (drilling and completion) activities, among other things (with an eye towards savings coming from IT and supply chain activities).

The prolific Permian Basin, which stretches across southeastern New Mexico and West Texas, is home to vast raw energy resources that can be extracted through a combination of horizontal drilling and hydraulic fracturing, or "fracking," activities. ConocoPhillips had a relatively small position in the Permian Basin before the move, and now with significant scale in the region, **the company's upside in the Permian Basin has become needle-moving.**

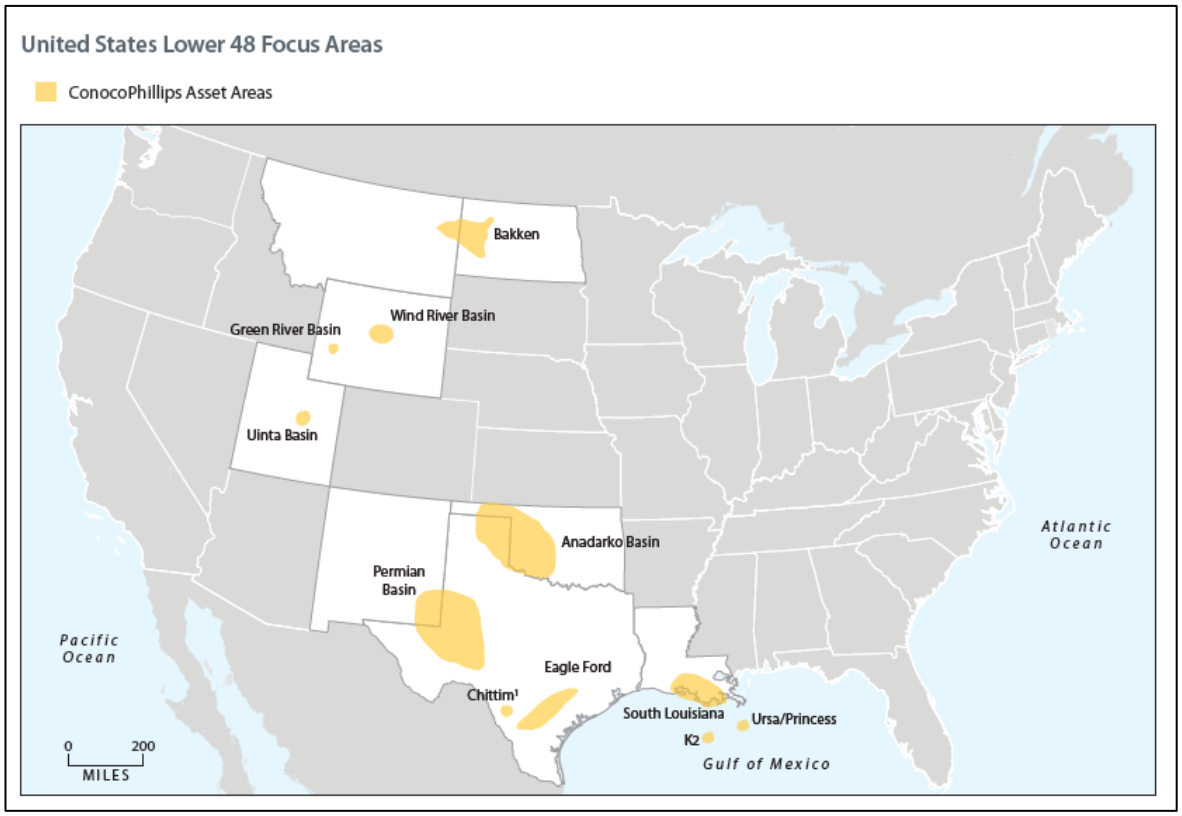


Image Shown: *An overview of ConocoPhillips' Lower 48 operations.* ***Image Source:*** *ConocoPhillips – Lower 48 Fact Sheet March 2021*

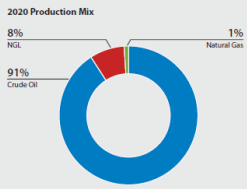
ConocoPhillips can use its enlarged position in the Permian Basin to quickly capitalize on higher raw energy resources pricing as this asset is home to an enormous portfolio of short-cycle upstream projects that can produce sizable cash flows within months, not years. Looking ahead, ConocoPhillips aims to produce ~1.5 million barrels of oil equivalent per day net in 2021 while spending $5.5 billion on its capital expenditures. That is roughly on par with its production during the first quarter of this year.

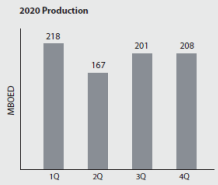
Pivoting here, we are also big fans of ConocoPhillips' recent deal with BP plc (BP), which saw ConocoPhillips effectively trade a large chunk of its position in the UK North Sea (where ConocoPhillips has a relatively small position) in return for BP's Alaskan operations. That included a much larger stake in the Greater Kuparuk Area, an upstream asset, and the Kuparuk Transportation Company, a midstream asset. **This deal closed back in 2018, and ConocoPhillips has only just begun to really benefit from the move.** Additionally, ConocoPhillips acquired then-Anadarko Petroleum's Alaskan operations back in 2018 (a bolt-on deal), before Occidental Petroleum Corporation (OXY) purchased Anadarko Petroleum.

Alaska is home to lucrative conventional upstream opportunities that are on the lower end of the cost curve in a tax regime that is favorable to private operators. While supermassive oil fields in the Middle East and Central Asia often have much lower production and development costs on a per barrel basis, usually most of those economic benefits flow to the government and state-run companies (either through aggressive tax regimes and/or by having private operators act only in a sub-contractor capacity). Therefore, **Alaska is a top tier region to operate in and ConocoPhillips is the largest crude oil producer in Alaska.**

ConocoPhillips—Average Daily Net Production, 2020

Area	Interest	Operator	Crude Oil (MBD)	NGL (MBD)	Natural Gas (MMCFD)	Total (MBOED)
Greater Prudhoe Area	36.1%	Hilcorp	68	16	4	84
Greater Kuparuk Area	89.2-94.7%	ConocoPhillips	74	-	2	74
Western North Slope	100.0%	ConocoPhillips	39	-	4	40
Alaska Total			**181**	**16**	**10**	**198**





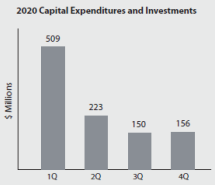
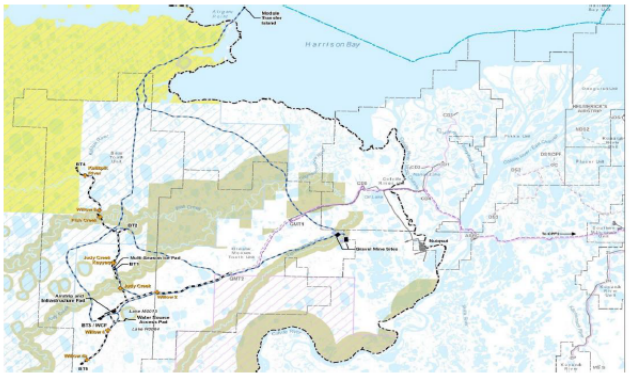


Image Shown: *An overview of ConocoPhillips' upstream position in Alaska, which is heavily weighted towards lucrative crude oil production.* ***Image Source:*** *ConocoPhillips – Alaska Fact Sheet March 2021*

Looking ahead, ConocoPhillips is working towards bringing new upstream developments online in Alaska, with its Willow development being the most intriguing due to its size. **By 2024 or 2025 (depending on the timing of permitting activities and other factors), ConocoPhillips aims to commercial the Willow discovery (which in the oil and gas industry is referred to as achieving first-oil) by bringing an upstream development online that could produce north of 100,000 barrels of crude oil per day at its peak.** The discovery was first located back in 2016 in the National Petroleum Reserve of Alaska ('NPR-A') and the resource potential was confirmed a couple of years later via appraisal activity. Given the low-cost nature of these resources along with Alaska's favorable tax regime and ConocoPhillips' outright ownership of the project, **this represents another needle-moving opportunity.**

Key Facts

- **Jobs created:** Potential for hundreds of direct jobs, thousands of construction jobs
- **Cost to develop:** Approximately $2-3 billion
- **Cumulative drilling capital over multiple years:** Additional $2-3 billion
- **Peak production:** In excess of 100,000 BOPD (gross)
- **First oil:** Estimated 2024-2025
- **Royalty Sharing:** Half of the federal royalty will be shared with the State of Alaska to be used to address potential needs of North Slope communities



Map produced by Bureau of Land Management, for the Willow Master Development Plan EIS

Image Shown: *An overview of the Willow project, a needle-moving oil-rich upstream opportunity for ConocoPhillips in Alaska.* ***Image Source:*** *ConocoPhillips – Willow Fact Sheet March 2021*

Beyond Alaska and the Permian Basin, **ConocoPhillips has an impressive position in Australia due to its 37.5% stake in the Australia Pacific LNG venture.** The venture produces natural gas in eastern Australia, cools it down to around negative 260 degrees Fahrenheit to convert it into liquified natural gas ('LNG'), which in liquid form takes up 1/600th of the volume of its gaseous state, and primarily ships that LNG to energy hungry countries in key markets in Asia under long-term contracts. **Rising crude oil prices have positively benefited LNG pricing which is usually linked to Brent (as stated in the contracts covering the LNG sales), the premier international oil pricing benchmark.**

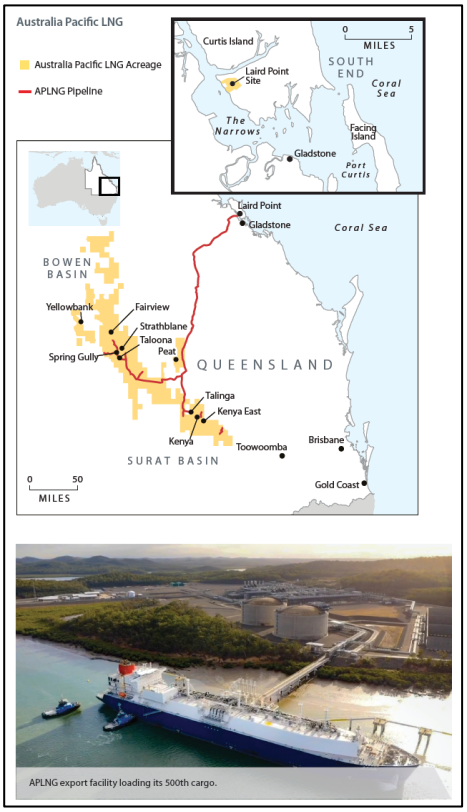


Image Shown: *A look at ConocoPhillips' APLNG facility in eastern Australia, which was been exporting LNG since 2016.* ***Image Source:*** *ConocoPhillips – Asia Pacific Fact Sheet March 2021*

ConocoPhillips is a solid generator of cash flow, though its business is capital-intensive, which means free cash flows can be difficult to come by in environments where raw energy resources pricing is subdued. However, **with raw energy resources pricing on a powerful upswing, ConocoPhillips' free cash flow generating abilities should be downright stellar going forward.**

Past balance sheet improvements (lower annual interest expenses) and cost structure improvements (shedding less economical assets, exiting the deepwater exploration space) combined with greater scale in key regions (such as Alaska and the Permian Basin), targeted synergies from its acquisition of Concho Resources, and new growth developments coming online (such as commercializing the Willow discovery) should significantly improve ConocoPhillips' free cash flow generating abilities in any environment. As the backdrop for the oil and gas industry is incredibly favorable right now, aided by a recovery in demand from the worst of the coronavirus ('COVID-19') pandemic and efforts by the OPEC+ oil cartel to prop up raw energy resources pricing (i.e., the current crude oil supply curtailment agreement that is expected to run through 2022), **ConocoPhillips' outlook is incredibly bright.**

There are some key downside risks to be aware of here. ConocoPhillips has a large net debt load, for example, and its financial performance is tied to volatile commodity prices. ConocoPhillips has ample liquidity on hand (~$8.5 billion in cash, cash equivalents, short-term investments, and its equity stake in Cenovus at the end of March 2021), a $6.0 billion revolving credit facility that matures in May 2023 with $5.7 billion in remaining borrowing capacity at the end of March 2021, and **an 'A-rated' investment grade credit rating from the "Big 3" rating agencies.**

Furthermore, **the company generated $0.9 billion in free cash flow in the first quarter of 2021** while spending $0.6 billion covering its dividend obligations during this period (along with an additional $0.4 billion buying back its stock). As noted previously, we expect ConocoPhillips' free cash flows will swell higher over the coming quarters and years.

Please note that S&P Global Inc (SPGI) downgraded ConocoPhillips' credit rating to A- from A back in February 2021, with a stable outlook. This does not shake our confidence in ConocoPhillips as its outlook has only improved since then. Management's commitment to further pare down ConocoPhillips' total debt load going forward will better position the firm to navigate future headwinds, whatever may arise.

ConocoPhillips' financial strength is rock-solid, and going forward, its free cash flows should swell upwards as it benefits from rising raw energy resources pricing and expected cost structure improvements. The company has a Dividend Cushion ratio of 1.8 as shown in the below graphic, earning the firm a "GOOD" Dividend Safety rating and please note this metric incorporates our expectations that ConocoPhillips will steadily grow its dividend going forward. **We like ConocoPhillips as our August 2021 High Yield Spotlight and view the company's outlook quite favorably.**

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

Dividend Cushion Ratio Deconstruction

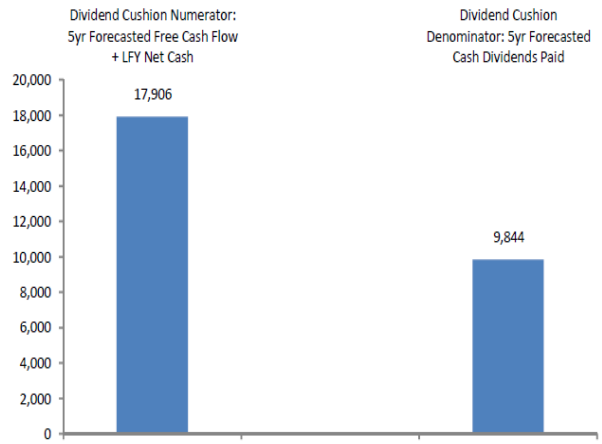


Image Shown: *A visual deconstruction of ConocoPhillips' Dividend Cushion ratio. The numerator is represented by ConocoPhillips' forecasted future free cash flows over the next five full fiscal years, less its net debt position at the end of its latest fiscal year. The denominator is represented by ConocoPhillips' future forecasted dividend obligations over the next five full fiscal years. Due to ConocoPhillips' bright outlook and stellar asset base, the company's dividend strength is rock-solid, indicating that a payout cut is highly unlikely at this time. Additionally, due to its dividend strength, there is ample room for ConocoPhillips to grow its dividend going forward in a sustainable manner.*

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

Phillip Morris' Transformation Continues

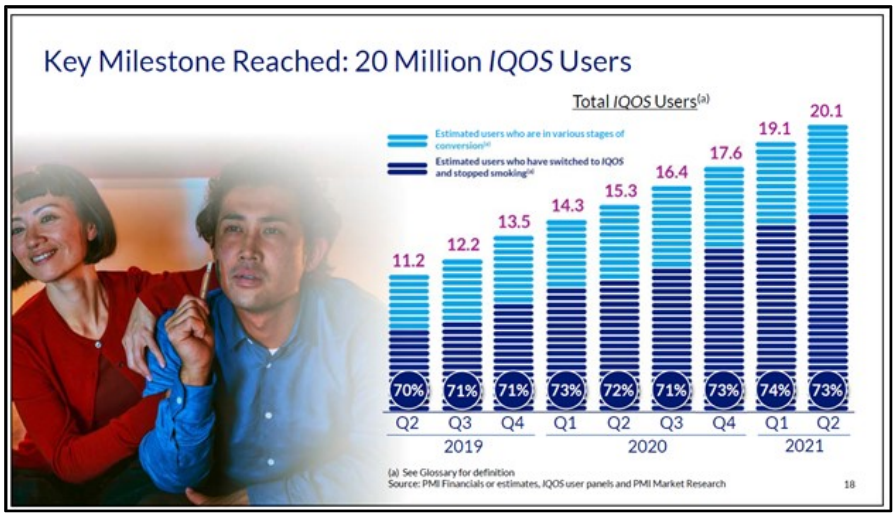


Image Shown: *Philip Morris International Inc's IQOS offering, a heated tobacco unit product (also classified as a "reduced risk product" by the company) that seeks to replicate the experience of traditional cigarettes for smokers in a bid to get those users to switch over to an offering the company views as relatively "safer," has continued to post solid user base growth of late. We are big fans of Philip Morris and its ongoing transformation and include shares of PM as an idea in the High Yield Dividend Newsletter portfolio.* ***Image Source:*** *Philip Morris International Inc – Second Quarter of 2021 IR Earnings Presentation*

By Callum Turcan

On July 20, the company behind the Marlboro cigarette brand (excluding sales of the cigarette brand in the US) and the smokeless IQOS nicotine offering Philip Morris International Inc (PM) reported second quarter 2021 earnings. The company missed consensus top-line estimates but beat consensus bottom-line estimates and **boosted its full-year guidance for 2021 in conjunction with the report.** Now Philip Morris expects to generate (the following are non-GAAP metrics) organic net revenue growth of 6%-7% (up from 5%-7% previously) and adjusted diluted EPS growth of 12%-14% (up from 11%-13% previously) on an annual basis in 2021 as its business steadily recovers from the worst of the coronavirus ('COVID-19') pandemic. **Shares of PM yield ~4.8% as of this writing and we continue to like the firm as an idea in our High Yield Dividend Newsletter portfolio.**

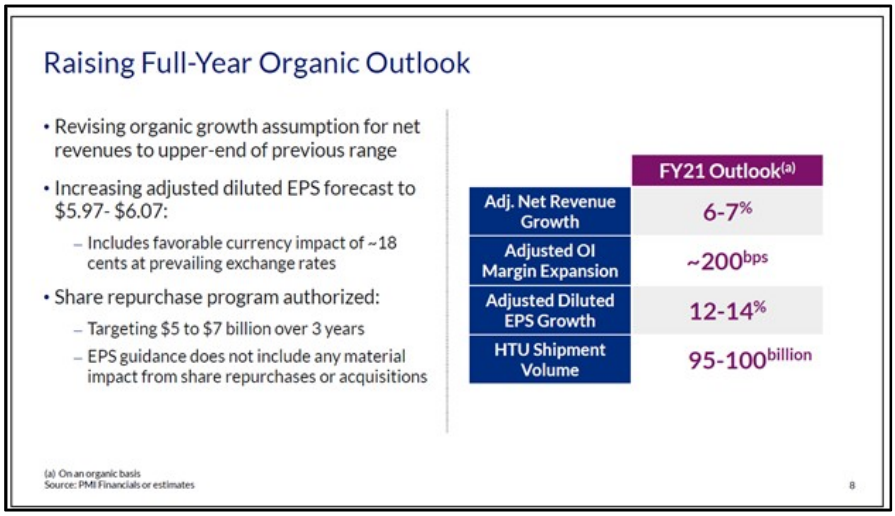


Image Shown: *Philip Morris boosted its full-year guidance for 2021 during its second quarter earnings report.* ***Image Source:*** *Philip Morris – Second Quarter of 2021 IR Earnings Presentation*

Shares of PM sold off initially after its second quarter earnings were published, potentially due to the guidance boost being smaller than what the market was looking for, though there is a good chance Philip Morris' current guidance is still conservative. **By the end of normal trading hours on July 30, shares of PM had more than recovered all their lost ground and then some**, as investors apparently warmed up to the company's major transformation story (one that we will cover in this article).

Financial and Operational Update

During the second quarter of 2021, Philip Morris' GAAP net revenues climbed higher by 14% year-over-year and its GAAP gross profit expanded by 17% year-over-year as its business continues to rebound. The firm's GAAP operating income grew by 15% year-over-year in the second quarter as Philip Morris reinvested some of its gross profit growth back into the business in the form of increased marketing, administration, and research expenses. Sales volumes of its traditional cigarette offerings grew by 3% year-over-year while sales volumes of its heated tobacco unit ('HTU') offerings grew by 30% year-over-year in the second quarter. Philip Morris also refers to some of its non-traditional nicotine offerings as reduced risk products ('RRPs').

As it concerns its traditional cigarette unit volumes, Philip Morris reported strength at its European Union, Middle East & Africa, South & Southeast Asia, and Latin America & Canada geographical segments last quarter. The company's HTU offerings experienced widespread unit volume growth across the board in the second quarter. In the US, Philip Morris has an exclusive licensing agreement with Altria Group Inc (MO) to sell its IQOS HTU offering. Pivoting to China, Philip Morris has had licensing agreements in the past, though very little information is publicly available on the subject (including in its latest 10-K SEC filing).

When excluding the US and China, Philip Morris views its market share of the cigarette and HTU industry standing at 27.3% in the second quarter of 2021. Furthermore, Philip Morris views its IQOS offering as having a user base of 20.1 million at the end of June 2021, with 14.7 million of those users represented by former smokers of traditional cigarettes that have since made the switch and stopped smoking traditional cigarettes. Its IQOS user base has grown at a steady clip of late with ample room for additional upside, in our view and the view of Philip Morris.

This year, Philip Morris aims to sell 95 billion – 100 billion HTUs, led by its IQOS offering. Scale at its HTU business combined with a rebound at its traditional cigarette business is expected to support its margins going forward. Now Philip Morris forecasts that it will see its total cigarette and HTU volumes either come in flat or grow by 2% this year, versus previous guidance that called for a decline of 1%-2% in its cigarette and HTU volumes. On an organic basis, Philip Morris aims to grow its non-GAAP adjusted operating margin by 200 basis points this year.

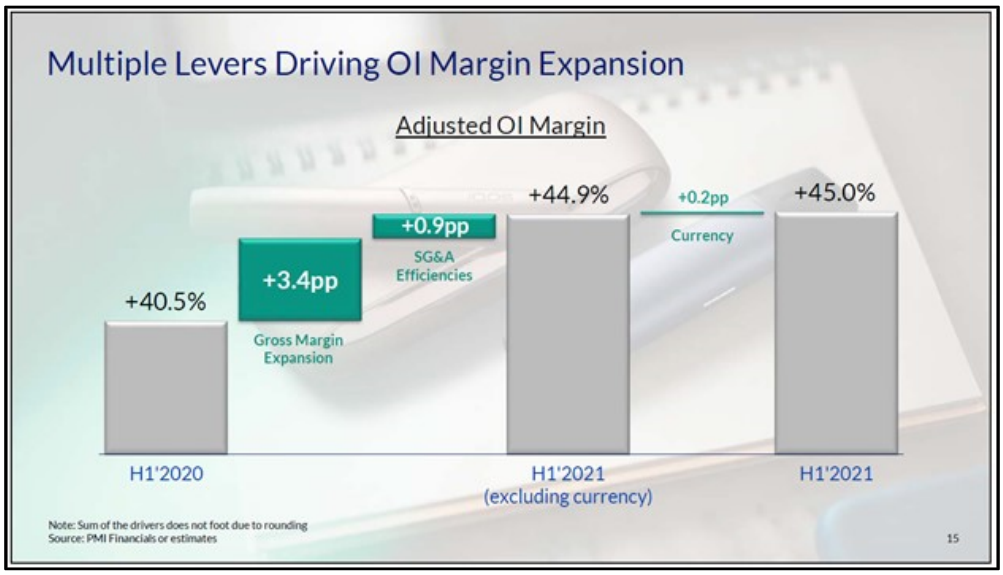


Image Shown: *A look and what is driving Philip Morris' adjusted non-GAAP operating margin higher.* ***Image Source:*** *Philip Morris – Second Quarter of 2021 IR Earnings Presentation*

In the second quarter of 2021, smoke-free products represented 29% of Philip Morris' net revenues. The launch of IQOS ILUMA in Japan in August 2021 is expected to help keep the momentum going on this front. **Philip Morris aims to generate the majority of its net revenues from smoke-free products over the coming years.** It also expects to invest more in its business, with an eye towards research and new product launches, during the second half of 2021 compared to the first half which will create short-term headwinds for its margins. However, **we view this strategy quite favorably as it better positions the company over the long haul as Philip Morris' long-term revenue growth outlook continues to improve.**

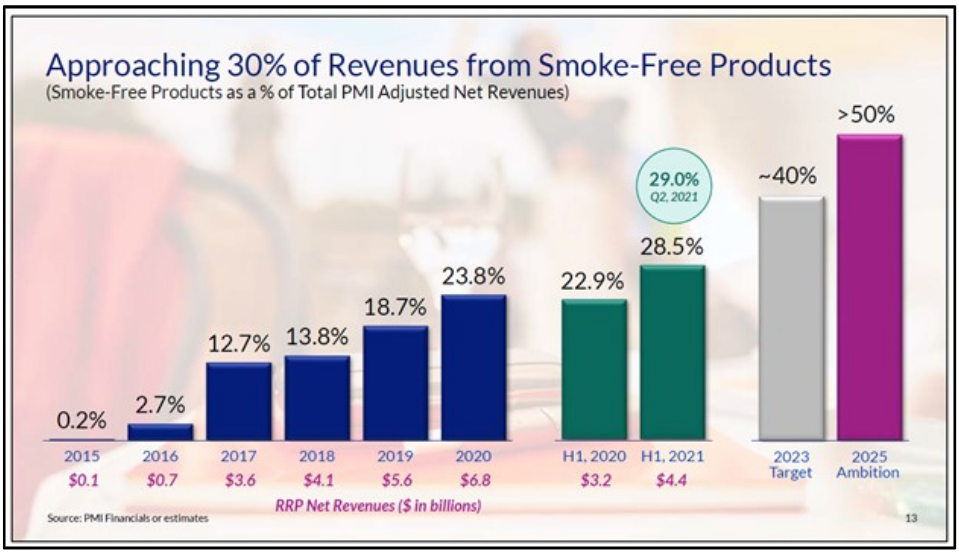


Image Shown: *Philip Morris aims to aggressively grow the net revenues from its RRPs, such as its HTU offerings led by its IQOS products, over the coming years.* ***Image Source:*** *Philip Morris – Second Quarter of 2021 IR Earnings Presentation*

During Philip Morris' big investor day update in February 2021, the firm noted it intended to roll out its IQOS offering in 100 markets by the end of 2025 versus 64 markets at the end of 2020. Additionally, the firm forecasted it will generate mid-to-high single-digit annual adjusted diluted EPS growth through 2023 (aided by its annual HTU unit volumes hitting 140 billion – 160 billion by 2023). By 2023, roughly 40% of Philip Morris' revenues is expected to come from smoke-less products, which is expected to grow to over half by 2025. We are impressed by Philip Morris' past performance and goals on this front.

Image Shown: *Philip Morris continues to innovate, seen through its planned new product launches.* ***Image Source:*** *Philip Morris – Second Quarter of 2021 IR Earnings Presentation*

Other than its upcoming IQOS ILUMA launch, Philip Morris is working towards launching its IQOS VEEV product (an e-vapor product built using its MESH technology) in over 20 markets this year. We are intrigued by Philip Morris' focus on innovation. **As the company scales up this part of its business, its margins should steadily improve over time.**

Image Shown: *Philip Morris is building on the success of its IQOS offering while also making investments in technologies that will make it easier to comply with regulatory and societal requirements as it concerns nicotine use.* ***Image Source:*** *Philip Morris – Second Quarter of 2021 IR Earnings Presentation*

Capital Allocation Priorities Update

Philip Morris also announced during its latest earnings report that it had initiated a share buyback program with up to $7.0 billion in share repurchasing authority. The firm plans to repurchase $5.0-$7.0 billion of its stock over the next three years starting in the third quarter of 2021. **Here, we would like to stress that this move represents a material change from Philip Morris' past capital allocation priorities** given the firm has not repurchased a meaningful amount of its stock for some time (historically, Philip Morris has prioritized dividend obligations and investing in its business). Our fair value estimate for Philip Morris sits at $99 per share with the top end of our fair value estimate range sitting at $119 per share.

We view the company's nascent share repurchase strategy favorably if done in moderation, given that Philip Morris is a tremendous free cash flow generator. A cash flow statement was not included in its latest earnings press release, though the company is guiding to generate around $11.0 billion in operating cash flow this year (subject to working capital adjustments and foreign currency fluctuations) while its capital expenditure forecast for 2021 sits at *just* $0.8 billion (given its relatively asset-light business model, which we are big fans of). Those operating cash flow and capital expenditure forecasts were unchanged versus the forecasts the firm put out during the first quarter of 2021.

Philip Morris had a net debt load of ~$24.2 billion (inclusive of short-term debt) at the end of June 2021, with its $4.9 billion cash and cash equivalents position supporting its near-term financing needs. The company retains solid access to capital markets (both debt and equity markets) and had a reasonable net debt to adjust EBITDA ratio of 1.74x at the end of June 2021.

Adjacent Opportunities

Philip Morris understands over the years and decades to come, its traditional cigarette business will continue to represent a much smaller part of its overall operations. While the firm can lean on its brand power and pricing strength to offset those headwinds (at least to a degree), eventually headwinds from reduced sales volumes will become nearly impossible to meaningfully offset via pricing increases alone. Traditional cigarette sales volumes across the globe are in secular decline and there is nothing that can change that, in our view. Its IQOS offering is one way Philip Morris is adapting to the changing landscape, but it is not the only card the company has up its sleeve.

Another way that Philip Morris is adapting is by seeking growth in what the firm views as adjacent industries. On July 1, Philip Morris announced it was acquiring privately-held Fertin Pharma through a deal with an enterprise value of ~$0.8 billion. Fertin Pharma is billed as "a leading developer and manufacturer of innovative pharmaceutical and well-being products based on oral and intra-oral delivery systems" with over 850 employees across Denmark, India, and Canada. In 2020, Fertin Pharma generated approximately $0.15 billion in revenue and the transaction values the firm at roughly 15x its 2020 EBITDA according to the press release. The deal is expected to close in the fourth quarter of 2021.

On July 9, Philip Morris announced it was acquiring Vectura Group (VEGPF) through a deal with an enterprise value of ~$1.2 billion. Vectura "is a provider of innovative inhaled drug delivery solutions that enable partners to bring their medicines to patients" and "has thirteen key inhaled and eleven non inhaled products marketed by major global pharmaceutical partners, as well as a diverse portfolio of partnerships for drugs in clinical development" according to the press release. Vectura generated approximately $0.25 billion in revenue in 2020 and the transaction values the firm at roughly 14x its 2020 EBITDA, with the deal expected to close in the second half of 2021.

Please note that certain funds managed by Carlyle Group Inc (CG) have also placed a bid to purchase Vectura, which was announced before Philip Morris' bid. After the news of Philip Morris' bid broke, Carlyle Group's relatively new Murano Bidco entity put out a press release noting that it "is considering its options and a further announcement will be made in due course." We are keeping an eye on the development.

The goal is for Philip Morris to utilize these acquisitions to build up a sizable "Beyond Nicotine" business, as the company puts it, that by 2025 will be capable of generating at least $1.0 billion in annual net revenues (according to the firm's forecasts). Philip Morris intends to use cash on hand, its access to capital markets (particularly debt markets), and impressive free cash flow generating abilities to fund these acquisitions and its endeavors in this arena.

We are intrigued, though these are still early days, as it appears Philip Morris is focusing on the licensing side of this space. If successful, having a sizable licensing business in the realm of life sciences and consumer health can be quite the lucrative endeavor, and Philip Morris has the financial capacity to make material R&D investments towards these goals. Here is what management had to say on the subject during the firm's latest earnings call (lightly edited, emphasis added):

> *"The proposed acquisition of Fertin Pharma and Vectura can enable us to more rapidly expand our development capabilities in innovative, in health, and oral product formulation while continuing to grow their respective CDMO [contract development and manufacturing organization] activities.* ***Fertin has a range of promising oral delivery technology, including pouches, gum, and lozenges, which can be applied in both the Modern Oral Nicotine and Beyond Nicotine areas, notably for self-care wellness product.***
>
> *With Vectura, we would gain access to differentiated proprietary technology and pharmaceutical development expertise to deliver a broad range of complex inhaled therapies.* ***Vectura has highly complementary human capital, technology, high quality infrastructure, and deep know-how of inhalable formulation and device design development and analysis, drug device combination, and pharmaceutical management processes and system.***
>
> *These proposed acquisitions would fully leverage PMI's [Philip Morris] existing capability in life science, product innovation, and clinical expertise related to inhalation. Such acquisitions can also enhance our progress on important sustainability priorities. Firstly, building our capabilities in Modern Oral is a key enabler of broadening the reach and access of our smoke-free alternative to other smoker[s] around the world.*
>
> *And secondly, building a strong Beyond Nicotine business is a major objective as we strive to develop commercially successful product with a net positive impact on society.* ***On ESG and sustainability, more broadly, we are firm believers in the power of investor engagement to drive positive change."*** *--- Emmanuel Babeau, CFO of Philip Morris since May 2020*

As a relevant aside, Philip Morris announced in June 2021 that it was moving its US corporate headquarters (which handles its Americas and other global operations) from New York to Connecticut, while keeping its 'Operations Center' in Lausanne, Switzerland. The new US corporate headquarters is expected to be operational by the summer of 2022.

Philip Morris' relatively new CEO, Jacek Olczak, noted in the June 2021 press release that "we are amid a profound transformation at [Philip Morris]" and that "our new base in Connecticut will serve to accelerate our progress. Beyond replacing cigarettes with better alternatives, we intend to draw on our expertise in life and medical sciences to develop solutions in areas that include respiratory drug delivery and botanicals." We are intrigued by the news, and its recent acquisition activity provides greater color on why the company decided to move its corporate headquarters.

Image Shown: *An overview of the rationale behind Philip Morris' pending acquisitions of Fertin Pharma and Vectura.* ***Image Source:*** *Philip Morris – Second Quarter of 2021 IR Earnings Presentation*

Concluding Thoughts

Since the start of 2021, Philip Morris has made some pretty big moves that over time should fundamentally transform the company for the better. It remains committed to its dividend obligations and is laying the groundwork for sustained revenue growth over the coming years as the traditional tobacco industry grapples with negative longstanding trends, namely the secular decline of cigarette volumes. **We are intrigued by Philip Morris' ongoing transformation and appreciate the boost in its near-term guidance provided during its second quarter earnings report.**

The company's changing capital allocation priorities need to be monitored given that Philip Morris' dividend obligations are quite sizable, though we do not expect management will fundamentally alter the firm's commitment to its dividend. Philip Morris understands that it needs to prepare for a future where traditional tobacco use plays a much smaller role (or no role whatsoever) in the daily activities of consumers across the globe. These moves that Philip Morris is making should significantly improve its revenue growth trajectory over the coming years and decades, which over time will have a powerful impact on its future forecasted net operating cash flows and most importantly, future forecasted free cash flows.

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

Bank Earnings Solid During Second Quarter 2021

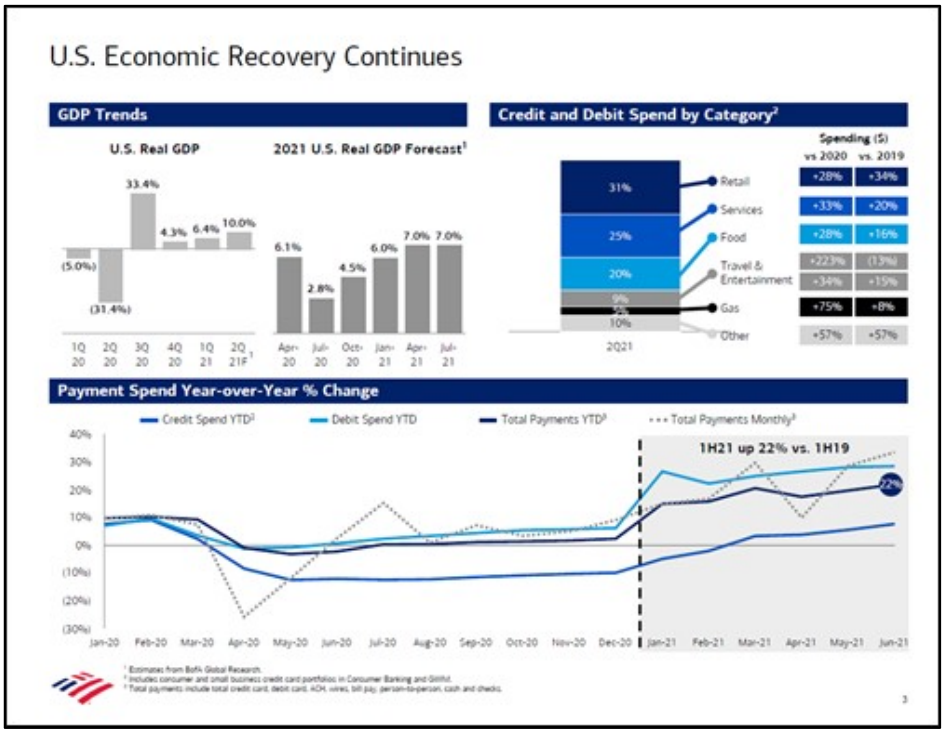


Image Source: *Bank of America Corporation – Second Quarter of 2021 IR Earnings Presentation*

In Alphabetical Order by Ticker: BAC, MS, JPM

By Callum Turcan

In this note, we cover three recent reports from the banking industry as earnings season gets underway. Ongoing coronavirus ('COVID-19') vaccine distribution efforts are enabling the domestic economy to reopen in earnest, and consumers are beginning to return to "pre-pandemic activities," though the risk of variants remains. **In our view, the outlook for the US economy is quite bright.** The outlook for net interest margins ('NIMs') should improve alongside the domestic economy, though yields remain rather low as of this writing and lackluster NIMs weighed on the performance of the banking space at-large last quarter.

Bank of America (BAC)

On July 14, Bank of America Corporation (BAC) reported second quarter 2021 earnings that missed consensus top-line estimates but beat consensus bottom-line estimates. **The firm's bottom-line benefited from a large net-credit-loss reserve release** after it set aside billions last year to cover potential loan losses during the initial phases of the COVID-19 pandemic. Deposits were up 14% year-over-year company-wide and Bank of America had a Common Tier 1 standardized equity ratio of 11.5% in the second quarter of 2021 (the minimum requirement is a ratio of 9.5% according to the firm).

Bank of America launched a $25 billion share buyback program in April 2021 and repurchased $4.2 billion of its stock last quarter. In June 2021, the firm announced it would boost its quarterly dividend 17% effective in the third quarter after a successful Fed stress test. The company's efficiency ratio (non-interest expenses divided by revenues) stood at 70% in the second quarter of 2021, up sharply from year-ago levels though this is partially due to the firm contributing $0.5 billion to the Bank of America foundation and partially due to the $0.3 billion in increased expenses associated with unemployment claims last quarter.

Its digital strategy continues to play out favorably, with 40.5 million active digital banking users last quarter at its Consumer Banking unit, up 3% year-over-year. Bank of America's net charge-off ratio fell to 0.27% in the second quarter of 2021 from 0.45% in the same period a year ago. Here is what management had to say regarding Bank of America's net charge off situation during the firm's latest earnings call (emphasis added):

> *"Net charge-off this quarter fell to $595 million or 27 basis points of average loans.* ***This is the lowest loss rate in more than two decades.*** *That is 28% lower than Q1 and more than 30% below the Second Quarter of 2019." --- Paul Donofrio, Bank of America's CFO*

Bank of America noted in its earnings presentation that "credit card delinquencies remain below pre-pandemic levels as deferrals expired and balances declined" which is a promising sign.

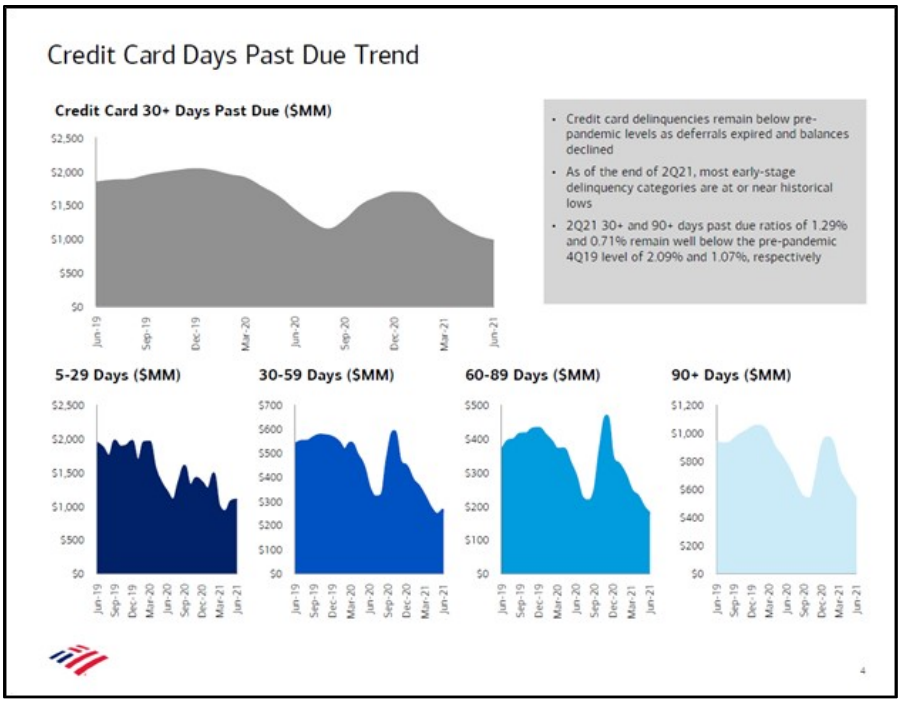


Image Shown: *Bank of America's credit card delinquency rates have been aggressively trending in the right direction of late.* ***Image Source:*** *Bank of America Corporation – Second Quarter of 2021 IR Earnings Presentations*

The company's return on average tangible common shareholders' equity stood at 19.9% in the second quarter versus 7.6% in the same quarter the prior year. **Bank of America is a rock-solid enterprise and remains one of our favorite banks out there. At its proposed payout rate, shares of BAC yield ~2.2% on a forward-looking basis as of this writing.**

Morgan Stanley (MS)

On July 15, Morgan Stanley (MS) reported second-quarter 2021 earnings that beat both consensus top- and bottom-line estimates, **aided by a sharp reduction in its provision for credit losses as the economy continues to improve.** Strength at its 'Wealth Management' and 'Investment Management' businesses was also key to its strong financial performance. The firm recently doubled its quarterly dividend and boosted its share repurchase program up to $12 billion over the next year after a successful Fed stress test.

Morgan Stanley recently acquired E*TRADE Financial through an all-stock deal worth ~$13 billion and Eaton Vance through a cash-and-stock deal worth ~$7 billion. When removing integration-related expenses, Morgan Stanley generated a return on tangible common equity ('ROTCE') of 19.0% in the second quarter (up from 17.8% in the same period the prior year). The firm had an efficiency ratio of 68% (flat year-over-year) and its Common Tier 1 standardized capital ratio stood at 16.7% in the second quarter of 2021.

James Gorman, CEO of Morgan Stanley, noted during the company's latest earnings call that "given our current earnings momentum, it takes some time to fully distribute that capital, but we feel strongly that this year is the time to make a big start." Things are looking up for Morgan Stanley and the market is clearly taking notice given the impressive technical performance seen at shares of MS year-to-date. **Shares of MS yield ~2.9% on a forward-looking basis as of this writing.**

JPMorgan (JPM)

On July 13, JPMorgan Chase & Co (JPM) reported second-quarter 2021 earnings that beat both consensus top- and bottom-line estimates, **with a large net credit reserve release providing a powerful uplift to its earnings.** Excluding the net credit reserve release, JPMorgan reported a ROTCE of 18% last quarter (its ROTCE stood at 23% when including the reserve release), up sharply from the 9% it reported in the same period last year. Its Common Tier 1 standardized capital ratio stood at 13%, its outstanding loans were broadly flat year-over-year, and its deposits were up 23% year-over-year last quarter.

2Q21 Reserves

Allowance for credit losses ($B)

	Jan 1, 2020	Jun 30, 2020	Mar 31, 2021	2Q21 Build / (release)	Jun 30, 2021
Consumer					
Card	$11.2	$17.8	$14.3	($1.8)	$12.5
Home Lending	2.0	3.2	1.4	(0.6)	0.8
Other Consumer[1]	1.0	1.9	1.5	(0.2)	1.3
Total Consumer	**14.2**	**22.9**	**17.1**	**(2.6)**	**14.5**
Wholesale[1]	**4.4**	**11.4**	**8.4**	**(0.4)**	**8.0**
Securities	**0.0**	**0.0**	**0.1**	**(0.0)**	**0.1**
Firmwide	**$18.6**	**$34.3**	**$25.6**	**($3.0)**	**$22.6**

Note: Totals may not sum due to rounding
[1] Other Consumer includes AWM's mortgage portfolio and excludes risk-rated Business Banking and Auto dealer portfolios that are classified in Wholesale

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JPMORGAN CHASE & CO.

Image Shown: *The improving outlook for the US economy played a leading role in enabling JPMorgan to reverse the huge build up in its loan loss reserves that occurred last year in the wake of the initial stages of the COVID-19 pandemic.* ***Image Source:*** *JPMorgan – Second Quarter of 2021 IR Earnings Presentation*

The company's adjusted overhead ratio (similar to adjusted efficiency ratio) stood at 56% last quarter, up from 50% in the second quarter of 2020, though flat sequentially. During JPMorgan's latest earnings call, management stated that the firm had recently raised its full-year expense guidance and noted that volume and revenue-related expenses, along with a fierce market for banking talent, were key drivers behind the expense guidance increase. Its 'Asset & Wealth Management' unit more than doubled its net income last quarter on a year-over-year basis.

Jamie Dimon, JPMorgan's CEO, stated that "we're going to be competitive in comp no matter what it takes" and JPMorgan's CFO, Jeremy Barnum, followed up to that statement by noting "it's also transaction-related volumes. It's also marketing expense in certain pockets. So, it's all the stuff that fits in the category of volume and revenue-related." The company intends to continue investing in the business to remain competitive as pockets of the global economy begin to emerge from the COVID-19 pandemic, creating ample opportunities for JPMorgan to capitalize on.

2Q21 Financial results[1]

$B, except per share data

	2Q21	$ O/(U) 1Q21	$ O/(U) 2Q20
Net interest income	$12.9	($0.1)	($1.1)
Noninterest revenue	18.5	(1.6)	(1.3)
Managed revenue[1]	**31.4**	**(1.7)**	**(2.4)**
Expense	**17.7**	**(1.1)**	**0.7**
Credit costs	**(2.3)**	**1.9**	**(12.8)**
Net income	**$11.9**	**($2.4)**	**$7.3**
Net income applicable to common stockholders	$11.5	($2.4)	$7.2
EPS – diluted	$3.78	($0.72)	$2.40
ROE[2]	18%	23%	7%
ROTCE[2,3]	23	29	9
Overhead ratio – managed[1,2]	56	57	50
Memo: Adjusted expense[4]	*$17.5*	*($1.2)*	*$0.7*
Memo: Adjusted overhead ratio[1,2,4]	*56%*	*56%*	*50%*

$B	2Q21	1Q21	2Q20
Net charge-offs	$0.7	$1.1	$1.6
Reserve build/(release)	(3.0)	(5.2)	8.9
Credit costs	**($2.3)**	**($4.2)**	**$10.5**

2Q21 Tax rate
Effective rate: 20.9%[5]
Managed rate: 25.4%[1,5]

2Q21	ROE	O/H ratio
CCB	44%	55%
CIB	23%	49%
CB	23%	40%
AWM	32%	63%

Note: Totals may not sum due to rounding
[1] See note 1 on slide 11
[2] Actual numbers for all periods, not over/(under)
[3] See note 3 on slide 11
[4] See note 4 on slide 11
[5] See note 3 on slide 12
[6] Reflects fully taxable-equivalent ("FTE") adjustments of $916mm in 2Q21

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JPMORGAN CHASE & CO.

Image Shown: *An overview of JPMorgan's recent financial performance.* ***Image Source:*** *JPMorgan – Second Quarter of 2021 IR Earnings Presentation*

Pivoting now, here is what JPMorgan's management team had to say on the net charge-offs and reserve release situation during the firm's latest earnings call (emphasis added):

> *"And then on credit costs, going back to last year again, you will recall,* ***in last year's second quarter, we built $8.9 billion in credit reserves during the height of the pandemic, whereas this year, we released $3 billion.*** *So in this quarter, credit costs were a net benefit of $2.3 billion. And setting aside the reserve release,* ***it's also worth noting that net charge-offs of just over $700 million were half of last year's second quarter number and continue to trend near historical lows.****" --- CFO of JPMorgan*

JPMorgan also had a successful Fed stress test and recently boosted its quarterly dividend 11% sequentially, bringing it up to $1.00 per share starting in the third quarter. The firm spent $5.9 billion buying back its common stock last quarter and continues to focus on distributing cash back to shareholders in light of the improving macro backdrop. **JPMorgan is one of the strongest banking institutions out there, and we are fans of the name. Shares of JPM yield ~2.6% as of this writing at the new payout level.**

Concluding Thoughts

After reviewing the second quarter earnings reports of several major US banking institutions, the domestic economy continues to stage an impressive though uneven economic recovery. **Net credit write-offs have been trending aggressively lower of late, a welcome sign. Banks are taking advantage of their improving financial outlook and have been aggressively rewarding shareholders via dividend increases and/or large share buyback programs.**

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

Enterprise Products Partners and Magellan Midstream Partners Best of Breed Pipeline MLPs

By Brian Nelson, CFA

Reports are coming in during this second-quarter earnings season, and thus far, they haven't been too shabby. Two of our pipeline MLP ideas in the High Yield Dividend Newsletter portfolio, Enterprise Products Partners (EPD) and Magellan Midstream Partners (MMP), have been performing well during 2021. Enterprise Products is up nearly 19% year-to-date while Magellan Midstream is up over 12%. Though this isn't blockbuster performance relative to the S&P 500, their respective distribution yields of ~7.75% and 8.6% make the all-in performance quite respectable.

Image shown: *The price performance of Enterprise Products Partners from the March 2020 bottom.*

Enterprise Products has been one of our favorite pipeline MLPs for some time, as it was an early adopter in including a measure of free cash flow in its quarterly press releases. The company's measure of free cash flow soared to $1.39 billion during the three months ended June 30, report released July 28, relative to the $305 million mark in the year-ago period. Distributable cash flow (DCF) was roughly flat, edging up to $1.6 billion from $1.58 billion in the year-ago period. We especially liked its disciplined capital investment of $634 million relative to operating cash flow generation of nearly $2 billion in the period. EPD last raised its distribution in January, a decent 1.1% increase, to $0.45 on a quarterly basis.

Image shown: *The price performance of Magellan Midstream Partners from the March 2020 bottom.*

We're also big fans of Magellan Midstream, in part, because it, too, reports a measure of free cash flow in press releases. As outlined in its second-quarter report, released July 29, the midstream entity is targeting free cash flow of nearly $1.27 billion for full-year 2021, a tally that it says will be more than $350 million greater than distributions. Though we like this distribution coverage with free cash flow quite a bit, Magellan did note that it "intends to maintain its quarterly cash distribution at the current level of $1.0275 per unit for the remainder of 2021." We have no qualms with that, as its distribution yield of ~8.6% is quite attractive, more than twice the yield of junk-rated debt.

We continue to cast a cautious eye on midstream pipeline plays, especially as many continue to cut their distributions. One of the most recent cuts was Shell Midstream Partners (SHLX), which slashed its payout nearly 35% July 22. The complexity of the MLP business model coupled with their capital-market dependence risk makes the group highly risky, but Enterprise Products and Magellan Midstream remain two of the best ways to gain exposure to this troubled sector. Both report a form of free cash flow, too, which makes them much more shareholder-friendly than others only reporting distributable cash flow. We don't plan to make any changes to their weightings in the High Yield Dividend Newsletter portfolio at this time; both garner a target weighting of ~2.5%.

Enterprise 2021 Financial Outlook

Capital Expenditure Updates

- Currently forecasting 2021 and 2022 growth capital of ≈$1.7B and $800MM, respectively*
  - Based on sanctioned projects to date only
- Projected 2021 Sustaining Capital Expenditures: $440MM
  - Including $115MM for turnarounds at PDH and octane enhancement facilities, which were completed 1H21

Maintain and Protect Balance Sheet

- Leverage Ratio: 3.5x target area (+/– 0.25x); 12 months ended June 30, 2021 was 3.24x
- Liquidity(1): $5.4 billion comprised of available credit capacity and unrestricted cash

Returning Capital to Investors

- Distribution declared with respect to 2Q 2021 was $0.45/unit payment; 1.1% increase over 2Q 2020
- CFFO Payout Ratio(2): 60% for the 12 months ended June 30, 2021
- Since our IPO, we have increased distributions 22 years in a row and returned $40.8 billion of capital to equity investors via LP distributions and unit buybacks

* Excludes capital investments associated with SPOT export terminal, which is pending governmental approval
(1) As of June 30, 2021
(2) See definitions

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enterpriseproducts.com Page 5

Image Shown: *An overview of Enterprise Products' near-term outlook.* ***Image Source:*** *Enterprise Products – Second Quarter of 2021 IR Earnings Presentation*

Disclosure: *Brian Nelson owns shares in SPY, SCHG, QQQ, DIA, VOT, and IWM. Brian Nelson's household owns shares in HON, DIS, HAS. Valuentum owns shares in VOO, SCHG, DIA, and QQQ.*

Key Contributors

- Brian Nelson, CFA
President, Investment Research
brian@valuentum.com

- Callum Turcan
Associate Director of Research, Co-Editor of Valuentum's Newsletters, Portfolio Manager
callum@valuentum.com

Disclosure: *Unless otherwise noted, 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%	3.21%
SPDR Portfolio S&P 500 High Dividend ETF	SPYD	5.0%	4.82%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	4.80%
iShares International Select Dividend ETF	IDV	5.0%	4.35%
iShares U.S. Preferred Stock ETF	PFF	5.0%	4.47%
Global X SuperDividend ETF	SDIV	5.0%	7.34%
Global X SuperIncome Preferred ETF	SPFF	10.0%	5.62%
Vanguard Consumer Staples ETF	VDC	5.0%	2.39%
Vanguard Real Estate ETF	VNQ	10.0%	2.99%
Utilities Select Sector SPDR	XLU	5.0%	2.99%
EQUITY			
AT&T	T	5.0%	7.42%
Crown Castle	CCI	5.0%	2.76%
CyrusOne Inc.	CONE	5.0%	2.92%
CubeSmart	CUBE	5.0%	2.74%
Digital Realty Trust	DLR	5.0%	3.01%
Philip Morris	PM	5.0%	4.80%
Public Storage	PSA	5.0%	2.56%
Enterprise Products Partners	EPD	2.5%	7.98%
Magellan Midstream Partners	MMP	2.5%	8.82%
Cash*	-	0.0%	0.00%
		100.0%	**4.31%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 8/1/2021. Est. Forward 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 10-Jul-2021 | Data as of 9-Jul-2021

Gilead Sciences GILD 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	$53.00 - $88.00	HEALTHY	GOOD / 1	GOOD	4.15%

Assessment of Company Dividend Strategy

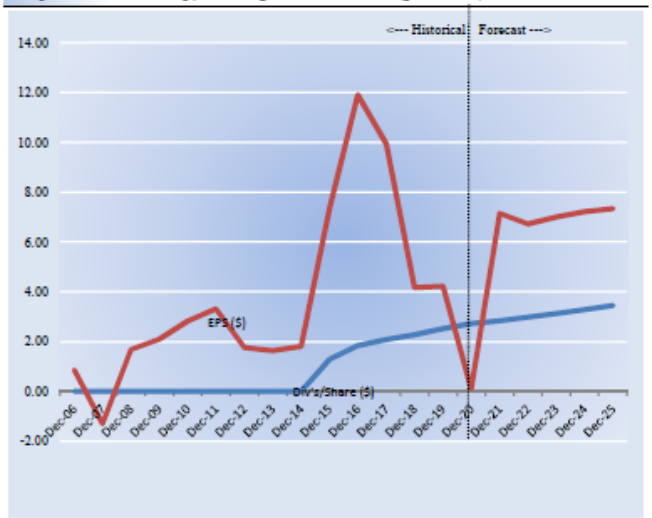
Key Strengths

Gilead's business has been transformed thanks to the success of its hepatitis-C cure. The company has a long history in developing HIV therapies, and it's working to develop more treatments. Free cash flow generation has been pressured alongside HCV revenue erosion, but the long-term health of Gilead's dividend will be dependent on advances across its pipeline, including hematology/oncology, cardiovascular and inflammatory diseases. We like the diversification and oncology presence the Kite Pharma (completed in October 2017) and Immunomedics (completed in October 2020) deals provides, even though both acquisitions impacted Gilead's balance sheet health.

Potential Weaknesses

Gilead's hepatitis-C franchise fueled the company's phenomenal free cash flow generation in the recent past, but competitive challenges have effectively truncated the opportunity, both with respect to pricing and volume. Political risk remains another key challenge for Gilead, as lawmakers continue to evaluate the pricing policies of drug makers. We weren't at all pleased to see Gilead expand its debt load, and we're not completely comfortable with share buybacks given questions over the sustainability of earnings. The company's HCV product concentration risk may give income investors reason for pause even if the financials look fine.

Graphical Relationship, Earnings and Dividends (per share)

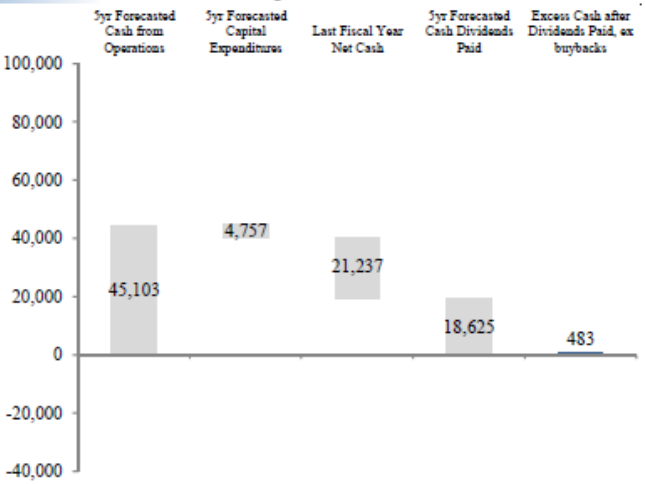


The graph above shows the relationship between a firm's earnings per share and its dividends per share.

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

Dividend Cushion Cash Flow Bridge

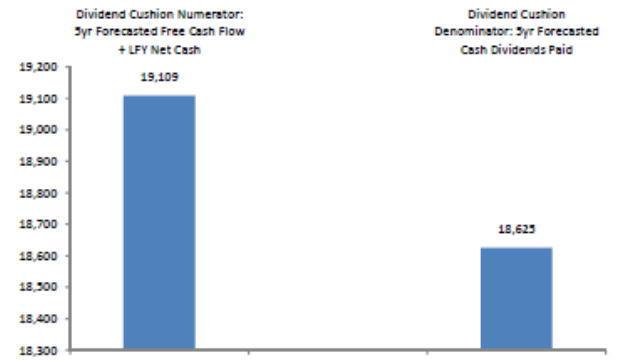


Source: Company Filings, Valuentum Projections

Dividend Cushion Ratio Evaluation

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

Dividend Cushion Ratio Deconstruction



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.

Disclosure: *Brian Nelson owns shares in SPY, SCHG, QQQ, DIA, VOT, and IWM. Brian Nelson's household owns shares in HON, DIS, HAS.*

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Amended June 1, 2021.