Sure Dividend

LONG-TERM INVESTING IN HIGH-QUALITY DIVIDEND STOCKS

The Complete Dividend Aristocrats in Focus Series

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Table of Contents

Introduction to The Dividend Aristocrats

The Dividend Aristocrats are an elite group of blue-chip dividend growth stocks. To be a Dividend Aristocrat, a stock must meet the following criteria:

1. Be a member of the S&P 500
2. Have paid 25+ years of consecutive rising dividends
3. Meet certain size and liquidity requirements

The Dividend Aristocrats have *outperformed the S&P 500… With lower volatility*. Over the last decade the Dividend Aristocrats index has generated annualized total returns of 18.5%, versus 16.7% for the S&P 500. That's 1.8 percentage points of outperformance annually. And, the Dividend Aristocrats index has done this with a price standard deviation of 12.2%, versus 12.9% for the S&P 500.
Source: S&P Dividend Aristocrats Fact Sheet

We believe the Dividend Aristocrats have outperformed because they have *durable competitive advantages and shareholder friendly managements*. A company must have both to increase its dividend through both bull and bear markets.

While the Dividend Aristocrats' performance has been impressive, not all Dividend Aristocrats are buys today. Some are overvalued with mediocre growth prospects. Others, however, appear poised to generate solid total returns ahead.

This special report has detailed analysis *on all 57 Dividend Aristocrats*. You can use the table of contents above to quickly jump to the ones you are most interested in. We have sorted our Dividend Aristocrats analysis by sector. Additionally, you can download a free spreadsheet of all 57 Dividend Aristocrats here.

Our 10 favorite Dividend Aristocrats today based on a mix of safety and expected total returns are listed below, in order with the best first. Click the links below to jump to detailed analysis for each specific Dividend Aristocrat:

1. AbbVie (ABBV)
2. Walgreens Boots Alliance (WBA)
3. AT&T (T)
4. Caterpillar (CAT)
5. Cardinal Health (CAH)
6. Target (TGT)
7. T. Rowe Price Group (TROW)
8. W.W. Grainger (GWW)
9. Chevron (CVX)
10. A.O. Smith (AOS)

Consumer Staples Dividend Aristocrats

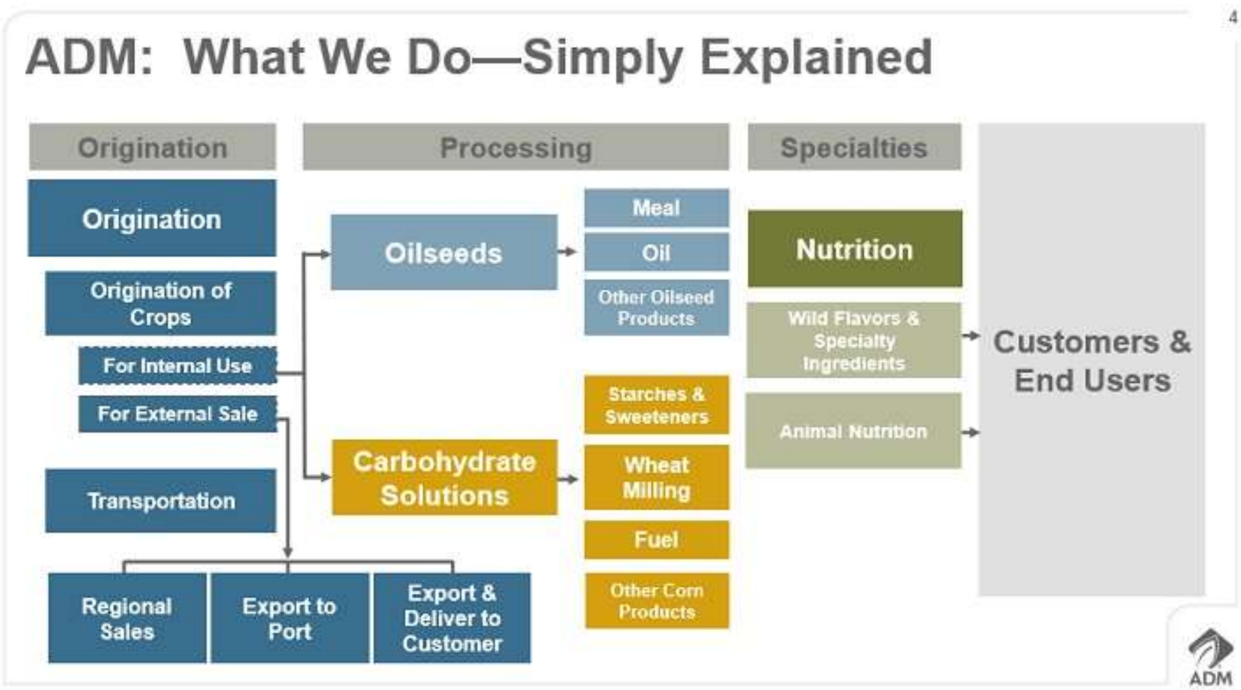
Archer-Daniels-Midland (ADM)

Business Overview

Archer Daniels Midland was founded in 1902, when George A. Archer and John W. Daniels began a linseed crushing business. In 1923, Archer-Daniels Linseed Company acquired Midland Linseed Products Company, which created Archer Daniels Midland.

Today, it is an agricultural giant. Archer-Daniels-Midland operates in 160 countries and generates annual revenue above $64 billion.

The company produces a wide range of products and services, designed to meet the growing demand for food due to rising populations.



Source: [Investor Presentation]

It operates four business segments: Origination, Oilseeds, Carbohydrate Solutions, and Nutrition. The Oilseeds segment is Archer Daniels Midland's largest, at 45% of annual profits, followed by Carbohydrate Solutions at 29%. The Origination and Nutrition segments comprise 17% and 10% of operating profit, respectively. The remaining 9% of operating profit is derived from a non-core ‘other’ segment.

Archer Daniels Midland is finally coming out of a prolonged downturn. The strong U.S. dollar and the decline in agricultural commodity prices, such as corn, weighed on the company's profitability for several years.

For example, company earnings fell 18% in 2015. Conditions did not improve much in 2016. Archer Daniels Midland's total sales fell 7.9% in 2016, along with a 27% decline in diluted earnings-per-share.

The good news is, Archer Daniels Midland remained profitable throughout the industry downturn, thanks to cost controls. The company launched an aggressive cost-cutting program in 2015 that had produced $200 million in annual run-rate cost savings by 2018.

And, industry conditions have finally improved, which set the stage for a return to growth.

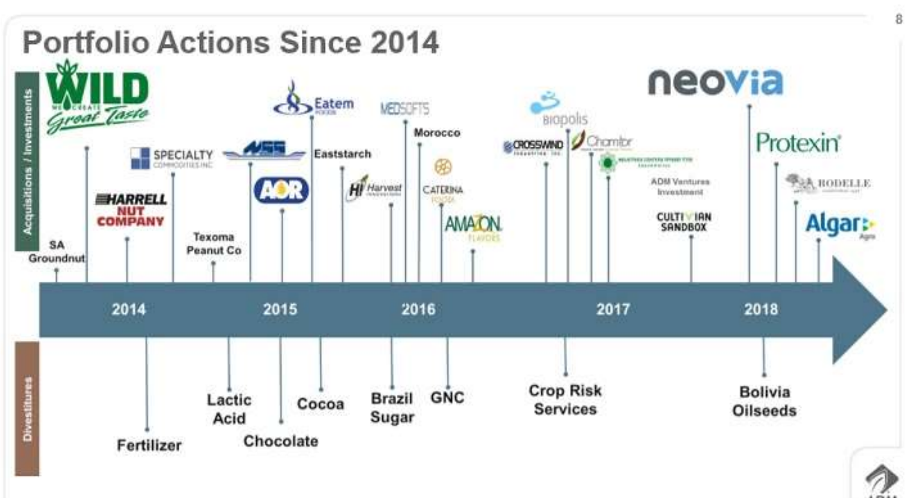
Growth Prospects

Conditions substantially improved for Archer Daniels Midland in 2018. In early February (2/5/18) the company reported fourth-quarter and full-year financial results. For the fourth quarter, adjusted earnings-per-share increased 7.3% from the same quarter a year ago.

Performance was mixed among Archer Daniels Midland's various operating segments. Operating profit more than doubled in Oilseeds, due to particularly strong demand for soybean meal. However, the Origination, Carbohydrate Solutions, and Nutrition segments posted declines in the fourth quarter.

Still, Archer Daniels Midland performed well in 2018. Adjusted earnings-per-share increased 44%, to $3.50.

Going forward, the company can still invest in growth initiatives to turn itself around. One of the ways is through portfolio optimization through acquisitions and divestitures.



Source: Investor Presentation

Archer Daniels Midland also frequently divests low-growth businesses, to further improve its portfolio. In total, the company has taken a number of actions to right the ship over the past several years.

Since 2014, Archer Daniels Midland invested more than $5 billion in new growth projects. This investment included building six new plants, five innovation centers and labs, 17 acquisitions, and four joint ventures.

Recent acquisitions are expected to boost growth in 2019. On January 17th the company announced it will acquire the remaining 50% stake in its Gleadell Agriculture Ltd. joint venture, including Dunns Ltd.

Archer Daniels Midland will combine its existing U.K. origination operations with the newly acquired businesses to create ADM Agriculture Ltd. This acquisition will increase Archer Daniels Midland's origination, storage, and destination market capabilities in the U.K.

Archer Daniels Midland is also expanding its animal nutrition business. In February, the company officially closed on its $1.8 billion acquisition of global animal nutrition leader Neovia.

Earnings will also be boosted by the company's share buybacks. This is a benefit of remaining consistently profitable during industry downturns—the company can use some of its excess cash flow to repurchase shares at lower prices.

Archer Daniels Midland reduced its diluted share count by 4.8% in 2016. It returned $1.7 billion to shareholders in dividends and share buybacks during the year.

Competitive Advantages & Recession Performance

Archer Daniels Midland has built significant competitive advantages over the year. It is the largest processor of corn in the world. This gives way to economies of scale and efficiencies in production and distribution.

The company has a $21.9 billion market capitalization. It is an industry giant, with 450 crop procurement locations, 270 food and feed ingredient manufacturing facilities, and 46 innovation centers.

At its innovation centers, the company conducts research and development on how to more effectively respond to changes in customer demand, and improving processing efficiency. Archer Daniels Midland has an unparalleled global transportation network, which serves as a huge competitive advantage.

The company's global distribution system provides the company with high margins and barriers to entry. In turn, this allows Archer Daniels Midland to remain highly profitable, even during industry downturns.

Profits held up, even during the Great Recession. Earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $2.38
- 2008 earnings-per-share of $2.84 (19% increase)
- 2009 earnings-per-share of $3.06 (7.7% increase)
- 2010 earnings-per-share of $3.06

Archer Daniels Midland's earnings-per-share increased in 2008 and 2009, during the Great Recession. Very few companies can boast such a performance, in one of the worst economic downturns in U.S. history.

The reason for Archer Daniels Midland's remarkable durability in recessions could be that grains still need to be processed and transported, regardless of the economic climate. There will always be a certain level of demand for Archer Daniels Midland’s products.

Valuation & Expected Returns

Archer Daniels Midland appears to be undervalued today. A breakdown of Archer Daniels Midland's historical price-to-earnings, price-to-book, and dividend yield can be seen in the table below:

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.7	8.5	9.5	10.3	13.1	17.6	13.5	15.4	18.8	19.9	***17.8***	***15.0***
Avg. P/B	1.6	1.4	1.3	1.1	1.1	1.2	1.5	1.5	1.4	1.3	***1.4***	***1.3***
Avg. Yld.	1.3%	2.1%	2.0%	1.9%	2.3%	2.8%	2.1%	2.4%	3.0%	3.0%	***2.8%***	***3.2%***

In this case, we also recommend investors utilize the price-to-book ratio for valuation purposes. Archer Daniels Midland's profits are volatile and fluctuate with the price of grains and commodities like oil. When oil prices are low, ethanol demand declines, which hurts Archer Daniel Midland's profits.

The company's book value is far more stable and gives a better idea of the company's 'real' value relative to its history.

Archer Daniel Midland's 10 year average price-to-book ratio is 1.36. Based on 2018 book value of $35 per share, the stock has a current price-to-book ratio of 1.19. As a result, the stock appears to be a bit undervalued at current prices on the basis of book value, our preferred valuation metric for this particular stock.

An expanding valuation multiple could generate 2.7% annual returns for shareholders over the next five years. Future returns will also be derived from earnings growth, and dividends. We expect Archer Daniels Midland to grow its future earnings by 4%-5% per year through 2024. And, the stock has a current dividend yield of 3.4%.

In this case, total expected returns are 10%-11% per year over the next five years. This is a strong expected rate of return for Archer Daniels Midland investors.

Final Thoughts

Archer Daniels Midland has encountered a difficult operating environment. It is being negatively impacted by declining prices of agricultural commodities and oil, which has weighed on its earnings in recent years.

With that said, the company has a long history of navigating through challenging periods. It has continued to generate profits and reward shareholders with rising dividends along the way.

The stock could be undervalued, and pays a solid 3.4% dividend plus annual dividend increases. As a result, Archer Daniels Midland appears to be an attractively valued dividend growth stock.

Brown-Forman (BF.B)

Business Overview

Jack Daniel's Tennessee Whiskey got its start all the way back in 1865, when Jack Daniel purchased Cave Spring Hollow. The following year, he registered the Jack Daniel Distillery, which stands today as America's oldest registered distillery.

Brown-Forman has a large product portfolio, which is focused on whiskey, vodka, and tequila. Its most famous brand is its flagship Jack Daniel's whiskey. Other popular brands include Herradura and el Jimador tequila, and Finlandia vodka.

Brown-Forman has focused its strategies on 10 core brands:

Source: [Investor Day Presentation]

In early December (12/5/18) Brown-Forman reported its financial [results] for the fiscal 2019 second quarter. The company reported revenue of $910 million for the second quarter, down 0.4% compared to the prior year's quarter. The revenue decline was surprising, but explained by tariffs announced last year, that pulled demand forward to the previous quarter.

In turn, demand was lower during the fiscal second quarter, as inventory levels were still relatively high at the beginning of the quarter. Fortunately, Brown-Forman expects that this impact is only temporary and that revenue will grow during coming quarters.

Brown-Forman's earnings-per-share increased 4% in the 2019 second quarter, and rose 8% through the first half of fiscal 2019. For the full year, the company expects sales growth of 6%-7%. Brown-Forman also recently announced a 5.1% dividend increase, its 35th consecutive year of dividend growth.

Next year and beyond, Brown-Forman will continue to benefit from its leading brand portfolio, with growth in new products and geographic markets.

Growth Prospects

Brown-Forman has continued to grow in the current fiscal year, and should maintain positive earnings growth over the long-term.

One of the most compelling growth catalysts for Brown-Forman is growth is the international markets. The company operates in 170 countries around the world. International sales now represent 53% of Brown-Forman's annual sales.

International growth is a major component of Brown-Forman's strategy, and particularly the emerging markets. Underlying net sales increased 10% in the emerging markets over the first half of fiscal 2019, compared with just 3% growth in the United States in the same period.

Brown-Forman is ideally positioned to capitalize on the growing demand for whiskey in the emerging markets.

Source: [Investor Day Presentation]

There is a great deal of growth potential for Brown-Forman in emerging markets such as China, India, and Mexico, all of which posted double-digit sales growth for the company over the first half of fiscal 2019. These countries are extremely attractive for Brown-Forman, as they hold large populations and high rates of economic growth.

Going forward, there is plenty of growth potential left, as the company further expands its product line, both inside and outside of its flagship Jack Daniels brand.

In the U.S., growth will be fueled by smaller premium brands such as Woodford Reserve, which reported double-digit sales growth in the fiscal 2019 first half. Woodford Reserve was the largest contributor to Brown-Forman's growth in the U.S. over the first half of the current fiscal year.

Separately, Brown-Forman is generating strong growth in tequila. Its Herradura and el Jimador brands each posted 10%+ sales growth over the first two quarters of fiscal 2019.

Competitive Advantages & Recession Performance

Brown-Forman has many competitive advantages. Its popular brands yield significant pricing power. And, it has a highly profitable business, with low manufacturing and distribution costs because of its global scale.

These qualities help Brown-Forman generate consistently high returns on invested capital. Return on capital exceeded 15% each year since 2008.

Brown-Forman is very resistant to recessions. This is typical among ‘sin’ stocks, as their products tend to be consumed in greater volume when economic times are tough. One could argue that alcohol manufacturers actually perform better during recessions.

Brown-Forman’s earnings-per-share through the Great Recession are shown below:

- 2007 earnings-per-share of $0.95
- 2008 earnings-per-share of $0.96 (1% increase)
- 2009 earnings-per-share of $1.03 (7.3% increase)
- 2010 earnings-per-share of $1.19 (15% increase)

As you can see, the company grew its earnings-per-share every year through the Great Recession. This is a rare accomplishment that demonstrates the company’s defensive business model. Put simply, spirits manufacturers such as Brown-Forman are among the most recession-resistant businesses.

Valuation & Expected Returns

We expect Brown-Forman to report earnings-per-share of $1.80 in fiscal 2019. Based on this, Brown-Forman stock trades for a price-to-earnings ratio of 26.4. Brown-Forman's valuation has come down since our report this time last year, when the stock traded with a price-to-earnings ratio above 30.

Still, Brown-Forman is valued significantly above the S&P 500 Index, and is also trading above our fair value estimate of 19.5. A complete review of Brown-Forman's historical price-to-earnings ratios can be found in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	16.1	17.9	21.4	24.1	24.7	28.4	28.8	27.6	33.2	32.0	***26.1***	***19.5***
Avg. Yld.	2.4%	1.9%	1.8%	1.5%	1.4%	1.3%	1.3%	1.5%	1.1%	1.1%	***1.4%***	***1.9%***

We maintain this fair value estimate based on a more challenged operating environment, due to cost inflation and potential margin compression.

Therefore, Brown-Forman appears to be an overvalued stock. If Brown-Forman's valuation multiple reverts toward its 10-year average, it would negatively impact future returns to the tune of 5.9% per year.

Future returns will be aided by the company's earnings growth and dividends. We expect approximately 9% annual earnings growth for Brown-Forman through 2024, based on revenue growth, share repurchases, and benefits of tax reform. In addition, the stock has a current dividend yield of 1.4%.

Based on this, total returns are expected to reach 4%-5% per year. This is a fairly mediocre rate of return, and is due to the present over-valuation of the stock. This makes Brown-Forman a hold on the basis of its strong business model and dividend growth, but the stock does not warrant a buy recommendation.

Investors should note that Brown-Forman pays a special dividend on occasion. For example, Brown-Forman paid a special dividend of $1.00 per share in 2018. Future special dividends could make Brown-Forman's total returns more acceptable; however, as the name suggests special dividends are not a guarantee.

Previous special dividends from Brown-Forman were paid in 2012 and 2010, so it is not something the company does every year.

Final Thoughts

Brown-Forman has a dominant position in its core product categories. Its flagship Jack Daniel's brand should continue to lead the whiskey industry, with high growth from its smaller whiskey brands and tequila.

The emerging markets are also an appealing growth catalyst for Brown-Forman.

However, Brown-Forman is a good example of a great business trading at an unattractive valuation. It would make a great purchase at a lower price. Until then, investors should wait for a better entry point before buying shares of this Dividend Aristocrat.

The Colgate-Palmolive Company (CL)

Business Overview

Colgate-Palmolive traces its roots all the way back to 1806, making it one of the oldest companies in the US stock market. It was founded by William Colgate, who started a starch, soap, and candle business in New York City.

Today, the company manufactures oral care products like toothpaste, personal care products such as soap, home cleaning products, and pet food.

Source: [Investor Presentation]

Major brands include Colgate, Palmolive, Hill's Science Diet, and many more. The core segment is Oral Care, which constitutes nearly half of revenue.

Colgate-Palmolive is a global giant. It sells its products in over 200 countries and territories around the world, and the company generates almost $16 billion in annual sales.

The company has a highly diversified business model, in terms of products as well as geographic markets. Approximately half of the company’s revenue comes from emerging markets, although its reliance upon these markets for growth has waned a bit recently.

This is due to the success of the company's pet nutrition business, as it continues to take revenue share from other segments. Emerging markets will be a critical growth catalyst for the company moving forward. Colgate-Palmolive has the #1 position in China, with market share above 30%.

However, the company also faces several challenges, including a strong U.S. dollar and cost inflation, which could keep a lid on growth going forward.

Growth Prospects

Colgate-Palmolive enjoys a world class brand portfolio and very high profit margins. Even after a dip in the company's profitability recently, it still maintains mid-20% operating margins. There aren't many manufacturing businesses in the world with that sort of profitability profile.

As mentioned, conditions have tightened as of late, and Colgate-Palmolive has struggled to generate meaningful growth in recent years.

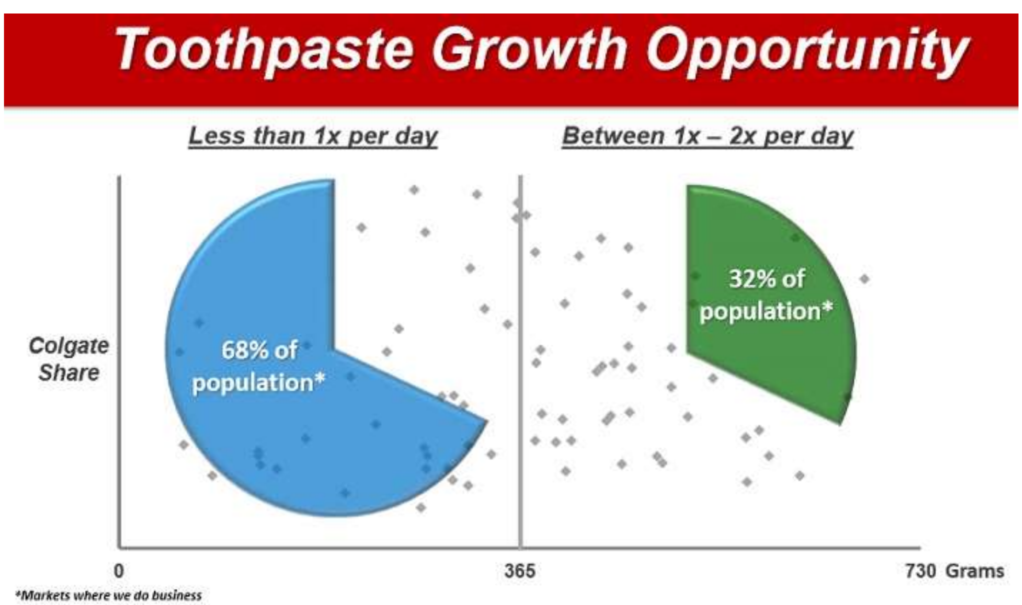
The company's fourth-quarter earnings report, released on January 25th, highlighted some of the recent struggles the company has had. Total sales were down 2% as organic sales increased 2% and acquisitions added a further 1% to the top line.

However, foreign exchange translation saw revenue fall by 5%, which was more than enough to offset the 0.5% increase in volume and a 2.5% gain in pricing and mix.

The company's regions turned in varying top line performances. Organic sales increased 0.5% in North America; 1% in Latin America, Europe, and Asia-Pacific; 4% in Africa/Eurasia; and 8% for Hill's Pet Nutrition.

Despite the difficulties posed by volatile exchange rates, Colgate-Palmolive continues to generate positive organic growth, which indicates the core business is performing well.

The emerging markets are a long-term growth catalyst for Colgate-Palmolive, as global toothpaste use remains relatively low.



Source: Investor Presentation

Colgate-Palmolive has a high market share in regions of the world where toothbrush use is low. This leaves lots of growth potential for Colgate-Palmolive in the years ahead.

However, profitability has been an issue of late, as Q4's gross margins fell 100bps on an adjusted basis to 59.4%. Management blamed higher raw material and packaging costs, which its competitors have suffered from as well.

Higher pricing as well as productivity savings helped to offset some of this headwind, but it wasn't enough. The company's margin issues have been persistent and in Q4, higher logistics and advertising costs sent SG&A costs rising at a time when gross margins declined, which crimped operating margins on both ends.

Indeed, operating margins declined 130bps in Q4 to 23.4%. Colgate-Palmolive's profitability is certainly not in question, but growth on this front has proven as elusive as revenue growth in recent reporting periods.

In total for 2018, revenue was flat while operating margins were also essentially flat, but a lower tax rate helped drive earnings-per-share 21% higher to $2.75.

Management guided for a low single-digit decline in earnings-per-share for 2019 on flat to slightly higher sales but also higher costs, so our earnings-per-share estimate for 2019 is $2.70. It appears the company's growth struggles will continue in 2019.

We see Colgate-Palmolive as producing 4% annual earnings-per-share growth on average in the coming years with 2019 coming in weaker than forecast. The company continues to produce low single digit organic revenue gains, but its significant global presence means forex translation continues to be a problem.

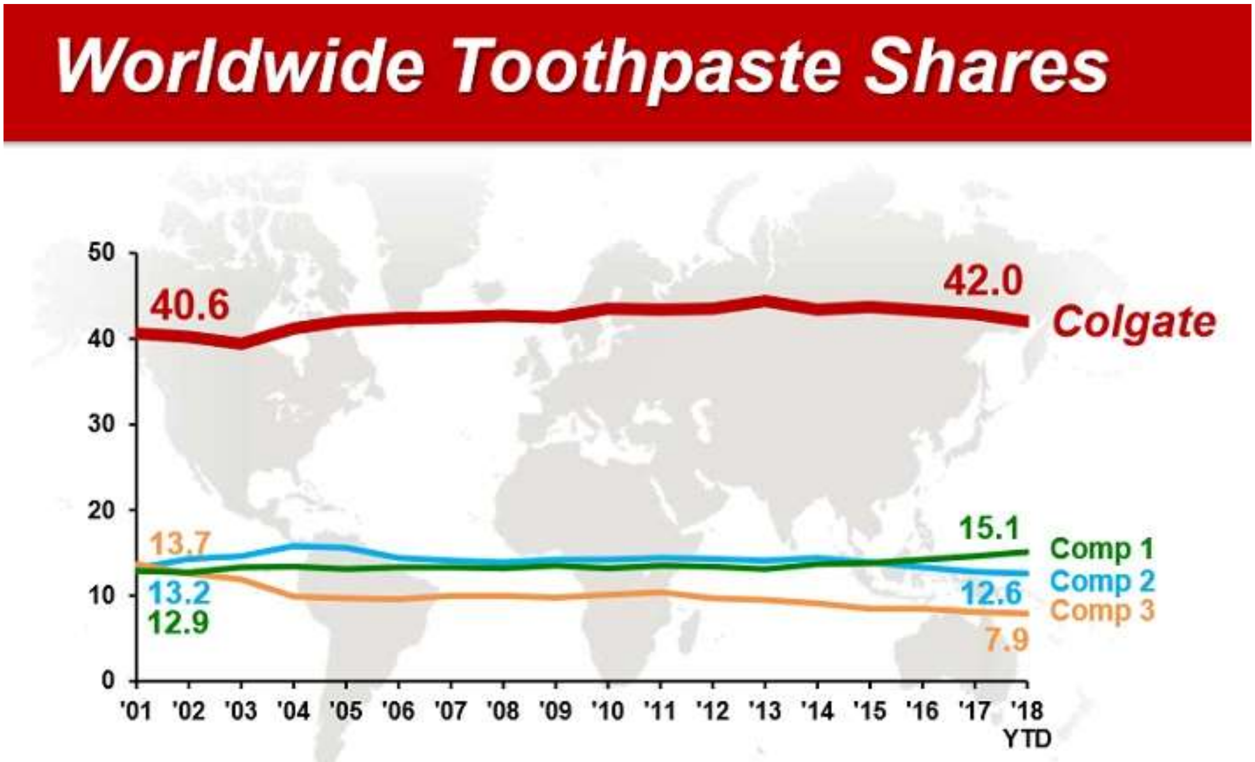
Product extensions into premium lines of soap and toothpaste, for instance, should help drive incremental revenue gains in the years to come, and higher pricing should help offset margin-crimping higher raw material costs.

Competitive Advantages & Recession Performance

Colgate-Palmolive has many competitive advantages which have fueled its growth over the past 200 years.

First, it has built a dominant position in its core product categories, most notably in toothpaste.

In toothpaste, Colgate-Palmolive’s market share has risen steadily for many years. Today, it commands a higher market share than the next-three biggest competitors combined.



Source: [Investor Presentation]

Such high market share allows Colgate-Palmolive to charge higher prices for its premium products, and raise prices over time. Pricing power is a critical competitive advantage for consumer goods stocks.

Another major advantage for Colgate-Palmolive is that products the company sells are necessities of modern life. Consumers need oral, personal, and pet care products irrespective of economic conditions.

Colgate-Palmolive enjoys steady demand, which gives the company consistent profitability, even during recessions.

Colgate-Palmolive's earnings-per-share through the Great Recession are shown below:

- 2007 earnings-per-share of $1.69
- 2008 earnings-per-share of $1.83 (8.3% increase)
- 2009 earnings-per-share of $2.19 (20% increase)
- 2010 earnings-per-share of $2.16 (1.4% decline)

Colgate-Palmolive generated positive earnings growth in 2008 and 2009, during the worst years of the recession. Earnings dipped slightly in 2010, but resumed growing in 2011 and thereafter.

The company’s strong performance from 2007-2010 is a credit to its strong business model and powerful brands. When the next recession strikes, we expect Colgate-Palmolive's earnings to hold up very well.

Valuation & Expected Returns

Colgate-Palmolive stock has a current price-to-earnings ratio of 24.2. While the stock has certainly had higher valuations than this in the past, it is still elevated.

Given Colgate-Palmolive’s struggles to generate earnings growth in recent years, it does not seem to justify a premium valuation multiple. Our estimate of fair value is 19 times earnings, and shares are well in excess of that today, meaning they are overvalued.

As a result, there is risk of multiple contraction. Should this contraction come to fruition, it would negatively impact shareholder returns. We see a ~5% headwind to total annual returns from the valuation reverting back to fair value over time.

We see total returns of just ~2% annually for shareholders of Colgate-Palmolive as the company's 2.6% yield and 4% earnings-per-share growth are partially offset by a ~5% headwind from the declining valuation. This makes the company's prospects unattractive and therefore, we rate the stock a sell.

Colgate-Palmolive's impressive dividend increase streak certainly counts for something, but the yield isn't high enough to warrant purchasing the stock since it is trading at a nearly-30% premium to fair value today.

Final Thoughts

Colgate-Palmolive is a high-quality business, with several category-leading brands. The company has growth potential, through product innovation, its outstanding Hill's brand, and in emerging markets.

Now might not be the best time to buy shares of Colgate-Palmolive, however, as the stock appears to be meaningfully overvalued. The company needs to prove it can generate higher levels of growth in order to justify its premium valuation.

Colgate-Palmolive does not offer a high yield, or high dividend growth. That said, investors can still count on steady dividend increases each year. The overvaluation of the stock, however, warrants a sell rating.

The Clorox Company (CLX)

Business Overview

Clorox started out over 100 years ago, with the debut of its namesake liquid bleach in 1913. Today, it is a global manufacturer of consumer and professional products than collectively span a wide variety of uses and customers. The company produces annual revenue in excess of $6 billion and it sells its products in more than 100 markets.

The product lineup spans multiple categories, including cleaning and household products, food, personal care, and cat litter. The Household segment includes the Glad, Kingsford, Fresh Step, and Renew Life brands. Cleaning products include Clorox, Pine-Sol, and the Clorox Commercial Solutions businesses.

Lifestyle brands include Hidden Valley, Burt's Bees, and Brita. Lastly, the International segment sells Clorox's brands around the world.

The strength of Clorox's business model lies in its industry-leading brands. Consider the market share held by the following brands:

Source: Investor Presentation

Many of Clorox's brands hold the #1 or #2 market share in their respective product categories. In fact, more than 80% of its total revenue comes from products that fit this description. This results in pricing power, and high profit margins.

For several years, Clorox had a tough time growing the top line. In fact, from 2009 to 2016, Clorox managed just 0.8% compounded revenue growth annually as it struggled with volume and pricing. However, the tables have turned and Clorox is back to some measure of top line growth.

Fiscal 2017 produced almost 4% top line growth while fiscal 2018 came in at 2.5% growth. While these aren't huge numbers by any means, they are vast improvements over what the company had been able to do in years past.

In the most recent quarter, Clorox reported another 4% sales increase, along with gross margin expansion of 70 basis points. Higher profitability was due to price increases and cost cuts. Earnings-per-share from continuing operations declined 21% for the quarter, as the implementation of U.S. tax reform in 2018 provided a one-time benefit in the year-ago quarter.

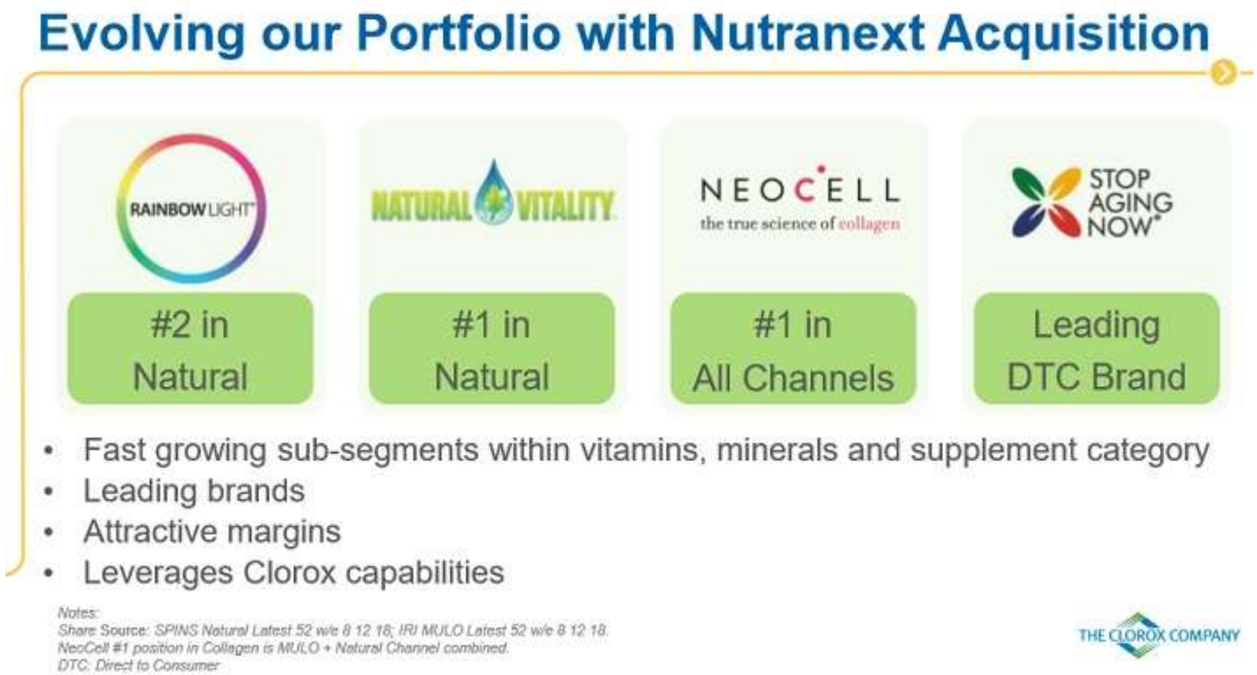
Sales increased 6% in Cleaning, 4% in Household, and 25% in Lifestyle, partially offset by an 8% decline in International segment sales.

Growth Prospects

Looking ahead, Clorox has some levers it can pull to continue its recent growth. The company is continuously innovating with product extensions on its current lineup, such as flavors and cross-branding. It has done those things for a long time and will continue to do so in order to stay competitive. However, it is also focusing its mergers and acquisitions on companies that are: (1) fast growing, (2) focused in the US, and (3) are margin-accretive. Said another way, the company wants to boost domestic growth and margins through acquisitions.

All too often, big companies - especially ones that have a hard time growing - will go after any sort of revenue growth. Clorox, however, is taking the more prudent approach and buying companies with a better margin profile than the rest of Clorox, boosting revenue and margins simultaneously.

One such example is the relatively recent purchase of Nutranext, a leader in dietary supplements. The company manufactures a wide variety of dietary supplements and generates about $200 million in annual revenue.



Source: Investor Presentation

The company has a favorable margin profile and derives the vast majority of its sales from the US. Thus, it is a perfect fit for Clorox' M&A strategy and should be a good purchase for the long term despite the relatively steep price paid of 3.5X sales.

Clorox is boosting margins via productivity and waste improvements each year as well, continuing to increase operating margins for many years consecutively. The company's focus on cost savings, combined with its accretive M&A strategy, should continue to drive earnings growth for years to come.

Clorox believes it can achieve 2% to 4% top line growth in fiscal 2019 as product innovation should drive a 3% improvement, while Nutranext will add 2.5% and forex translation will cost the company 2% off of the top line.

Management further sees flat gross margins and a combination of SG&A and marketing costs to drive earnings-per-share near flat against fiscal 2018. Indeed, the midpoint of the company's guidance at $6.30 is only slightly higher than the $6.26 produced in fiscal 2018.

Longer-term, management sees revenue growth at 3% to 5% annually and small yearly improvements in operating margins. We forecast 5% earnings-per-share gains in the coming years as Clorox should see low single-digit gains in revenue combined with small margin improvements and share buybacks.

Competitive Advantages & Recession Performance

Clorox has multiple competitive advantages. First, it holds a tremendously strong brand portfolio. As previously mentioned, Clorox products enjoy very high market share across the portfolio.

Clorox retains its high industry position in part through advertising and it spends very heavily to maintain that position. Product marketing is a necessity for consumer products manufacturers and Clorox spends 10% of its revenue on this each year.

Another advantage of Clorox's business model is that its products are used by millions of people each day, in good economies and bad. According to the company, Clorox-branded products are in about two-thirds of U.S. households.

There will always be a certain level of demand for household cleaning products and food, even if the economy enters a downturn. This allows the company to remain profitable during recessions. Indeed, Clorox is a strong example of a defensive stock.

Clorox's earnings-per-share through the Great Recession are shown below:

- 2007 earnings-per-share of $3.23
- 2008 earnings-per-share of $3.24 (0.3% increase)
- 2009 earnings-per-share of $3.81 (18% increase)
- 2010 earnings-per-share of $4.24 (11% increase)

As you can see, Clorox increased earnings-per-share each year throughout the recession, including double-digit earnings growth in 2009 and 2010. This demonstrates the company has a very recession-resistant business model and we like it for its high level of safety.

Valuation & Expected Returns

Clorox trades for a price-to-earnings ratio of 23.6, which is well in excess of our estimate of fair value of 19 times earnings. Indeed, as the stock is trading at 124% of fair value, we see it as overvalued. This condition has existed for a number of years but we continue to believe the valuation will drift lower over time as current growth rates simply do not support a valuation of 23+ times earnings.

A breakdown of Clorox's historical price-to-earnings ratios can be seen in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	14.5	14.4	31.9	16.7	18.2	20.7	22.3	25.1	24.0	22.3	***24.3***	***19.0***
Avg. Yld.	3.4%	3.4%	3.4%	3.6%	3.4%	3.3%	2.9%	2.5%	2.5%	2.4%	***2.5%***	***3.2%***

In our view, this introduces the distinct risk of a lower valuation in the years to come, which would have significantly negative impacts on shareholder returns. Indeed, should the stock return to 19 times earnings from the current valuation of 23.6, it would produce a ~4% annual headwind to total returns.

We see total shareholder returns at just ~4% thanks in part to this, combined with the 5% forecast earnings growth and the 2.6% current yield. As a result, we see the stock as a sell at current prices despite the obvious improvements the company has made in recent years. The slate of growth in front of Clorox doesn't support the current valuation, and we think that is enough to avoid the stock altogether at current prices.

Final Thoughts

Clorox is an ultra-reliable dividend stock. The company has a leadership position across its product markets, with potential for some measure of growth. Right now does not appear to be a good buying opportunity, as Clorox stock trades significantly above its 10-year average and at 124% of our fair value estimate.

That said, the company should be able to continue its four-decade long streak of annual dividend raises regardless of the overall economic climate. The valuation, however, is enough for us to rate the stock a sell and we think investors interested in owning it should wait for a much lower valuation.

The Coca-Cola Company (KO)

Business Overview

Coca-Cola was founded in 1892. Today, it is the world's largest non-alcoholic beverage company. It owns or licenses more than 500 non-alcoholic beverages, including both sparkling and still beverages.

It now sells products in more than 200 countries around the world, and has 21 brands that each generate $1 billion or more in annual sales.

The sparkling beverage portfolio includes the flagship Coca-Cola brand, as well as other soda brands like Diet Coke, Sprite, Fanta, and more. The still beverage portfolio includes water, juices, and ready-to-drink teas, such as Dasani, Minute Maid, Vitamin Water, and Honest Tea.

Source: Investor Presentation

Coca-Cola dominates sparkling soft drinks, where it commands over 50% market share. The company is attempting to maintain and even improve this dominant position with product extensions of existing popular brands, including reduced and zero-sugar versions of brands like Sprite and Fanta.

This is a challenging time for Coca-Cola. Soda consumption in the U.S. has fallen for more than a decade. Declining soda consumption is a significant challenge for the company.

While Coca-Cola's total volumes certainly still rely upon sparkling beverages such as soda, the company has gone to great lengths in recent years to diversify away from its core products, understanding that the long-term growth prospect for sparkling beverages isn't particularly inspiring. Coca-Cola has acquired multiple still beverage brands in recent years.

Coca-Cola reported Q4 earnings on 2/14/19 and while results were fine, guidance for 2019 sent investors heading for the exits. Total revenue was off 6% during the quarter, but that was due to the company's ever-present currency headwinds, as well as its bottler refranchising efforts.

Coca-Cola has seen its revenue decline for years as it continues to divest bottling operations, but on an organic basis, revenue rose strongly, up 5%. This was thanks to a 1% gain from concentrate sales and a 4% gain from pricing and mix; volume was flat in Q4. While flat volume isn't ideal - and reflects continued challenges with the sparkling beverage portfolio - Q4's organic revenue number was stronger than anticipated.

Operating income was up nicely as well, adding 21% in Q4 thanks to ongoing productivity efforts as well as higher margins from the bottling divestitures. Indeed, a primary reason the company is undertaking this effort is because the bottling business has very low margins and doesn't fit the company's long-term goals.

In total, fourth quarter earnings-per-share increased 9% on an adjusted basis and was negatively impacted by a 10% headwind from currency exchange. Coca-Cola's enormous non-US presence means it is particularly susceptible to currency fluctuations, and Q4 saw a particularly large swing from this.

Guidance for 2019 was for organic revenue growth of 4%, but flat earnings-per-share. Management cited declining economic growth outlooks in certain parts of the world, continued currency swings, and rising transportation costs. As a result of this weak guidance, our initial estimate for 2019 earnings-per-share is $2.05, which is a fractional decline from 2018.

On 2/21/19, Coca-Cola authorized its 57th consecutive annual dividend increase, raising the payout from $1.56 to $1.60 per year.

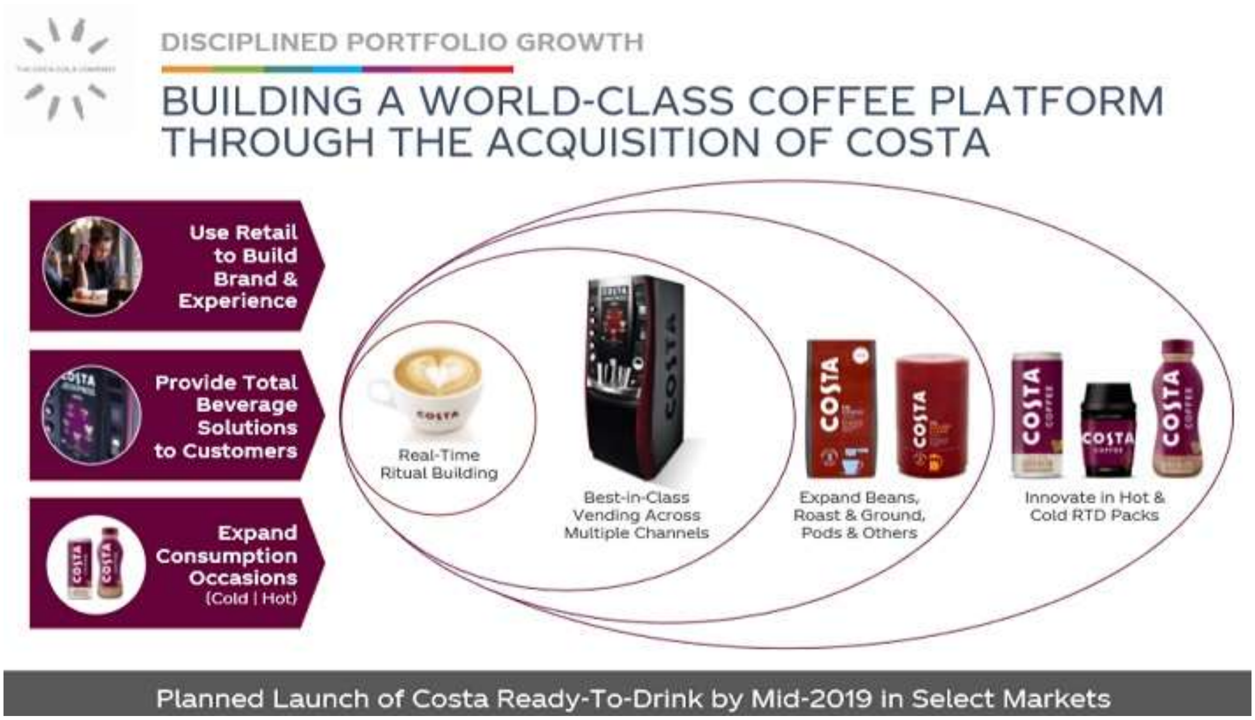
Growth Prospects

In an effort to return to growth, Coca-Cola has invested heavily outside of soda, in areas like juices, teas, dairy, and water, to appeal to changing consumer preferences. Despite weak guidance from an earnings perspective in 2019, we continue to see Coca-Cola as having a favorable long-term growth outlook.

One reason we like the stock is because it competes in an industry that continues to grow globally in excess of the rate of broad economic growth. This leads to strong levels of overall growth in the industry, which Coca-Cola has certainly been capitalizing on in recent years.

In addition, the ready-to-drink category is sold through highly-diversified channels and continues to have mid-single digit projected growth rates, both for Coca-Cola and the industry. This is particularly true for still beverages like milk, tea and water. Coca-Cola's years-old strategy to diversify away from sparkling beverages is due to this and it is undoubtedly bearing fruit.

Coca-Cola also continues to acquire brands in order to grow, including its unexpected acquisition of Costa, a coffee brand based in the UK.



Source: Investor Presentation

This is certainly an out-of-the-box buy for a sparkling beverage behemoth, but Coca-Cola is doing what it takes to secure its future.

Finally, we continue to like the nearly-complete plan to divest the company's bottling operations. The major portions of the plan are complete and the rest should be done shortly.

This has resulted in some pretty significant revenue declines over the years, but the end goal is higher margins. That has already begun occurring and with completion of the transformation in 2019, revenue growth will return. Not only will revenue move higher, but margins will continue to do so as well.

Taking all of this into account, in addition to the company's ample buyback program and productivity efforts, we see total earnings-per-share growth of 6% annually in the coming years. This year is one of transition thanks to the bottling divestitures, but Coca-Cola should see meaningful growth beginning in 2020.

The company’s dividend is now up to $1.60, a 2.6% increase from the prior payout. The current yield is 3.5%, which is higher than it has been for just about all of the past decade. On this measure, Coca-Cola seems quite attractive for income investors.

Competitive Advantages & Recession Performance

Coca-Cola enjoys two distinct competitive advantages, which are its strong brand and global scale. According to *Forbes*, Coca-Cola is the sixth-most valuable brand in the world. The Coca-Cola brand is worth $57 billion.

In addition, Coca-Cola has an unparalleled distribution network. It has the largest beverage distribution system in the world. Of the roughly 60 billion beverages consumed around the world every day, about 2 billion come from Coca-Cola.

These advantages allow Coca-Cola to remain highly profitable, even during recessions. The company held up very well during the Great Recession:

- 2007 earnings-per-share of $1.29
- 2008 earnings-per-share of $1.51 (17% increase)
- 2009 earnings-per-share of $1.47 (3% decline)
- 2010 earnings-per-share of $1.75 (19% increase)

Not only did Coca-Cola survive the Great Recession, it thrived. Coca-Cola grew earnings-per-share by 36% from 2007-2010. This shows the durability and strength of Coca-Cola's business model.

Valuation & Expected Returns

Coca-Cola expects adjusted earnings-per-share to be roughly flat this year despite a mid-single digit rise in organic revenue. At our initial estimate of $2.05 for this year, Coca-Cola trades for a price-to-earnings ratio of 21.9.

This is a premium of approximately 22% from our fair value estimate of 18 times earnings, which takes into account the stock's historical valuations as well as future growth estimates.

While the stock is still overvalued in our view, it has come well off of the highs of recent years, when it traded in the 25+ area at times. Should the stock revert to our fair value estimate of 18 times earnings, it would introduce a 4% headwind to total annual returns.

Putting all of this together, we expect total annual returns of 5% to 6%, consisting of the 3.5% dividend yield, 6% earnings growth and a 4% headwind from the valuation.

Final Thoughts

Coca-Cola has made great strides repositioning its portfolio to meet changing consumer tastes. It has built a large portfolio of juices and teas, to cater to a more health-conscious consumer.

There is more work to be done to diversify away from sparkling beverages, and we see much-improved growth prospects beginning in 2020.

We continue to rate the stock a hold given its valuation, but we very much like Coca-Cola's dividend as well as its improved growth outlook. We recommend investors wait for a better entry price before initiating a position.

Hormel Foods Corporation (HRL)

Business Overview

Hormel was formed all the way back in 1891, when George A. Hormel established the Geo. A. Hormel & Company in Austin, Minnesota.

Consumers took a liking to Hormel's fresh pork products, which were a novelty at the time. In 1926, the company produced the world's first canned ham.

Hormel has continued to grow in the decades since, and now generates more than $10 billion in annual revenue.

It has a diverse product portfolio today, across several categories. Some of its major brands include Skippy, Jennie-O, Spam, Hormel, and Dinty Moore. In recent years, it has added more natural products to compliment its processed offerings, such as Justin's and Applegate.

Source: [Investor Presentation]

This is a challenging time for Hormel, because the company's large Jennie-O segment has been under pressure for years. Record turkey production has caused significant price deflation, and volume has suffered as well.

Revenue and operating profit numbers for Jennie-O have moved in the wrong direction for a number of years due to a variety of factors. After a very weak 2017 and 2018, Jennie-O saw its revenue, volume and segment profit all flat year-over-year in the company's Q1 earnings report, which was released on 2/21/19.

While total volume and sales were flat, improved results in foodservice and commodity sales were offset by declines in retail. The company is seeing success with its raw and cooked boneless breasts, respectively, but continued weakness in retail ground turkey is offsetting those gains.

However, lower selling, general and administrative expenses helped offset that weakness, keeping segment profit flat year-over-year.

The good news is that other categories have helped offset weak performance in turkey products. The refrigerated foods segment saw its volume up 1%, while net sales declined 2%, but segment profits rose 3% during Q1.

Sales growth was led by the company's Hormel Deli Solutions business, as well as strength from other deli meat and retail brands. Segment profit increased as higher volumes and contribution margins helped offset higher freight and operational expenses.

The grocery products segment was led by Herdez salsas and sauces, Wholly Guacamole dips and the SPAM family of products. In total, volume rose 3% but net sales were up just 1%, while operating profit fell 2%.

Declines in contract manufacturing took their toll, while operating profits fell due to some one-time benefits that were present in 2018 that did not reoccur in 2019. However, adjusting these out, the grocery segment performed well in Q1.

Despite the protracted deterioration of the Jennie-O segment, we believe Hormel's long-term growth potential remains intact. Management reiterated guidance for fiscal 2019 after the Q1 report, implying that the ensuing three quarters will be stronger than Q1. The reaffirmed range of $1.77 to $1.91 in earnings-per-share has us keeping our estimate of $1.84 unchanged.

Subsequent to the end of the quarter, Hormel announced on 2/19/19 it was selling the CytoSport business to Pepsico for $465 million. The brand, which makes protein powders and Muscle Milk drinks, didn't fit Hormel's long-term plans.

The deal will cause Hormel to cede $300 million in annual revenue, but we see the sales price as favorable. Hormel can use the proceeds to buy back stock, acquire future growth or pay down debt.

Growth Prospects

Hormel has an extremely impressive history of generating consistent growth from year to year, regardless of the broader economic climate. This speaks to the company's strong brands.

In fact, the company has increased earnings in 28 out of the past 32 years--a track record that only seven companies in the S&P 500 Index have reached.

Source: [Investor Presentation]

Hormel's growth prospects depend upon a few different levers it can pull in the coming years. We see organic growth as a small but meaningful variable in the company's growth outlook as it appears Jennie-O has stabilized.

This is important because in recent years, that segment has offset any gains that have been seen in other segments, so if Jennie-O stabilizes and eventually grows, we could see a low single-digit tailwind from organic growth.

In addition, Hormel has made a living buying its growth over the years. The company has made many acquisitions and divestitures over the years as it continues to move its mix around to accomplish its growth goals.

The CytoSport divestiture is the latest example of the company exiting a business it doesn't feel meets its long-term goals, and it will use the ample proceeds for something else that does.

Margins are the wildcard for Hormel as the food processing business is notoriously volatile on that front. Hormel has seen its margins move around for many years and we don't expect that will change.

However, management has committed to getting some of that variability under control and seeing margins become a source of earnings growth, rather than a factor the company needs to try and offset with more sales growth.

Segment profits were largely mixed once again in Q1 and some of that certainly is due to commodity prices, but freight inflation has hurt Hormel in recent reporting periods as well.

Importantly, our long-term growth estimate of 5% annually doesn't require Hormel to see margin expansion; we are counting on sales growth providing essentially all of the company's future growth.

Hormel has committed to evolving its mix to be broader than it is today, building upon the strength in its foodservice business, expanding internationally to increase diversification, divesting non-core assets and lastly, modernizing its supply chain.

All of these things should support earnings growth as they grow sales and/or margins, respectively, so we believe 5% annual growth to be quite reasonable.

Competitive Advantages & Recession Performance

Hormel has a number of operational advantages. First, it operates in a wide variety of food businesses, which are very stable. Everyone has to eat, which provides the company with a certain level of demand, even during recessions.

In addition, Hormel's products are affordable for everyone, so that stability should shine through during tough economic times.

In addition, Hormel has many strong brands, which give the company pricing power. In all, Hormel has brands with the #1 or #2 position in over 35 product categories.

Its popular products make it difficult for competing food companies to take market share. In fact, Hormel has been in that enviable leadership position for years, so it is certainly a lasting advantage.

Hormel’s competitive advantages provide the company with a recession-resistant business model. Hormel’s earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $0.54
- 2008 earnings-per-share of $0.52 (3.7% decline)
- 2009 earnings-per-share of $0.63 (21% increase)
- 2010 earnings-per-share of $0.76 (21% increase)

As you can see, Hormel experienced a mild earnings decline in 2008, then racked up two consecutive years of 20%+ earnings growth. We expect Hormel to perform very well whenever the next recession strikes.

Valuation & Expected Returns

Hormel expects earnings-per-share of $1.77 to $1.91 for fiscal 2019. At the midpoint of earnings guidance, the stock currently trades for a price-to-earnings ratio of 23.3. This is well above Hormel's 10-year average price-to-earnings ratio of 18, which we also see as fair value.

As a result, it appears Hormel is overvalued quite significantly. The stock trades above its fair value and earnings growth has slowed in recent years, which is not a favorable combination.

While the stock is not likely to see a higher valuation multiple, it can still generate somewhat positive returns from earnings growth and dividends.

We see total returns of just 2% annually in the coming years, consisting of the current 2% yield, 5% earnings growth and an offsetting 5% headwind from the valuation we believe needs to come down.

The company's dividend is very safe and will almost certainly continue to grow for many years, but given that the yield is roughly in line with the broader market and that the valuation is so high, we rate Hormel a sell.

We would be apt to upgrade Hormel to a hold or buy if the valuation weren't so high, but until that happens, we recommend investors steer clear.

Final Thoughts

Hormel has paid 361 consecutive quarterly dividends without interruption. It has established one of the longest streaks of dividend increases in the market, and is a Dividend King.

Consumer staples stocks, particularly food companies with strong brands, enjoy steady demand and pricing power. Investors looking for stability and consistent dividend growth should give Hormel a closer look.

However, the stock is overvalued, meaning over the next five years investors are likely to receive the dividend but not much else. As a result, overvaluation means the stock is pricing in too much growth today, and we rate Hormel a sell.

Kimberly-Clark Corporation (KMB)

Business Overview

Kimberly-Clark traces its beginnings back to 1872. Four young businessmen, John A. Kimberly, Havilah Babcock, Charles B. Clark, and Frank C. Shattuck, came up with $30,000 of start-up capital to form Kimberly, Clark and Co.

Today, Kimberly-Clark is a global consumer products giant that operates in 175 countries. It manufactures a wide range of products, including paper towels, diapers, tissues, and more, that are arranged into three reporting segments:

- Personal Care (~50% of sales)
- Consumer Tissue (~32% of sales)
- K-C Professional (~18% of sales)

Kimberly-Clark's stable of brands is in the number 1 or 2 market share position in 80 countries around the world, which is an incredible feat.

Kimberly-Clark's Personal Care segment includes the Huggies, Pull-Ups, Kotex, Depend, and Poise brands. This is the company's largest business segment as measured by sales.

Source: Barclays Global Consumer Staples Conference, page 20

The Consumer Tissue segment includes Kleenex, Scott, Cottonelle, and Viva. Lastly, K-C Professional services businesses and workplaces.

Kimberly-Clark's strong brands provide the company with profitability and steady growth. The company's full-year 2018 results showed organic revenue up just over 1% as price/mix as well as volume were up slightly.

Forex translation reduced sales by about 1% as Kimberly-Clark's significant global presence, combined with strength in the US dollar, made top line growth a bit more difficult.

Adjusted operating profits fell in 2018 against 2017 thanks to $795 million of higher input costs, which Kimberly-Clark has struggled with for years, that was only partially offset by cost savings.

Still, a lower share count, the organic sales increase, as well as a lower tax rate helped drive adjusted earnings-per-share growth of 6%. Even in a down year, Kimberly-Clark was able to deliver respectable adjusted earnings-per-share expansion.

Going forward, the company has committed to elevating its core business, driving further growth in its developing and emerging markets (D&E), and expanding its digital marketing and e-commerce capabilities.

Growth Prospects

Kimberly-Clark has committed to elevating its core brands as one of the three pillars of growth in the coming years. It will do this by launching different product innovations via extensions of existing lines and entirely new products. The company will also continue to manage its revenue via pricing and mix as well as promotional strategies.

Finally, it will use its significant marketing expertise to go after underpenetrated categories to drive market share gains and ultimately, higher revenue and profit.

The second growth pillar is accelerating growth in its D&E markets, which make up about 30% of total sales today. The company will focus on its personal care and professional segments in particular, with its largest opportunities coming from places where it has low category penetration and frequency of usage.

Source: [Earnings Presentation]

The company's focus for D&E development is Latin America and China in particular, with smaller markets seeing a meaningful push as well. Kimberly-Clark plans to use its significant supply chain and marketing experience to pursue growth in areas where it underperforms today, and that should help drive some incremental growth.

The final pillar of growth is driving digital marketing and e-commerce. Kimberly-Clark has committed to building one-to-one consumer relationships by investing more in digital marketing.

Specifically, it will utilize data to engage in precision targeting of relevant consumers, which should help improve loyalty and consumer engagement. This growth pillar has some overlap with the second one in the D&E markets as Kimberly-Clark is using this strategy in its growth areas in particular.

Kimberly-Clark also continues to pursue cost savings and as mentioned, they continue to add up to hundreds of millions of dollars annually. The company is attacking earnings-per-share growth from all angles: revenue growth, margin expansion and share repurchases.

In total, management sees adjusted earnings-per-share of $6.50 to $6.70 for 2019, which is essentially even with 2018 results.

Management does see better earnings in the second half of the year after pricing increases have been allowed to impact the top line, and also said the company's tax rate will move up 3 to 4 points, creating a drag on net earnings.

Competitive Advantages & Recession Performance

Kimberly-Clark's most important competitive advantages are its brands and global scale. The company enjoys a leadership position across its brand portfolio and indeed, across the world.

It retains its competitive advantages through marketing and innovation. Kimberly-Clark spends over $1 billion each year on advertising and research and development. This allows the company to stay ahead of the competition. Given its commitment to its growth pillars, we expect this will only increase over time.

In addition, Kimberly-Clark's global reach provides the company with the efficiency to keep costs low. The FORCE program is an example of its ability to keep costs steady, even as revenue grows, and has seen years of success in reducing operating costs.

Kimberly-Clark remains highly profitable, even during recessions. For example, it performed well through the Great recession of 2007-2009. Its earnings-per-share through the Great Recession are shown below:

- 2007 earnings-per-share of $4.25
- 2008 earnings-per-share of $4.06 (4.5% decline)
- 2009 earnings-per-share of $4.52 (11% increase)
- 2010 earnings-per-share of $4.45 (1.5% decline)

As you can see, while Kimberly-Clark did see earnings decline in 2008 and 2010, it also registered a double-digit growth rate in 2009. The reason for its strong performance over the course of the recession is that the company sells products that consumers need regardless of economic conditions.

Consumers will always need personal care products, regardless of the condition of the economy. This gives Kimberly-Clark a certain level of product demand each year, even during recessions.

Valuation & Expected Returns

Based on adjusted earnings-per-share of $6.60 at the midpoint of 2019 guidance, Kimberly-Clark trades for a price-to-earnings ratio of 17.9. Our estimate of fair value is 18 times earnings based upon its historical valuations, so it is trading right at fair value.

Given that the stock is fairly valued, we don't see any impact on total returns from the valuation one way or the other.

Instead, future returns will be generated from earnings growth and dividends. Given the company's strong brands and growth catalysts, average annual earnings growth in the mid-single digits is a reasonable expectation.

In total, we see annual returns of 7.5%, consisting of the 3.5% dividend yield, 4% earnings-per-share growth, and essentially no impact from the valuation.

Given the strong yield, 47-year history of dividend increases and moderate growth expectations, we rate the stock a buy for dividend growth investors.

Final Thoughts

Kimberly-Clark is a high-quality company with a diverse portfolio of strong brands. It has positive growth prospects moving forward and, it is an extremely reliable dividend stock.

Kimberly-Clark has been in operation for more than 100 years, and currently has a dividend yield of 3.5%. It therefore meets our definition of a blue-chip stock.

With the stock at its fair value with a high yield and improving growth prospects, we rate Kimberly-Clark a buy. We believe its strategic plan is prudent and should drive some growth in the coming years while shareholders collect a 3.5% yield.

McCormick & Company (MKC)

Business Overview

McCormick was formed in 1889, when founder Willoughby M. McCormick started making flavors and extracts in his cellar, which he then sold door-to-door.

The business grew at a gradual pace. In 1896, McCormick entered spices by issuing its first McCormick's Cookbook. Over time, the company has steadily built itself into the leading spices and seasonings company in the world.

Today, McCormick sells its products in more than 150 countries and has annual sales of approximately $5.4 billion. It manufactures and distributes a wide range of spices, seasoning mixes, and condiments.

Source: [Investor Presentation]

Major brands include McCormick, Lawrys, Stubb's, Club House, Ducros, Schwartz, Kamis, Kohinoor, Zatarains, Thai Kitchen, and Simply Asia.

McCormick operates in two segments. Its Consumer segment represents approximately 68% of annual sales, while the Flavor Solutions segment contributes approximately 32% of sales.

The business environment for McCormick is very strong. It is benefiting from changing trends. Consumers are cooking more at home, due in part to falling grocery prices.

To do this, consumers are using more spices, seasonings, and flavorings. This has created a favorable fundamental backdrop for McCormick, and as the industry leader, it has taken full advantage.

McCormick's constant-currency sales were up 11% in 2018. Sales growth was due to a mix of volume growth, acquisitions and pricing increases. Adjusted earnings-per-share grew 17% last year.

Growth Prospects

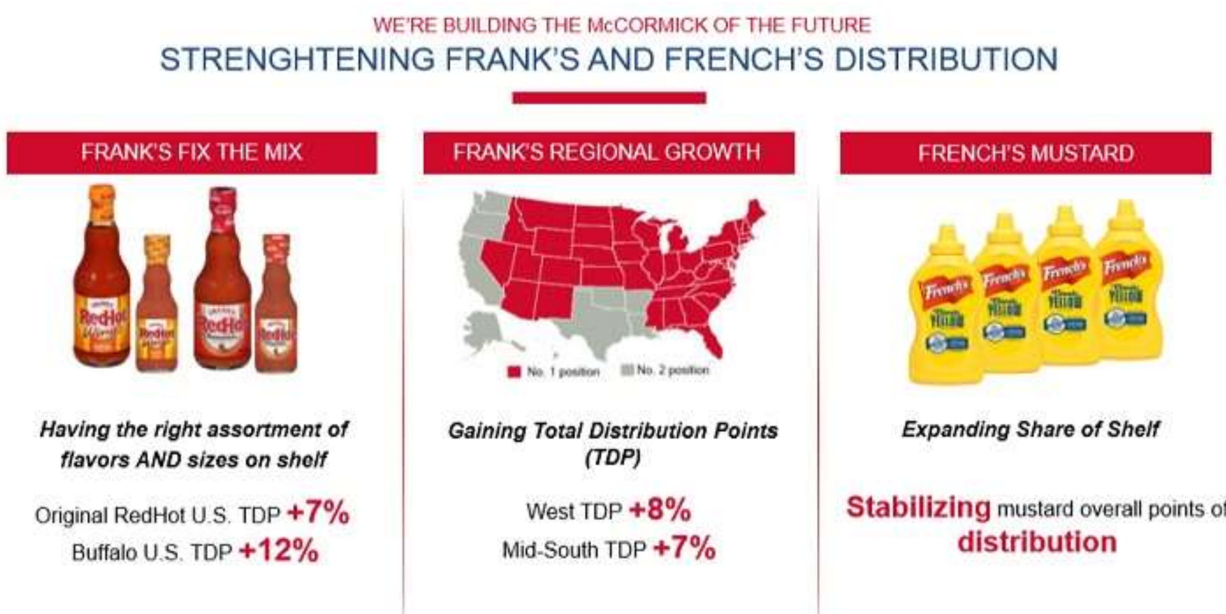
Going forward, there is plenty of room for continued growth for McCormick, due to growth in the emerging markets, and acquisitions.

First, international growth is a strong catalyst for McCormick, particularly in emerging markets like China.

McCormick's sales in the Asia/Pacific region, particularly in China, have improved dramatically in recent years thanks to its popular brands like Daqiao and others. This growth is evident primarily in the consumer segment, as sales grew 10.3% last year. Sales in Asia/Pacific were up 8.5% in the fourth quarter, largely due to 10% volume growth in China during the fourth quarter.

Economic growth in the emerging markets is higher than in developed nations. And, China is a huge opportunity for consumer products manufacturers like McCormick. China has a population of 1 billion, high economic growth, and a rapidly-expanding middle class.

Separately, acquisitions are a major part of McCormick's growth strategy. Recent acquisitions include Frank's RedHot, French's, and Cattlemen's.



Source: Investor Presentation

In 2018, McCormick acquired Frank's RedHot and French's as part of a $4.2 billion purchase of RB Foods, the food division of consumer products giant Reckitt Benckiser (RGBLY). This was the largest deal in McCormick's history, and is already a driver of growth for the company.

RB Foods added 8% to sales growth in 2018, and should continue to contribute to sales growth in the coming years.

For example, Frank's RedHot is the leading hot sauce brand in the U.S., with double the market share of the next-closest competing brand. Meanwhile, French's has four times the retail market share as the next closest mustard brand.

The common theme within McCormick's M&A strategy is that it seeks out top brands that lead their respective categories, that can be easily scaled up.

For 2019, McCormick expects currency-neutral sales growth of 3%-5%. Earnings-per-share are expected in the range of $5.17 to $5.27. At the midpoint, this would represent 5% earnings per share growth. Negative currency translation will be a 2% to 4% headwind this year.

Competitive Advantages & Recession Performance

The two most important competitive advantage for McCormick are its brand strength and global scale.

McCormick is the top brand in the $11 billion global spices and seasonings industry, which is expected to grow at a 5% compound annual rate for the next five years. And, McCormick has market share of 20%, which makes it nearly four times the size of its next-largest competitor.

As a result, this gives McCormick leverage over retailers, and pricing power. These qualities help the company generate consistent profits each year, even when the economy enters recession.

McCormick managed to grow earnings-per-share each year during the last recession. Earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $1.92
- 2008 earnings-per-share of $2.14 (11% increase)
- 2009 earnings-per-share of $2.34 (9.3% increase)
- 2010 earnings-per-share of $2.65 (13% increase)

As you can see, McCormick & Company grew earnings-per-share every year through the Great Recession. Not only that, the company averaged double-digit annual growth each year, which was highly impressive and a very rare accomplishment, even for a Dividend Aristocrat.

Valuation & Expected Returns

At the midpoint of 2019 guidance, McCormick expects adjusted earnings-per-share of $5.22 this year. As a result, the stock trades for at a forward price-to-earnings ratio of 24.7. This is slightly above its 10-year average price-to-earnings ratio of 20.2.

McCormick's valuation multiple has expanded considerably in recent years, as the company has turned in strong earnings growth. However, our fair value estimate is a price-to-earnings ratio of 21. In this case, we view the stock as overvalued.

If shares of McCormick trade down to our fair value estimate, investors would see annual returns reduced by 3.2% through 2024.

Fortunately, shareholder returns will be derived from expected earnings growth and dividends. McCormick has increased its earnings-per-share by 7% per year, over the past 10 years. It is worth noting that the past decade includes the Great Recession.

If the economy stays out of recession, the company should easily manage at least 8% earnings growth going forward. The company's strong brand and multiple catalysts for future growth should add up to higher growth as well.

A potential breakdown of expected returns is below:

- 8% earnings-per-share growth
- 1.8% dividend yield
- 3.2% valuation reversion

In all, we feel investors can expect total annual returns of 6.6% through 2024. The high valuation is putting a lid on our expected total return.

McCormick is a high-growth dividend stock. The company has increased its dividend by 9% per year over the past five years. Last November, it increased its dividend by 9.6%.

McCormick has a healthy dividend payout ratio, of 43.7% based on expected 2019 adjusted earnings-per-share. This means McCormick should continue its annual dividend increases for many years to come.

Final Thoughts

McCormick dominates the spices and seasonings category. Its strong brands provide the company with high profit margins and growth opportunities, both in the U.S. and the international markets.

Income investors may be turned off by McCormick's 1.8% dividend yield. However, McCormick has a very strong dividend growth history.

That being said, the stock is not a screaming bargain right now. It has a premium valuation multiple, but it could be argued that a high-quality company such as McCormick deserves a relatively high stock valuation. Still, the high price-to-earnings ratio makes the stock a hold at the current price, rather than a buy.

That said, we would be buyers of McCormick on a meaningful pullback in the share price, which would result in a lower valuation and a higher dividend yield.

PepsiCo (PEP)

Business Overview

Pepsi-Cola was created in the late 1890s by Caleb Bradham, a North Carolina pharmacist. Meanwhile, Frito-Lay, Inc. was formed in 1961 from the merger of Frito Company, and the H. W. Lay Company.

In its current form, PepsiCo came together as a result of the 1965 merger of Pepsi-Cola and Frito-Lay.

Today, PepsiCo is a global food and beverage giant. It has a market capitalization of $163 billion, and generates more than $63 billion of annual revenue.

PepsiCo's business is nearly equally split between its food and beverage segments. It is also balanced geographically, between the U.S. and the rest of the world.

PepsiCo has a large portfolio, and owns many popular brands. Some of the company's major brands include Pepsi and Mountain Dew sodas, as well as non-sparkling beverages like Pure Leaf, Tropicana, Gatorade, and bottled water.

Source: [Investor Presentation]

In addition to PepsiCo's core beverage brands, it also has a large snacks business under the Frito-Lay brand. The company has also built a portfolio of healthier foods, including Quaker, Naked, and Sabra.

PepsiCo's diverse portfolio has served the company well. It has products that cater to all tastes, across the health spectrum.

PepsiCo released financial [results] for the fourth quarter and full year 2018 on 2/15/2019. Organic revenue (which excludes the impact of currency) increased 4.6% for the fourth quarter. Along with revenue growth, margin expansion, share repurchases, and tax reform resulted in 17% adjusted earnings-per-share growth for the quarter.

For the year, organic revenue increased 3.7%, while PepsiCo produced 9% adjusted EPS growth for 2018.

Growth Prospects

PepsiCo has a long history of steady growth. Even in a challenging environment for soda, PepsiCo has continued its consistent growth. An illustration of the company's performance since 2012 can be seen in the below image.

Source: [Investor Presentation]

Going forward, two of PepsiCo's most promising catalysts are growth in healthier foods and beverages, and in the emerging markets.

Sales of soda are slowing down in developed markets like the U.S., where soda consumption has steadily declined for over a decade. As a result, large soda companies like PepsiCo have had to adapt to a more health-conscious consumer.

PepsiCo has shifted its portfolio toward healthier foods that are resonating better with changing consumer preferences.

In addition, PepsiCo has a huge growth opportunity in emerging markets like China, Africa, India, and Latin America. These are under-developed regions of the world, with large consumer populations and high economic growth rates.

Competitive Advantages & Recession Performance

PepsiCo has numerous competitive advantages. Among them, are strong brands, and global scale. According to *Forbes*, Pepsi is the #29 most valuable brand in the world. Frito-Lay takes the #41 spot.

In all, PepsiCo has 22 individual brands that each collect at least $1 billion in annual revenue. Strong brands give PepsiCo optimal shelf space at retailers, and give the company pricing power.

PepsiCo's financial strength also allows the company to invest in research and development, as well as advertising, to retain its competitive advantages.

For example, PepsiCo invested nearly $4 billion in R&D from 2011-2017, to innovate new products and packaging designs. In addition, PepsiCo regularly spends more than $2 billion each year on advertising, to maintain market share and build brand equity with consumers.

PepsiCo's competitive advantages and strong brands allow the company to be highly profitable, even during recessions. Food and beverages always retain a certain level of demand, which is why the company held up so well during the Great Recession.

PepsiCo's earnings-per-share throughout the Great Recession of 2007-2009 are listed below:

- 2007 earnings-per-share of $3.34
- 2008 earnings-per-share of $3.21 (3.9% decline)
- 2009 earnings-per-share of $3.77 (17% increase)
- 2010 earnings-per-share of $3.91 (3.7% increase)

As you can see, PepsiCo's earnings-per-share declined only modestly in 2008. The company proceeded to grow earnings by nearly 20% in 2009, which is very impressive. Earnings continued to grow once the recession ended.

Valuation & Expected Returns

PepsiCo is expected to generate earnings-per-share of $5.50 in 2019. Based on this, the stock trades for a price-to-earnings ratio of 21.1. This is slightly above its 10-year average price-to-earnings ratio of 18.7.

Our fair value estimate is a price-to-earnings ratio of 18.9. Based on this, the stock appears overvalued. A declining price-to-earnings ratio could reduce annual returns by 2.2% each year.

As a result, future returns will likely be comprised of earnings-per-share growth, and dividends. We expect PepsiCo to grow earnings-per-share each year by 5%-6%, consisting of organic revenue growth, acquisitions, modest margin expansion, and share repurchases.

PepsiCo also has a 3.2% current dividend yield. The combination of valuation changes, earnings growth, and dividends results in total expected returns of 6.5% per year over the next five years.

PepsiCo has a secure dividend, with a projected dividend payout ratio of 69% for 2019. This gives PepsiCo enough room to continue increasing the dividend at a high-single digit rate each year.

Final Thoughts

PepsiCo is a very strong business, with a number of category-leading brands. By investing heavily in new products and acquisitions, it is likely to continue growing sales and earnings for many years.

Shareholders should continue to benefit from PepsiCo's strong business through annual dividend increases. The stock is not deeply undervalued, which means value investors might want to wait for a more attractive entry point before buying shares.

That said, PepsiCo remains a valuable holding for a dividend growth portfolio.

Procter & Gamble (PG)

Business Overview

P&G is a global consumer products giant. It sells its products in over 180 countries around the world. It generates over $65 billion in annual sales. Approximately 55% of sales are derived from outside North America.

During P&G's massive portfolio restructuring over the past few years, the company sold off dozens of consumer brands. Its recent sales include battery brand Duracell to Berkshire Hathaway (BRK-A) for $4.7 billion, and a collection of 43 beauty brands to Coty (COTY) for $12.5 billion.

Today, P&G has slimmed down to just 65 brands, down from 170 previously.

Source: Investor Day Presentation

The company now operates five reporting segments, based on the following product categories:

- Fabric & Home Care (32% of sales)
- Baby, Feminine, & Family Care (27% of sales)
- Beauty (19% of sales)
- Health Care (12% of sales)
- Grooming (10% of sales)

The benefit of the restructuring is that P&G held onto its core consumer brands such as Tide, Charmin, Pampers, Gillette, and Crest, while shedding low-margin businesses with limited growth potential.

The effect of the transformation is that P&G is now a nimbler, more flexible organization with renewed growth potential.

Growth Prospects

P&G's slimmed down portfolio has made the company more efficient, with lower costs and higher margins.

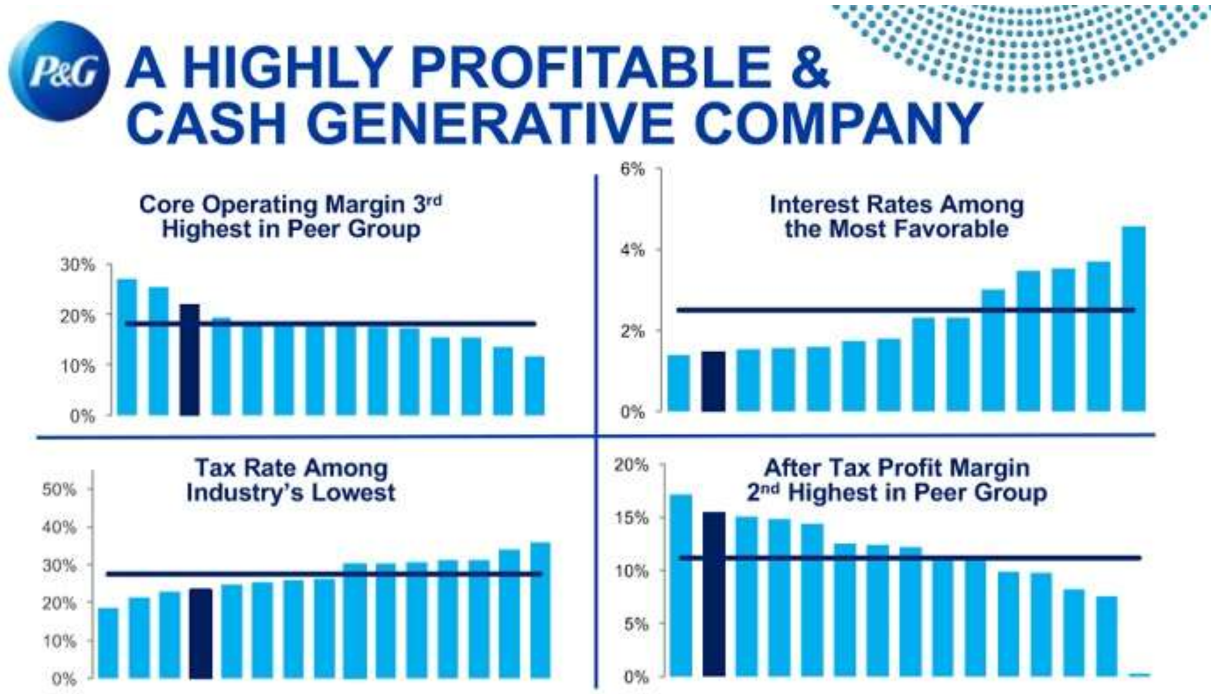
In addition, P&G received billions of dollars from its various asset sales, a large portion of which was used to buy back stock. The company utilized $14.6 billion for share reduction in fiscal 2017.

This has improved P&G's earnings growth. In the most recent fiscal quarter, revenue of $17.4 billion rose 0.2% from the same quarter last year, and beat analyst expectations by $280 million. Adjusted earnings-per-share of $1.25 increased 13% excluding currency, and beat analyst expectations by $0.04 per share.

Organic sales (which excludes currency fluctuations, acquisitions, and divestments) increased 4% for the period. Breaking down Procter & Gamble's results by product segment, Beauty products led the way with 8% organic sales growth, followed by Fabric & Home Care with 6% growth. Health Care segment organic sales increased 5%, while Baby, Feminine, and Family Care sales increased 3%.

Growth in these segments was partially offset by a 3% sales decline in Grooming products. Procter & Gamble also maintained fiscal 2019 guidance. The company is expecting 3% to 8% adjusted earning-per-share growth, for adjusted earnings-per-share of $4.45 at the midpoint.

Margin expansion is a major component of P&G's earnings growth strategy. P&G's cost-cutting efforts have elevated its operating margins and after-tax profit margins toward the top of its peer group.



Source: Investor Day Presentation

As part of the restructuring, P&G launched a massive cost-cutting effort. P&G cut costs by $10 billion over the course of its restructuring, through headcount reduction and lower SG&A expenses. Company management sees the potential for another $10 billion in additional cost savings by fiscal 2021.

Another growth catalyst for P&G is through expansion in under-developed economies. Emerging markets like China and India are fertile territory for large consumer products companies like P&G. These two countries have populations over 1 billion each, with rising middle classes.

Approximately 35% of P&G's annual sales are derived from developing markets such as China, India, the Middle East, and Africa, which are all attractive new growth markets.

P&G will continue to make acquisitions to accelerate its growth in new markets, such as the $4.2 billion acquisition of Germany-based pharmaceutical giant Merck's global consumer health business. The acquisition includes 10 core brands in vitamins, nutritional supplements, and other over-the-counter products. According to Merck, the global OTC market is expected to grow 5% annually through 2025, which explains why P&G wants to invest more heavily in this area.

Finally, P&G's digital platform is a catalyst for future growth. In fiscal 2018, P&G's global e-commerce sales increased 30% for the year, to nearly $4.5 billion. There is plenty of room for continued growth in e-commerce, as this booming segment still represents just 7% of the total business.

Competitive Advantages & Recession Performance

P&G has several competitive advantages. The first is its strong brand portfolio. P&G has several brands that generate $1 billion or more in annual sales.

The 65 remaining core brands hold leadership positions in their respective categories. These products are associated with high quality, and consumers will pay a premium for them.

To retain its competitive position, the company invests heavily in advertising, which it can do thanks to its financial strength.

P&G's advertising spending in recent years is as follows:

- 2016 advertising expense of $7.2 billion
- 2017 advertising expense of $7.1 billion
- 2018 advertising expense of $7.1 billion

P&G also invests nearly $2 billion each year in research and development. This investment is a competitive advantage for P&G; R&D fuels product innovation, while advertising helps market new products and gain share.

P&G's competitive advantages allow the company to remain profitable, even during periods of recession. Earnings held up very well during the Great Recession:

- 2007 earnings-per-share of $3.04
- 2008 earnings-per-share of $3.64 (20% increase)
- 2009 earnings-per-share of $3.58 (1.6% decline)
- 2010 earnings-per-share of $3.53 (1.4% decline)

As you can see, P&G had a very strong year in 2008, with 20% earnings growth. Earnings dipped only mildly in the following two years.

This was a very strong performance, in one of the worst economic downturns in the past several decades. P&G has a recession-resistant business model. Everyone needs paper towels, toothpaste, razors, and other P&G products, regardless of the economic climate.

Valuation & Expected Returns

Based on adjusted earnings-per-share of $4.45 expected in fiscal 2019, P&G stock has a price-to-earnings ratio of 22.1.

The stock is currently trading at a premium its 10-year average valuation of 18.8; as a result, P&G appears to be fairly valued, to slightly overvalued. Our fair value estimate for P&G is a price-to-earnings ratio of 20.

If P&G's stock valuation retraces back to the fair value estimate, future returns would be reduced by 2% per year over the next five years.

Earnings growth and dividends will help offset the impact of a contracting price-to-earnings multiple. We expect P&G to generate 5% annual earnings growth through 2024. And, the stock has a current dividend yield of 3.0%.

Adding it all up, total returns would be approximately 6% per year over the next five years.

The current dividend payout is well-covered by earnings, with room to grow. Based on expected fiscal 2019 earnings, P&G has a payout ratio of approximately 66%. This leaves enough cushion for future dividend increases each year, in the low-to-mid single digit range.

Final Thoughts

P&G has many strong qualities. It is a highly profitable company, with strong brands, and global growth opportunities.

And, it has a long history of rewarding shareholders with dividends. P&G has been paying a dividend for nearly 130 years.

With an operating history of over 100 years, and a 3% dividend yield, P&G earns a place on our list of "blue chip" stocks. We have compiled a list of several dozen stocks with these two qualities. You can see the full list of blue chip stocks here.

However, right now is not the best time to buy P&G stock because it is overvalued. This limits the total return potential for the stock over the next five years.

Because of this, P&G stock remains a hold for dividend growth investors, and would earn a buy recommendation on a meaningful pullback from present levels.

Sysco (SYY)

Business Overview

Sysco was founded in 1969, and went public the following year. In its first year as a publicly-traded company, it had sales of just $115 million. The company has grown steadily over the nearly five decades since. Last year, Sysco had sales of more than $58 billion.

Today, Sysco is the largest food distributor in the U.S. It distributes products including fresh and frozen foods, as well as dairy and beverage products. It also provides non-food products including tableware, cookware, restaurant and kitchen supplies, and cleaning supplies.

The company has a wide range of customers, which include:

- Restaurants (62% of sales)
- Healthcare (9% of sales)
- Education/Government (8% of sales)
- Travel/Leisure/Retail (8% of sales)
- Other (13% of sales)

The ‘other' category includes bakeries, churches, civic and fraternal organizations, vending distributors, and international exports.

In all, Sysco has approximately 600,000 customers. Its position atop the food distribution provides Sysco with high profit margins, and future growth potential.

Growth Prospects

The operating climate for Sysco was challenged in 2017, due to the "restaurant recession" that took place in the United States. Restaurant traffic slowed down, driven by several factors including eroding mall traffic, and low grocery prices.

Fortunately, Sysco cut costs in its U.S. business to protect its profit margins. And the company has enjoyed a resurgence in recent quarters, driven by a strong U.S. economy and high consumer confidence. Sysco now expects at least 4% annual sales growth and up to 12% annual EPS growth through 2020.

Source: Investor Presentation

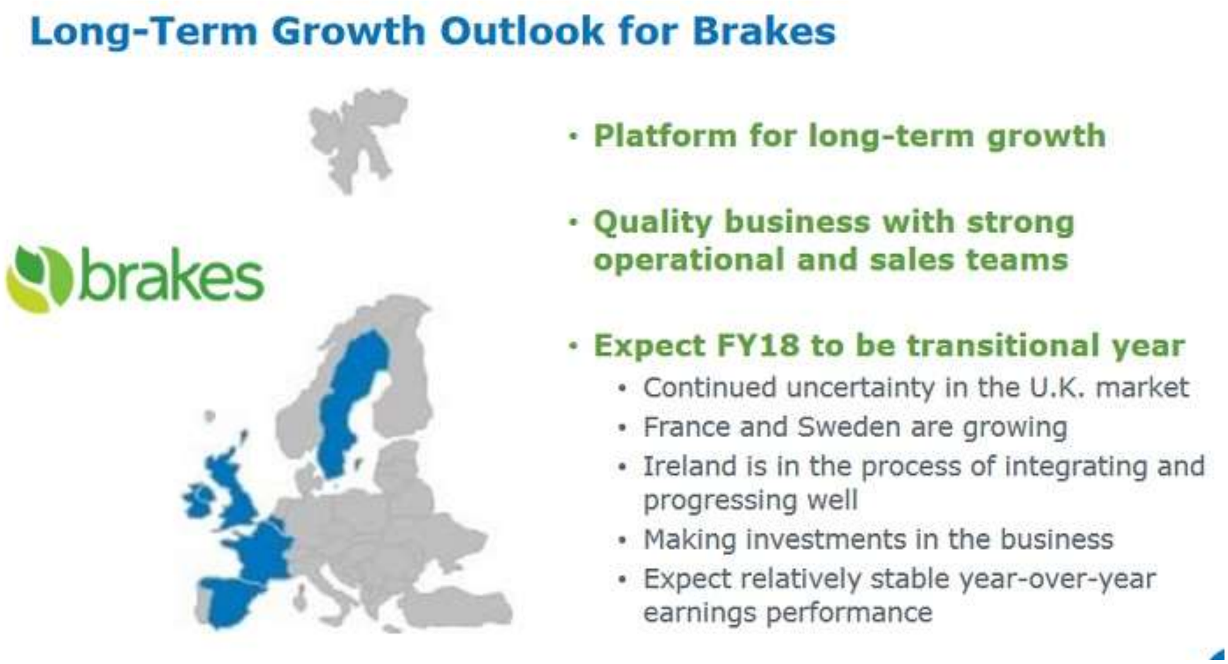
Sysco reported its second quarter (fiscal 2019) earnings results on February 4th. Revenue of $14.77 billion for the quarter increased 2.5% from the same quarter last year. Management explained that consumer confidence remained strong during the most recent quarter, despite the volatility in the financial markets during the last couple of months.

Strong consumer confidence has a positive impact on restaurant sales, which, in turn, is a positive for Sysco's ability to sell to its customers. Sysco grew its sales by 4% in the United States. The International segment was a bit weaker, as sales rose by just 0.8% outside of the U.S.

Sysco increased its gross profits by 2.7% last quarter, which, combined with some operating leverage, allowed for a 4.8% increase in the company's operating profits. Sysco's earnings-per-share totaled $0.75 during the second quarter, which was $0.02 more than what the analyst community had forecast.

Over the first half of the current fiscal year, Sysco generated free cash flow of $701 million, up 3% from the first half of fiscal 2018. Adjusted earnings-per-share increased 9.2% over the first two fiscal quarters.

Sysco has increasingly utilized acquisitions to drive growth in recent years. In 2016, Sysco acquired U.K.-based Brakes Group for $3.1 billion.



Source: Barclays Consumer Staples Conference, page 11

Brakes is one of the largest foodservice companies in Europe. It serves fresh, refrigerated, and frozen foods to over 50,000 customers, and has a leading presence in the U.K., France, Sweden, Ireland, Belgium, Spain, and Luxembourg.

In late January (1/28/19) Sysco announced the acquisition of Waugh Foods, Inc., a food distributor with approximately $40 million of sales. Continued acquisitions such as this help Sysco generate growth in a fairly saturated–and highly competitive–food distribution industry.

Competitive Advantages & Recession Performance

The U.S. foodservice industry is fiercely competitive. There are thousands of competitors to Sysco, which include other food distributors, as well as wholesale or retail outlets, grocery stores, and online retailers. Sysco also faces the risk of its customers negotiating directly with its suppliers.

However, what has kept competitors at bay for so many years, is that Sysco is the largest operator in the industry. It controls about 16% of the $280 billion U.S. foodservice industry. Sysco operates 330 distribution facilities worldwide and serves over 600,000 customer locations. Such a huge presence allows Sysco to keep costs low, ant it can pass on the benefit to its customers.

Another benefit of Sysco’s business model is that it is resistant to recessions. Everyone has to eat, which gives Sysco a certain level of demand, regardless of the condition of the U.S. economy.

This is why Sysco's profits held up well during the Great Recession:

- 2007 earnings-per-share of $1.60
- 2008 earnings-per-share of $1.81 (13% increase)
- 2009 earnings-per-share of $1.77 (2% decline)
- 2010 earnings-per-share of $1.99 (12% increase)

Sysco grew earnings-per-share at a double-digit pace in 2008 and 2010, with only a mild dip in 2009. The company grew earnings from 2007 to 2010, which was a rare achievement.

Sysco's stable industry and top competitive position, allowed it to raise its dividend each year, even during recessions.

Valuation & Expected Returns

Sysco is expected to produce adjusted earnings-per-share of $3.61 in fiscal 2019. Based on this, the stock has a price-to-earnings ratio of 18.5. Our fair value estimate is also a price-to-earnings ratio of 18.5, which means the stock is currently trading right at fair value.

Because Sysco is a fairly valued stock, we do not anticipate multiple expansion being a meaningful driver of future shareholder returns. Instead, shareholder returns will be generated by earnings growth and dividends.

Fortunately, Sysco does not need to rely on multiple expansion, as the company has an attractive growth profile and dividend.

We expect Sysco to deliver up to 7% annual earnings growth going forward, consisting of organic growth, acquisitions, and share repurchases.

In addition, Sysco has a current dividend yield of 2.4%, which is a higher yield than the average yield of the broader S&P 500 Index.

This leads to total expected returns of 9.4% per year over the next five years. While Sysco is not a deeply undervalued stock, it offers a more than satisfactory expected rate of return.

Sysco should have little trouble increasing its dividend going forward. The company had a dividend payout ratio of 44% in fiscal 2018. This indicates the dividend is more than sufficiently covered, with room for future dividend increases.

Final Thoughts

Sysco operates at the top of a stable industry. It is highly profitable, and should see steady demand, even during recessions. These qualities make Sysco a reliable stock for annual dividend increases.

The stock is not significantly undervalued, but can still generate returns through earnings growth and dividends. As a result, Sysco remains a quality holding within a dividend growth portfolio.

Wal-Mart (WMT)

Business Overview

The first Walmart store opened in 1962 in Rogers, Arkansas. It was founded by Sam Walton, who started the business with a simple vision: to offer the lowest prices. This philosophy led to Walmart's huge growth over the years.

Walmart went public in 1972. At that time, it had 51 stores, and annual sales of $78 million.

Today, Walmart generates annual sales of $514 billion. It operates almost 11,700 stores, located in 28 countries around the world.

Walmart has also expanded into a variety of different services, making it a true conglomerate.

Source: [Investor Presentation]

The Walmart U.S. segment includes retail stores in all 50 U.S. states, Washington D.C., and Puerto Rico. It also includes Wal-Mart's digital business. Walmart International consists of operations in 27 countries outside of the U.S.

Lastly, Sam's Club consists of membership-only warehouse clubs and operates in 48 states in the U.S. and in Puerto Rico.

Walmart's earnings-per-share [increased] 4% in fiscal 2019, due to higher than expected same-store sales. The company's investments in e-commerce are really paying off. Given the company's results and guidance for fiscal 2020, Walmart should see continued growth for years to come.

Growth Prospects

Walmart’s total sales increased 1.9% in the fourth quarter, to $138.8 billion. Sales for fiscal 2019 improved 2.8% to $514.4 billion. Excluding currency, sales were higher by 3.1% for the quarter and 3% for the year.

Comparable sales increased 4.2% during the quarter, well above estimates of 3.3%. Store traffic improved 0.9% while the average ticket was higher by 3.3%. E-commerce sales rose 21% worldwide for the year, with 43% growth in the U.S.

For fiscal 2019, U.S. same-store sales increased 3.6%. Walmart offers grocery pickup at more than 2,100 stores while providing delivery services at more than 800 locations.

Source: [Investor Presentation]

These services were credited with a portion of same-store sales gains. The company plans to add grocery pickup at another 1,000 stores this year while doubling the amount of locations offering delivery.

Walmart’s resurgence is due mostly to its e-commerce investments. E-commerce sales reached $16 billion last fiscal year, and have continued to grow at a high rate each quarter.

Walmart has also made a number of acquisitions to accelerate its e-commerce growth, including the $3.3 billion purchase of Jet.com. It also has an investment stake in Chinese e-commerce site JD.com.

In late August of last year, Walmart announced that it had completed its $16 billion investment in Flipkart, a leading online shopping company in India. With this investment, Walmart has taken a 77% stake in one of the most popular e-commerce companies in the second most populace country on earth.

Overall, Walmart's multiple investments in e-commerce are the reasons why this emerging category will contribute most of the company's growth going forward.

Source: [Investor Presentation]

Another growth catalyst for Walmart is international growth. The company expects to add more than 300 new international stores during the current fiscal year, primarily in China. By contrast, Walmart will open fewer than 10 Supercenters in the U.S. over that same time.

New international store openings will be focused on Mexico and China, which are major growth opportunities for Walmart. Both countries have large consumer classes. Last quarter Walmex grew comparable sales by 3.8%, while sales decreased 0.2% in China.

The calendar shift of the Mid-Autumn Festival and increased competition factored into the decline in comparable sales. A slowing economy in China also impacted results. Long term, management feels that China will be a sizable source of growth for the company.

The company expects earnings-per-share for fiscal 2020 to decline by a low single digit percentage from fiscal 2019 from an increase in the expected tax rate and share dilution due to the Flipkart acquisition.

Walmart will also reinvest $11 billion in store remodels, customer initiatives, e-commerce and other areas to improve the customer experience.

Net sales are expected to grow 3% in constant currency. Walmart expects U.S. same-store-sales to range from 2.5% to 3% growth with e-commerce sales increasing 35%. Walmart international sales should be higher at 5% in constant currency.

While the company hasn't given specific guidance for earnings-per-share, we believe the company will earn $4.84 per share in fiscal 2020.

We expect that Walmart can grow earnings-per-share at an annual rate of 5.5% through 2024 due to a combination of same-store-sales and e-commerce growth.

Competitive Advantages & Recession Performance

Walmart's main competitive advantage is its massive scale. A Walmart store is located within 10 miles of approximately 90% of the U.S. population.

Its distribution efficiencies allow Walmart to keep transportation costs low. It can pass on these savings to customers through everyday low prices.

Walmart retains its brand strength through advertising. Because of its immense financial resources, Wal-Mart can afford to spend heavily on advertising:

- 2015 advertising expense of $2.4 billion
- 2016 advertising expense of $2.5 billion
- 2017 advertising expense of $2.9 billion
- 2018 advertising expense of $3.1 billion

Walmart’s competitive advantage provides the company with steady profitability. This is true, even during recessions.

Walmart performed phenomenally well during the Great Recession. The company steadily grew earnings-per-share each year in that time.

- 2007 earnings-per-share of $3.16
- 2008 earnings-per-share of $3.42 (8.2% increase)
- 2009 earnings-per-share of $3.66 (7% increase)
- 2010 earnings-per-share of $4.07 (11% increase)

This was a very impressive performance, in one of the worst recessions in decades. Walmart’s growth indicates the company might actually benefit from recessions. As the low-cost leader in retail, Walmart conceivably sees higher traffic during economic downturns, when consumers scale down from higher-priced retailers.

Valuation & Expected Returns

Walmart shares currently trade at a price of almost $100. Using our earnings-per-share estimate of $4.84 for the current fiscal year, the stock has a price-to-earnings ratio of 20.7. This is well above the stock's ten-year average price-to-earnings ratio of 15.

As you can see, Walmart’s current valuation stands well above its historical levels. If shares were to revert to their historical average by 2024, annual returns would be reduced by 6.7% over this period of time.

Walmart shares have performed very well for an extended period. While this has rewarded shareholders with strong returns, it makes the stock fairly unattractive today.

The stock has not held an average price-to-earnings ratio above 20, since the middle of the last decade. A prolonged period of multiple contraction soon followed, with Walmart’s price-to-earnings ratio spending most of the past 10 years in the mid-teens.

Aside from its valuation multiple, Walmart will generate returns from earnings growth and dividends. A projection of expected returns is below:

- 5.5% earnings-per-share growth
- 2.1% dividend yield
- -6.7% multiple reversion

In this scenario, total annual returns would reach less than 1% per year over the next five years. Shares of Walmart are significantly overvalued compared to its history and this is weighing on our expected total returns.

Final Thoughts

While many retailers have struggled with adapting to the change in commerce shopping habits, Walmart has made the proper strategic investments in our view. The company's e-commerce growth is reflective of this view.

The company has performed well and the stock has outpaced the S&P 500 over the past two years. We find the company's dividend track record to be impressive, even if the most recent raise was on the small side.

However, sometimes a great company can be a poor investment, if too high a valuation is placed on a stock. We feel this is the case with Walmart today. Despite its strong business model and growth potential, the stock appears to be significantly overvalued.

The extended rise in share price has absorbed much of the stock's potential total return, implying that the next five years will result in weak returns to shareholders. We recommend investors looking to purchase shares of Walmart do so after a meaningful pullback.

Walgreens Boots Alliance (WBA)

Business Overview

Walgreens was founded all the way back in 1901. In its current form, the company was created when Walgreens merged with Alliance Boots in 2014. The merger created the largest retail pharmacy in the U.S. and Europe. Today, together with its equity method investments, Walgreens Boots has more than 18,500 stores in 11 countries around the world.

Source: Investor Presentation

Investor sentiment has been subdued in recent years, due to fears of rising competition from online retail giants like Amazon (AMZN).

This is a challenging time for all of retail. The rapid growth of e-commerce has put pressure on brick-and-mortar retailers. However, Walgreens hasn't skipped a beat. The company recently concluded fiscal 2018, and the results were very strong.

Walgreens reported 18% adjusted earnings-per-share growth for fiscal year 2018 and sales increased 11.3%, thanks to strong business execution and the continued integration of the recently-acquired Rite Aid stores. Expanded pharmacy market share was a major contributor to growth.

The most recent quarter showed that the company continues to perform well. Net sales improved nearly 10% in the first quarter of fiscal year 2019 while adjusted earnings-per-share grew 14.4%. Top and bottom lines were supported by higher prescription volumes from the Rite Aid stores.

U.S. retail sales were higher by 14.4% from the previous year. Once again, the Pharmacy segment of the business led the way.

Retail Pharmacy USA – pharmacy

Walgreens

1Q19 vs. 1Q18	Total	Comparable[7]
Pharmacy sales	+ 17.5%	+ 2.8%
Prescriptions[8]	+ 11.4%	+ 2.0%

- Continued improvement in comp. prescription[7] growth
  - up 2.0% in 1Q19 versus 1.3% in 4Q18
  - benefits from Rite Aid largely offset by Med D network changes
  - last year's script comp.[7] boosted by hurricane impact (60 bps)
- 1Q market share 22.4%[9]: up 180 bps
- Gross margin reflects continued shift to specialty (180 bps) and ongoing reimbursement pressure; FEP specialty contract laps in January 2019

Source: Investor Presentation

Pharmacy sales were up 17.5% while prescriptions grew 11.4%. Even without the addition of Rite Aid, pharmacy sales and prescriptions still grew 2.8% and 2.0%, respectively.

And, Walgreens continues to take share in the critical, high-growth category. Prescription market shares increased 180 basis points to 22.4%. Organic growth increased 4.3% during the quarter.

On the other hand, the company's international segment saw a 6% decline in sales due to negative currency translation, the divestiture of Boots Contract manufacturing and soft market conditions in the U.K. Comparable U.S. retail sales dropped 3.2% due to special events in the previous year.

Currency is expected to be a $0.07 headwind to earnings-per-share in fiscal 2019. However, there should be plenty of room for growth next year and beyond, thanks to organic growth, as well as the continued integration of the Rite Aid acquisition.

Growth Prospects

Walgreens' most important catalyst in the U.S. has been to grow through new stores and customers. It has accomplished this through acquisitions.

For example, Walgreens recently acquired over 1,900 Rite Aid (RAD) stores, three distribution centers, and related inventory, for $4.375 billion. 458 Rite Aid stores were optimized in 2018, with more renovations coming in 2019.

As discussed above, the Rite Aid transaction has already helped Walgreens grow earnings.

Walgreens is assuming the real estate obligation, but is not assuming any debt. And, the acquisition should also result in a tax benefit, from amortization of intangible assets.

There will be significant cost synergies to accelerate earnings growth from the acquisition. Since Walgreens and Rite Aid have nearly identical operations, Walgreens will be able to eliminate duplicated functions across the business. Walgreens expects to realize more than $300 million in annual cost savings by 2021.

Share buybacks will also help fuel Walgreens' future earnings growth. Last year, Walgreens approved an additional $10 billion to the company's share repurchase authorization. This represents nearly 15% of the current market capitalization of the stock, meaning the buyback could be a significant boost to EPS.

For fiscal 2019, Walgreens expects adjusted earnings-per-share of $6.40 to $6.60. At the midpoint, earnings would increase 8% in 2019, which would represent another year of strong earnings growth.

Looking out further, Walgreens should continue to grow earnings for the long-term, due to very favorable macro-economic conditions. Specifically, the U.S. is an aging population. As they age, consumers will have higher demand for healthcare products and prescriptions.

Judging by Walgreens' recent financial results and future outlook, it is clear the highly pessimistic sentiment is misguided. There is nothing wrong with Walgreens from the perspective of its fundamentals, which remain strong.

Competitive Advantages & Recession Performance

The first competitive advantage for Walgreens is its scale. Walgreens has one of the world's largest global wholesale and distribution networks, with nearly 400 distribution centers that supply more than 230,000 pharmacies, doctors, health centers, and hospitals.

With such a massive global footprint, it is very challenging for a competitor to compete on the same scale as Walgreens.

Despite the difficulties facing retail, there is still an operational advantage of physical stores. Most of the U.S. lives within a short distance of a Walgreens store. As a result, it is very difficult for competitors to take market share.

Separately, Walgreens benefits from a strong brand, and operates in a stable industry. Consumers cannot go without prescriptions and health care products. This helps earnings stay afloat, even during recessions.

For example, Walgreens suffered only a slight decline in earnings-per-share during the Great Recession:

- 2007 earnings-per-share of $2.03
- 2008 earnings-per-share of $2.17 (6.9% increase)
- 2009 earnings-per-share of $2.02 (7.2% decline)
- 2010 earnings-per-share of $2.16 (6.9% increase)

Walgreens grew earnings-per-share from 2007 to 2010. It followed up this performance with over 20% earnings growth in 2011.

Earnings-per-share have nearly tripled from fiscal year 2009 to fiscal year 2018, which equates to a CAGR of more than 24% during this time period. Erring on the side of caution, we anticipate an annual earnings growth rate of 8% through 2024.

It is clear that Walgreens has a recession-resistant business model, which helps it raise its dividend each year.

Valuation & Expected Returns

Walgreens has a current share price of $73 and a midpoint for adjusted earnings-per-share of $6.50 for fiscal 2019. As a result, the stock trades for a price-to-earnings ratio of 11.2. This is a low valuation for a highly-profitable company with a strong brand and leadership position in its industry.

In addition, Walgreens appears undervalued, relative to both the market and its own historical averages. The S&P 500 Index has an average price-to-earnings ratio of 21.3.

Over the past 10 years, Walgreens held an average price-to-earnings ratio of 16.2. Due to slower growth, we have a 2024 price-to-earnings ratio target of 15 for the stock.

If shares were to expand to meet our target valuation, investors would see an addition 6% added to annual returns over the next five years. Plus, Walgreens will generate returns from earnings growth and dividends. Expected returns could be as follows:

- 8% earnings-per-share growth
- 2.5% dividend yield
- 6% multiple expansion

In this forecast, total annual returns could reach 16.5% through 2024. This is an excellent projected rate of return, and indicates that Walgreens stock offers a mix of all attractive qualities. The company has compelling growth potential, is undervalued, and offers a solid dividend yield.

The combination of these three major catalysts results in a buy recommendation for value and income investors.

Final Thoughts

When it comes to retail stocks, there is a great deal of fear in the market. This is apparent, even with strong retailers like Walgreens. Not only are investors worried about a sluggish environment for brick-and-mortar retailers, but the threat of Amazon entering the healthcare industry is a constant overhang.

Walgreens remains a strong company, with a great brand and positive growth prospects moving forward. The addition of Rite Aid has allowed the company to grow its prescription drug market share.

In addition, Walgreens offers an above market dividend yield. Given the business fundamental, the company should have no trouble raising the dividend every year. We view the stock as significantly undervalued and recommend investors looking to initiate a position in Walgreens do so at the current price.

Industrials Dividend Aristocrats

A.O. Smith (AOS)

Business Overview

A.O. Smith is a global leader applying energy-efficient products and solutions. It manufactures a variety of residential and commercial water heating equipment, as well as water treatment and air purification products.

The company is perhaps best-known for its water heaters. It operates in two operating segments, separated by geography:

- North America (64% of sales)
- Rest of World (36% of sales)

As you can see, the company has a sizable international presence, particularly in China where it generates 34% of total sales. The company is also in the early stages of operating in India, the second most populous country in the world. This business represents approximately 2% of total sales.

A.O. Smith has performed very well over the past decade, thanks largely to the steady global economic recovery coming out of the Great Recession of 2007-2009. The company's sales have grown at a double-digit annual rate, on average, in the past 10 years.

Source: [Investor Presentation]

Combined with margin expansion and share repurchases, A.O. Smith's impressive sales growth has fueled impressive earnings growth as well. In the same 10-year period, adjusted earnings-per-share increased 25% per year.

A.O. Smith has continued its growth in recent periods. On January 29th, A.O. Smith released fourth-quarter earnings, which were very strong. The company generated earnings-per-share of $0.74, which topped estimates and were an improvement of 23.3% from the previous year. Quarterly revenue grew 5.7% to $812.5 million, but missed estimates by $8.9 million.

For the full year, revenue increased 6.4% to $3.2 billion, while adjusted earnings-per-share increased 19%, to $2.61.

Growth Prospects

A.O. Smith's growth catalysts in the U.S. include continued economic growth and increasing housing prices. As a manufacturer of water heating, water treatment, and air purification products, the company is reliant on a financially healthy consumer and housing market.

When home prices are rising and unemployment is low, consumers with disposable income are much more willing to invest in upgrades like new water heaters. This is how A.O. Smith realized record sales for 2018, which broke 2017's record sales total.

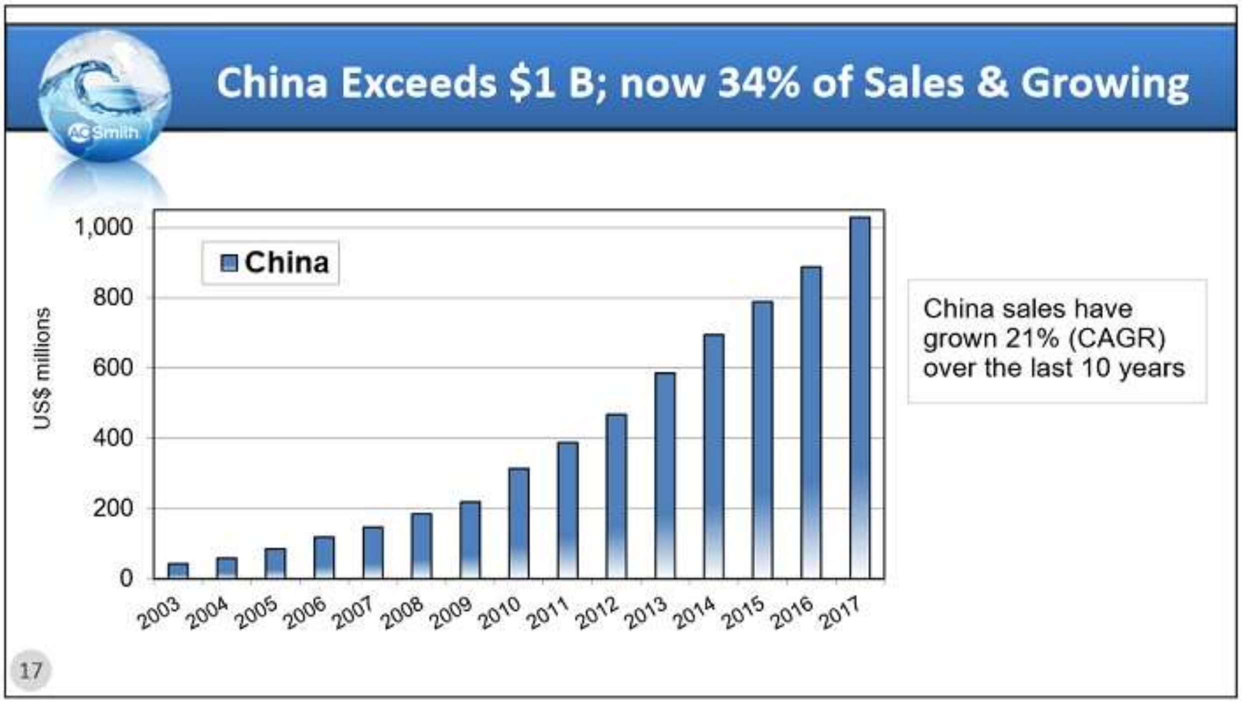
Outside the U.S., the company's main growth prospects are in China, where it already has a large operation. China is arguably the most attractive economy in the world. Not only does it have a population of 1 billion, and a growing middle class, but the country has been growing its economy at a high rate.

While sales in China for 2018 grew 4% (2% excluding currency), sales for this very important region declined 5% quarter-over-quarter. In local currency, sales in China declined 3% from the fourth quarter of 2017.

The company cited deprecation of Chinese currency and higher advertising cost related to online holiday shopping as the primary reasons for the decline in the quarter. Trade worries could also be impacting sales in the country

Still, China represents a major long-term opportunity for A.O. Smith. China now contributes over $1 billion in annual sales for the company, and is growing at a high rate.

Sales in China rose more 20% each year in the ten year-period through 2017.



Source: [Investor Presentation]

There are reasons to be optimistic about A.O. Smith's China business. Besides China's large population, the air quality in the country is quite poor. This has caused demand for A.O. Smith's air purifiers to be quite strong.

We expect A.O. Smith to grow earnings-per-share at a rate of 9% per year through 2024, which is half of the company's growth rate over the last decade. We believe the company should be able to achieve at least this level of growth due to organic revenue growth and share repurchases.

A.O. Smith bought back 3.8 million shares in 2018 and has 6.1 million shares remaining on its repurchase authorization. The remaining share repurchase authorization represents 3.6% of the current $9 billion market cap.

Competitive Advantages & Recession Performance

A.O. Smith's strong growth is due to its competitive advantages, primarily its top market share. A.O. Smith has the #1 market share in U.S. water heaters. It holds 40% domestic share, nearly 10 percentage points above its closest competitor.

In the commercial gas water heater market, A.O. Smith's U.S. market share exceeds 50%, while the closest competitor has market share below 30%. A.O. Smith is also the exclusive supplier of Lowe's (LOW) water treatment products.

Possessing the top industry position gives A.O. Smith pricing power, and high margins. In turn, this provides the company the ability to generate lots of cash flow, which enables it to invest in new product innovation.

One potential risk for A.O. Smith is a recession. As a manufacturer, the company is closely tied to the health of the overall economy. It is not a highly recession-resistant business model.

Earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $0.48
- 2008 earnings-per-share of $0.49 (2% increase)
- 2009 earnings-per-share of $0.57 (16% increase)
- 2010 earnings-per-share of $0.43 (25% decline)
- 2011 earnings-per-share of $0.60 (39% increase)

As you can see, the company performed very well during 2008 and 2009, the worst years of the recession. Earnings took a significant hit in 2010, but quickly recovered in 2011. Overall, the company performed exceptionally well, since it was still able to grow earnings over the course of the recession.

Valuation & Expected Returns

Based on the current share price of $53 and the company's earnings per share guidance for 2019 of $2.72, A.O. Smith shares currently trade for a price-to-earnings ratio of 19.5. The stock has traded with a least a price-to-earnings ratio of at least 20 for much of the past decade. As such, we have a price-to-earnings multiple target of 20 for 2024.

While the stock has spent much of the last ten years above this valuation, shares of A.O. Smith are slightly undervalued at the moment against this figure. If the stock could expand to meet our target valuation by 2024, investors would see an additional 0.5% added to annual returns over the next five years.

Total annual returns will also include earnings growth and dividends. As a result, a potential breakdown of future returns is as follows:

- 9% earnings-per-share growth
- 0.5% multiple expansion
- 1.7% dividend yield

Added together, we expect shares of A.O. Smith to offer a total annual return of 11.2% through 2024.

Another item investors should keep in mind is that A.O. Smith has a fairly low dividend payout ratio. The company should payout $0.88 in dividends per share in 2019.

Using the company's guidance for earnings-per-share, this would equate to a payout ratio of just 32.4%. This is slightly above the company's 10-year average payout ratio of 25.5%.

This leaves A.O. Smith plenty of room to increase its dividend, even in the event of a prolonged recession.

Final Thoughts

A.O. Smith is an industry-leading company. It has the top brand in its category, with compelling future growth potential.

While currency and trade issues may impact performance in China in the short term, A.O. Smith has such a dominant market share of its industry that the company can likely weather near term difficulties.

The stock is also somewhat undervalued today. While the yield is on the low side, the company's dividend growth is impressive.

With more than 11% expected annualized returns over the next five years, A.O. Smith is a good option for investors looking to add to the industrial portion of their portfolio.

Caterpillar (CAT)

Business Overview

Caterpillar was founded in 1925, and today competes in the manufacturing and selling of construction and mining equipment. The company also manufactures ancillary industrial products such as diesel engines and gas turbines. Caterpillar generates annual revenue of $58 billion and the stock has a market capitalization of $77 billion, making it one of the largest industrial stocks.

Industrial stocks have struggled in the recent past as fears over slowing – or even declining – global economic growth have compressed valuation multiples in the industry. Caterpillar is particularly beholden to commodity prices of all sorts, from metals to crops, so this fear has hit the share price significantly in the past couple of years. However, we see shares as quite meaningfully undervalued at current prices even if some of these fears over growth and commodity prices come to fruition.

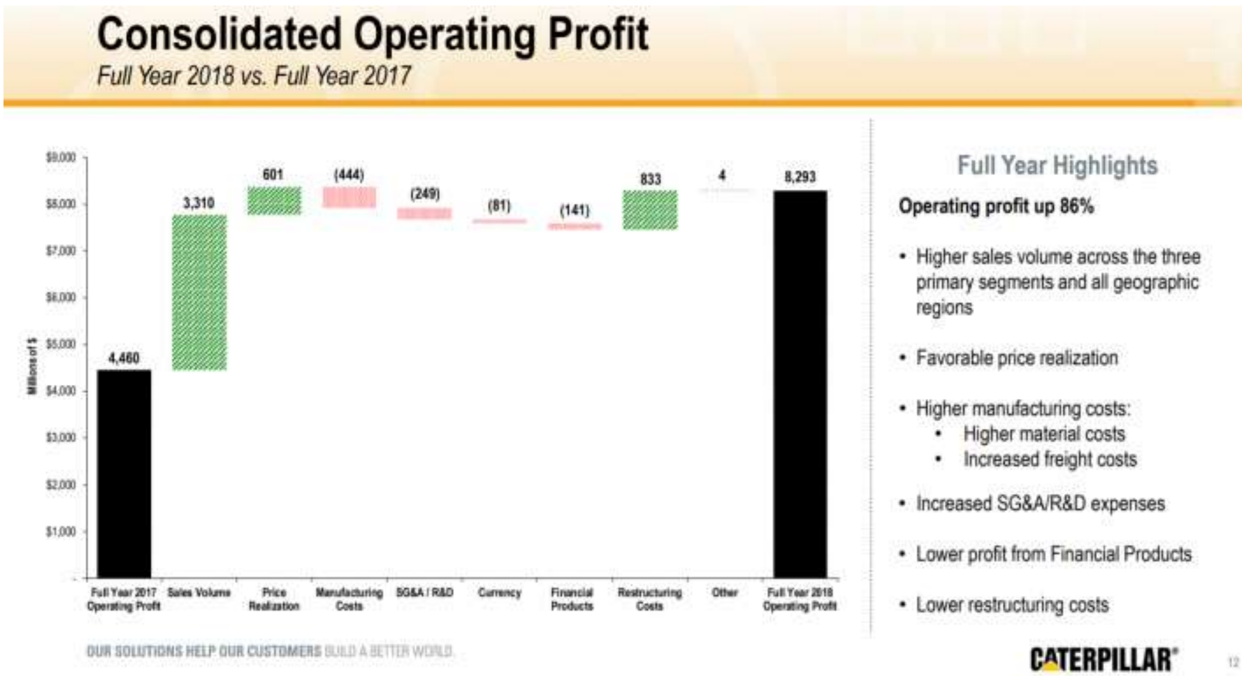
Caterpillar reported fourth-quarter earnings on 1/28/19 and the results were strong. Revenue was up 11% during Q4 to $14.3 billion, as the company saw each of its major segments grow revenue at sizable rates. The construction segment produced an 8% increase in revenue while the resource segment's revenue rose 21%, and energy and transportation saw an 11% rise in the top line.

The company's financial services business was a small drag on Q4 results with its 4% revenue increase, but overall, Q4 was tremendous from a revenue perspective.

Source: [Q4 earnings presentation](), page 11

For the full year, results were even better as the top line rose 20% and adjusted earnings-per-share soared 63%. That earnings-per-share growth to $11.22 was good enough to be a new record for Caterpillar, which is hardly what one would expect based upon the way the share price has behaved recently.

Caterpillar, however, is not just a revenue growth story. Its operating margins continue to move higher, which helped immensely with earnings-per-share growth in 2018.



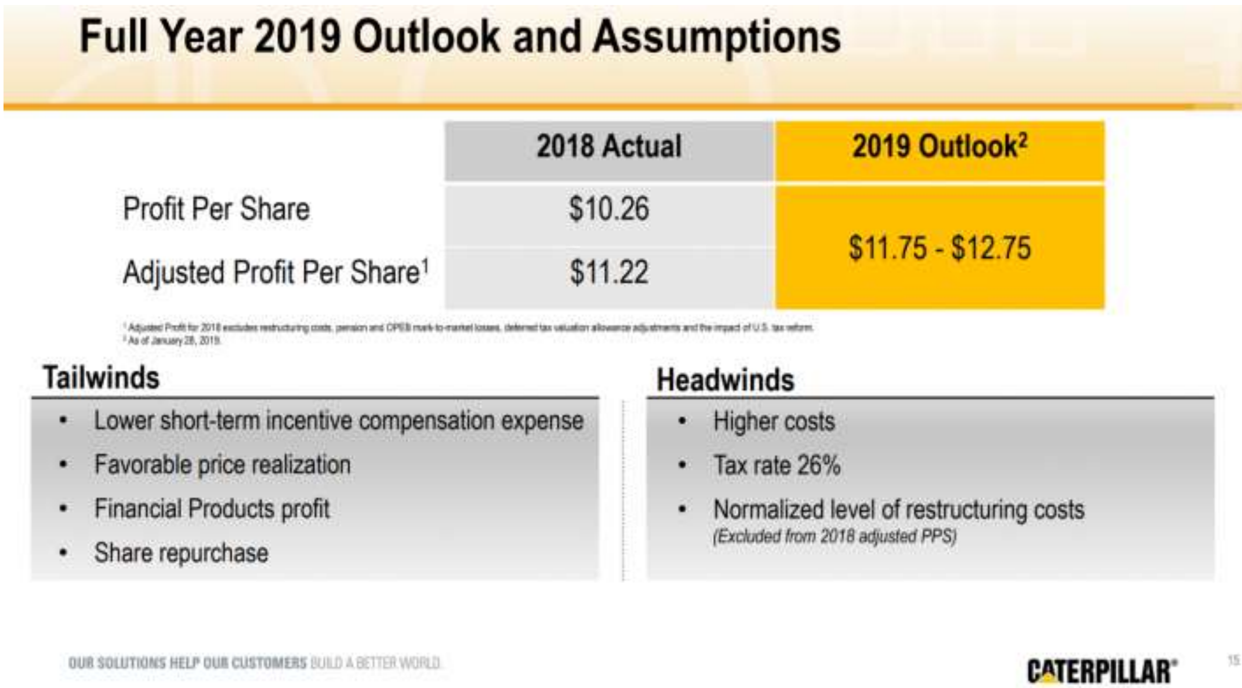
Source: [Q4 earnings presentation](), page 12

We can see from this slide Caterpillar managed to boost operating profits by a staggering 86% despite some headwinds from variable costs during the year. Selling, general, and administrative (SG&A) costs and research and development expense increased, removing $249 million from operating profits during 2018. Higher material and freight costs took away another $444 million.

However, stronger sales and better price realization were more than enough to offset those costs, and operating profits soared from $4.46 billion to $8.29 billion year-over-year. Caterpillar's years-long effort to boost operating leverage has paid off and 2018 was yet more evidence of that.

Caterpillar is not just an earnings growth story, however, as it returns billions of dollars of cash annually to shareholders via dividends and buybacks. The company repurchased $3.8 billion of stock in 2018, nearly half of which was purchased in Q4 alone.

The dividend was raised 10% for 2018, which is roughly congruent to other increases in recent years as Caterpillar is certainly doing much more than a low single digit increase simply to keep its streak going. The company also made a discretionary $1 billion payment to fund its pension program as it found a creative way to use its excess cash.



Source: [Q4 earnings presentation](), page 15

Management has guided for $11.75 to $12.75 in earnings-per-share for 2019, representing a potential range of growth of 5% to 14%. Caterpillar sees tailwinds from continued revenue growth, including better pricing, as well as lower compensation expenses, combined with share repurchases.

Headwinds include a higher tax rate and higher manufacturing costs, as we saw in 2018. Considering all of this, we expect 2019 earnings-per-share of $12.25, which is the middle of the guidance range.

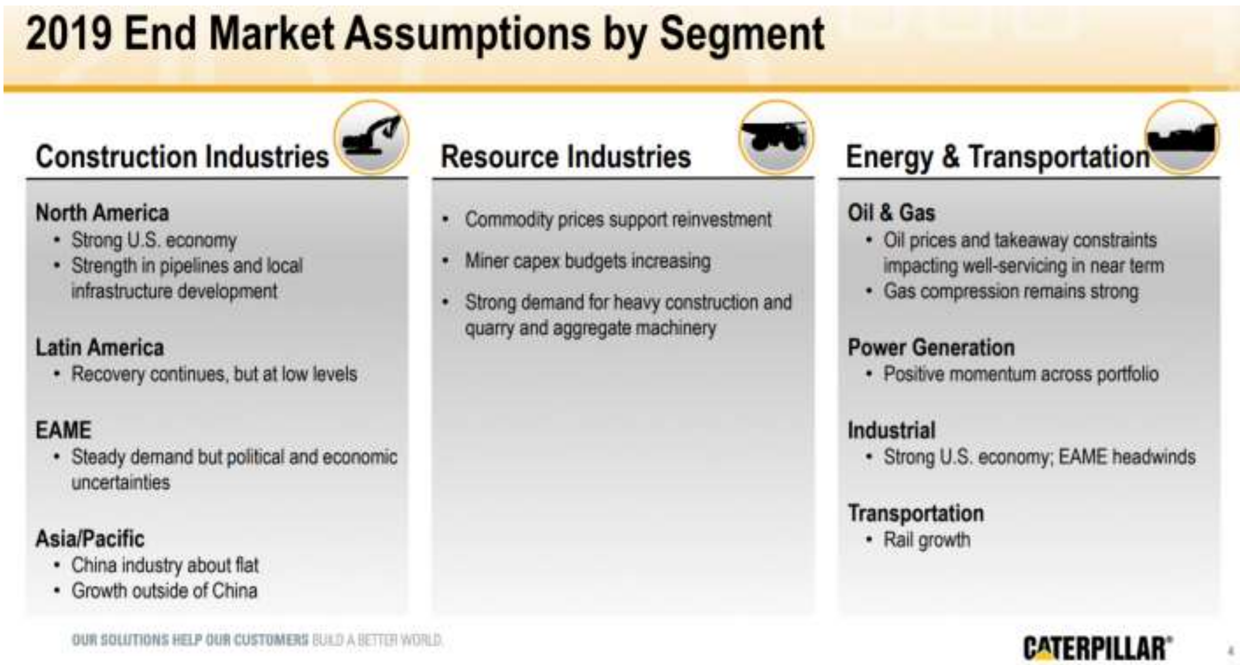
Growth Prospects

Caterpillar is closely tied to global economic growth, as well as commodity prices. Its customers extract resources from the earth as well as build and construct a wide variety of structures, so economic growth is key to fund that development. This leads to some fairly extreme cyclicality in Caterpillar's results, which then sees the stock swing wildly between extremes of the sentiment scale.

However, today, Caterpillar appears to be firing on all cylinders as its customers are still spending, driving its revenue higher. Mining companies are expanding operations as commodity prices remain favorable, and construction continues to expand in the US, China and other key markets around the globe.

Further, Caterpillar's own cost-cutting measures have driven operating margins higher for years and while the low-hanging fruit has certainly been picked, we don't see that story as ending just yet.

The company's rising cash flows afford it the ability to invest in its business where necessary, but also to return cash to shareholders in the billions of dollars.



Source: Q4 earnings presentation, page 4

This slide shows management's assumptions in terms of its major end markets for 2019, and overall, the picture is quite favorable. All three of the company's major segments have fundamental tailwinds continuing at least through 2019, supporting what is very likely to be another record in earnings-per-share this year.

Competitive Advantages & Recession Performance

Competitive advantages in industrial applications can be difficult given that for most applications, there are competitors that make largely similar products. However, Caterpillar has built itself into one of the largest players in lucrative end markets such as construction, energy, and mining over the years.

Its global presence affords it some diversification of revenue by segment and industry, but also geographically, which has served it well in recent years. Its scale also gives it the ability to leverage down variable costs per unit, which boosts margins.

However, Caterpillar is certainly not immune from recessions as slowdowns in the global economy are generally accompanied by lower commodity prices and slowing construction spending. These factors took a major toll on Caterpillar's bottom line during the Great Recession, as earnings were devastated, if only briefly.

Caterpillar's earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $5.32
- 2008 earnings-per-share of $5.71 (7% increase)
- 2009 earnings-per-share of $1.43 (75% decline)
- 2010 earnings-per-share of $4.15 (190% increase)

While Caterpillar certainly felt the pain from the Great Recession, its earnings rebounded fairly quickly and it reclaimed its pre-recession earnings-per-share number in 2011. The next recession likely won't be as damaging for Caterpillar as the Great Recession, but it is almost certain to see a meaningful decline in earnings-per-share when it does strike.

Valuation & Expected Returns

Caterpillar's current price-to-earnings ratio is just 10.6 today, which compares very favorably to our fair value estimate of 15.5. This makes Caterpillar significantly undervalued in our view, and should provide shareholders with an annual tailwind to total returns of around 8%.

You can see a breakdown of Caterpillar's historical price-to-earnings ratios in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	29.4	16.6	12.4	10.0	15.1	15.8	17.1	22.8	16.4	11.3	***10.1***	***15.5***
Avg. Yld.	4.0%	2.5%	1.9%	2.2%	2.7%	2.7%	3.8%	3.9%	2.8%	2.7%	***2.8%***	***2.0%***

Periods of cyclicality are normal for Caterpillar when it comes to the valuation, and today, we are certainly seeing a swing lower in the price of the stock relative to earnings.

Based upon the factors discussed above, we see total earnings-per-share growth at 6.2% annually. This will accrue from a combination of revenue growth, margin expansion, and the sizable share repurchase program. While Caterpillar has some potential headwinds in front of it should we see a global economic slowdown, overall, its fundamentals are quite strong.

In addition to earnings growth and a boost from the valuation, the current yield of 2.8% will help drive shareholder returns. Combining the three factors, we see total annual returns of around 17% for the next five years. That makes Caterpillar very attractively priced today and we rate the shares a buy as a result.

Final Thoughts

Caterpillar offers investors a wide variety of reasons to want to own the stock today. It has a nearly-3% yield in addition to 25 consecutive years of dividend increases. Its payout ratio is less than one-third of earnings, so its dividend has a very high safety rating and has lots of room to continue to expand in the coming years.

It also has favorable fundamental backdrops in its major segments, which means earnings growth should continue for the foreseeable future. Finally, the stock is very attractively priced as it trades for roughly two-thirds of our fair value estimate. Putting these factors together paints a bullish picture of Caterpillar, and we believe it is a buy today.

Cintas (CTAS)

Business Overview

Cintas Corporation started out in 1929, under the name Acme Industrial Laundry Company. It was founded by Richard "Doc" Farmer, who got his start collecting chemical-soaked rags from factories and cleaning them for a fee.

Doc Farmer's grandson, Richard T. Farmer, joined the company in 1956 after graduating from college. After gaining enough experience, he left the family business to start Cintas in 1968.

Today, it is the largest company in its industry, generating annual revenue of nearly $7 billion.

Source: Investor Relations

It designs and manufactures corporate uniforms, entrance mats, restroom supplies, fire protection, and first aid products.

The company has a large and diversified customer base, which includes more than 1 million businesses in North America, Latin America, Europe, and Asia.

Cintas is split up into two main businesses. The Uniform Rental segment is the largest business, representing more than 80% of annual revenue. It provides products and services to customers through the company's local delivery routes.

Cintas also has a first aid and safety services business, which provides products through its distribution network and local delivery routes.

Cintas is certainly a growth company, and has been for a long time. Halfway through the company's fiscal 2019, adjusted earnings-per-share has risen a staggering 32% over the comparable period last year. The company has enjoyed a 6.2% increase in total revenue thanks to broad-based growth, as well as continued margin expansion.

Going forward, we estimate that Cintas will be able to produce 8% earnings-per-share growth annually, continuing a long tradition of high rates of earnings growth.

Growth Prospects

Cintas has enjoyed strong growth for the past several years. It saw particularly high growth rates in the years following the Great Recession, when hiring picked up and the labor market recovered. This has led to the huge rally in Cintas stock since the market lows of 2009 as Cintas is seen as a direct play on job growth in the US. As unemployment rates remain very low, Cintas is performing extremely well.

Cintas has generated excellent growth of revenue and net income over the past five years.

Five-Year Financial Summary

(In thousands except per share and percentage data)

Fiscal Years Ended May 31,	2014(1)	2015(1)	2016(1)	2017(1)(2)	**2018(1)**	Compound Annual Growth (2014-2018)
Revenue	$4,091,204	$4,369,677	$4,795,772	$5,323,381	$6,476,632	12.2%
Net Income, Continuing Operations	330,541	402,553	448,605	457,286	783,932	24.1%
Net Income, Discontinued Operations	43,901	28,065	244,915	23,422	58,654	7.5%
Net Income	$ 374,442	$ 430,618	$ 693,520	$ 480,708	$ 842,586	22.5%

Source: 2018 Annual Report

The company continued to perform well to start fiscal 2019. After the Q2 earnings report, management saw fit to boost guidance to a midpoint of $7.34 in earnings-per-share for this year.

Cintas also said revenue would be up ~6% this year to $6.9 billion and that margins would continue to expand. With the job market continuing to perform well and with a bright outlook, management is justifiably confident.

Cintas has a positive growth outlook moving forward. Catalysts for future growth include the very strong job market in the US as well as Cintas' willingness and ability to purchase growth, as it did with G&K Services in 2017.

Cintas benefits from global economic growth. As companies grow and hire new employees, demand for service uniforms and related equipment rises. This is how Cintas has been able to produce such high growth rates over time and given the state of the US job market, Cintas' near-term growth is all but assured.

Another growth catalyst for Cintas is its portfolio restructuring. The company has divested under-performing segments and has acquired companies in new areas as management is willing to make difficult decisions about what is best for the company's future.

For example, Cintas sold its interest in Shred-it International, for $578 million. This business was not meeting management’s expectations, and was not deemed critical to the future growth strategy of the company.

The G&K acquisition added nearly a billion dollars of annual revenue without shareholder dilution. In addition, the company is saving more than $100 million annually from synergies between the two companies and is providing Cintas with another strong growth catalyst.

The G&K purchase was a sizable one for Cintas so it may be some time before we see another big acquisition, but Cintas certainly isn't afraid to make bold moves to fuel the next leg of growth.

In total, we see 8% average annual earnings-per-share growth in the coming years for Cintas. Cintas doesn't buy back enough stock to impact earnings-per-share growth, but revenue growth and margin expansion have been outstanding in recent years.

Competitive Advantages & Recession Performance

Cintas has a distinct operating advantage, which is its vast distribution network. Cintas has more than 11,000 local delivery routes, hundreds of operational facilities, and 11 distribution centers.

It is the largest company in its industry, which gives it market control. It would be very difficult for a new competitor to enter the market and try to disrupt Cintas’ business model and this is even more so the case after the G&K purchase.

This helps keep competition at bay as Cintas has a highly entrenched customer base and no other company has the scale to compete.

Its distribution capabilities and reputation for quality, provide Cintas with high margins. So far this year, gross margins are in excess of 45% of revenue and operating margins are better than 14% of revenue.

While Cintas is a high-growth business, it is also reliant on a healthy global economy. When the economy goes into recession, companies hire less and often reduce headcount. This results in reduced demand for the products Cintas manufactures.

Cintas had a difficult time growing earnings-per-share, despite the fact that the recession officially ended in 2010.

The company's earnings-per-share for 2008-2010 are shown below:

- 2007 earnings-per-share of $2.09
- 2008 earnings-per-share of $2.15 (2.9% increase)
- 2009 earnings-per-share of $1.83 (15% decline)
- 2010 earnings-per-share of $1.49 (19% decline)

As you can see, Cintas struggled during 2009 and 2010, with two consecutive years of double-digit earnings declines. This reflects how closely the profits of the business are tied to the condition of the economy.

At the same time, Cintas remained profitable, which allowed it to continue increasing dividends each year.

And, Cintas quickly emerged from the recession. The company grew earnings-per-share by 13% and 35% in 2011 and 2012, respectively. To be clear, the risk of recession in the near term is low, but shareholders should note that economic downturns are very unfriendly to Cintas' earnings capabilities.

Valuation & Expected Returns

Cintas stock trades for a price-to-earnings ratio of 27.8. This is a very high valuation against the broader market, as well as Cintas' own historical valuations.

Cintas has had an average price-to-earnings ratio of 17.5, which means the stock is currently trading 59% above its fair value. The stock has traded for such high valuations in the past, but these periods preceded significant multiple contraction, which hurts shareholder returns.

If the stock were to return to its 10-year average price-to-earnings ratio over the next five years, shares would decline nearly 9% annually from multiple contraction.

As a result, Cintas is extremely overvalued, and is a confirmed sell for us at any price above $128 per share. This would represent a price-to-earnings ratio of 17.5, on par with the the company's normalized valuation.

In total, we expect essentially flat shareholder returns for the coming years. Cintas' significant runway for growth has already been priced into the stock, as the 1% dividend yield and 8% earnings-per-share growth will likely be entirely offset by a ~9% annual headwind from a declining valuation.

Cintas' valuation today, in other words, has priced in five years' worth of growth, and we believe investors should avoid the stock as a result.

Final Thoughts

Cintas is a very strong company, with a high growth rate of earnings and dividends. However, due to the recent impressive rally in the stock price, Cintas now has a dangerously elevated valuation.

Another consequence of the huge share price increase in recent years is that the stock has a low dividend yield of 1%.

While the company has a secure dividend payout with room for future dividend increases, the stock is grossly overvalued. We rate it a sell despite its superior fundamentals simply because the valuation is so high. If Cintas returns to a normalized valuation, it could earn a buy recommendation because of its strong growth and high-quality business.

Dover (DOV)

Business Overview

Dover is an industrial manufacturer, with annual revenue of more than $7 billion. Its products include equipment, components, specialty systems, and more. After spinning off its energy business in 2018, the company now has three operating segments: Fluids, Engineered Systems, and Refrigeration & Food Equipment.

Source: Investor Presentation

Dover's largest segment, the fluids segment helps customers improve transfer and dispensing of fluids. Manufactured products include specialized pumps and tubes.

The company's engineered systems designs and manufactures components. Its products are used across multiple end markets, including consumer goods, textile printing, automotive service, environmental solutions, and industrials.

The refrigeration segment supplies energy-efficient equipment to the food industry.

Dover's divested its energy business into a stand alone company called Apergy (APY) in early May of 2018. Revenue for this sector declined tremendously as the price of oil declined in 2014. Customers cut spending in response to low oil prices. The energy segment contributed the least to annual revenue. Removing energy allows Dover to focus on its core businesses.

Growth Prospects

Dover saw a notable improvement across most of its operating segments in the fourth quarter of 2018. Revenue and earnings-per-share grew 3.4% and 27%, respectively, in the fourth quarter.

For the year, revenue decreased 6.6% to $7.3 billion. Revenue from continuing operations, however, increased 2.5%. Earnings-per-share for 2018 totaled $4.97, $0.14 above the company's guidance and a 13.5% increase from the prior year.

And, bookings were up 8% last quarter to $1.9 billion. This bodes well for growth moving forward.

Dover's Fluids segment grew 17.2% organically during the fourth quarter and is now the largest contributor to revenue. This segment was led by its pumps and process solution businesses, which saw robust demand for products.

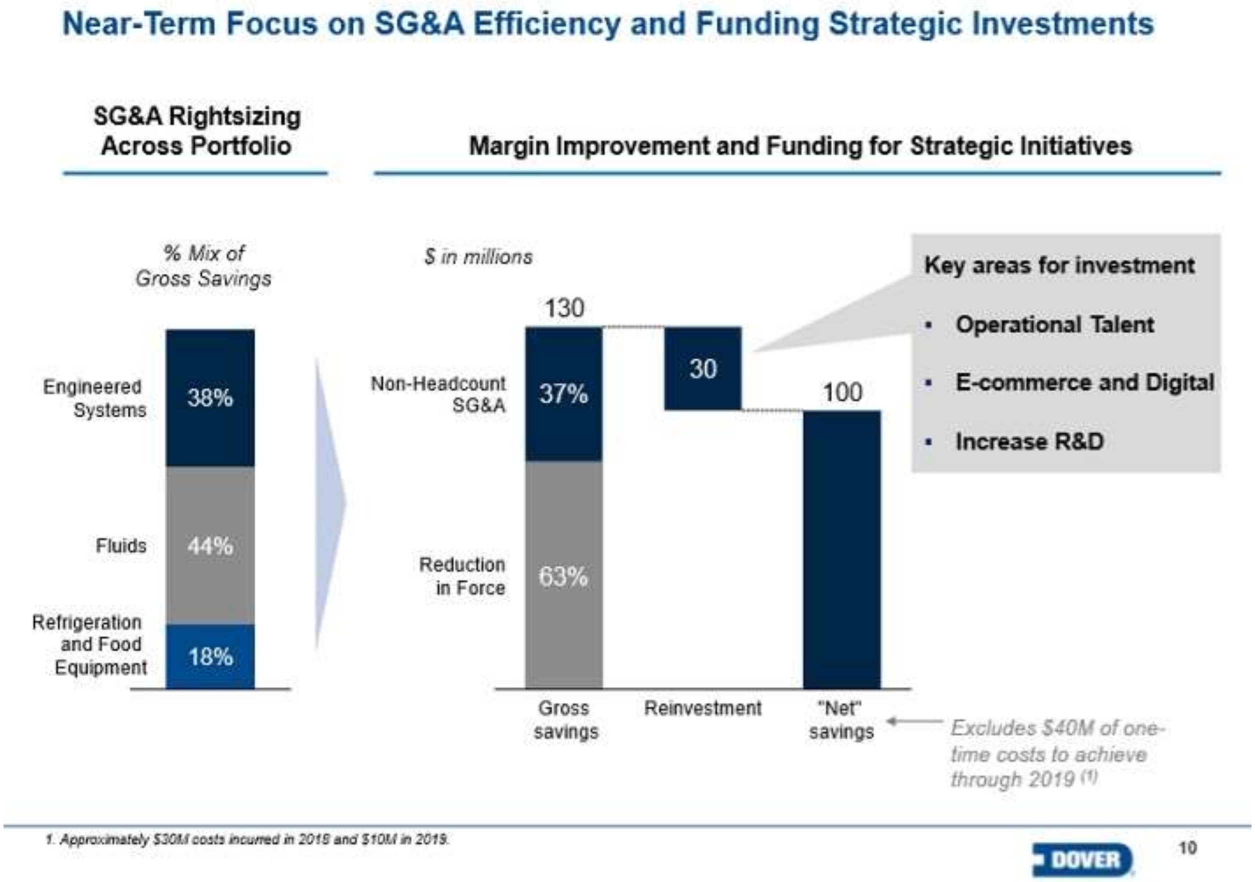
The engineered systems segment grew sales 4.3% on an organic basis as printing and IT businesses were strong during the quarter.

Dover's refrigeration and food equipment business was the lone division to see revenues decline during the quarter. Revenues were down 10% due to lower volumes in the company's can making and retail refrigeration businesses.

Dover is truly a global business as only half of sales in the last quarter came from the U.S. Sales for this region improved 6%.

Besides organic growth in existing businesses, Dover's earnings growth will also come from margin improvements and acquisitions, which are key parts of the company's growth strategy.

First, Dover launched an aggressive cost-cutting program to boost margins across its operating segments.



Source: Investor Presentation

The ambitious cost-reduction effort will also free up additional resources for investment in growth. Dover is active on the mergers and acquisitions front. Since 2014, Dover has spent billions on a number of bolt-on acquisitions.

The latest acquisition was for Belanger Inc, a full-line car wash equipment manufacturer. Belanger has been in business for 50 years and generated $55 million in sales last year. This purchase cements Dover as one of the largest car wash systems and equipment manufactures in the world. The deal closed at the end of January.

For 2019, Dover expects earnings-per-share of $5.65 to $5.85. This would represent nearly 16% earnings growth from 2018.

Dover expects full-year revenue growth of 2% to 3%. This includes organic growth of 2% to 4%, with unfavorable currency translation estimated to be a 2% headwind.

Competitive Advantages & Recession Performance

No company can increase its dividend for 60+ years in a row, without durable competitive advantages. In Dover's case, its competitive advantages include a large intellectual property portfolio, economies of scale, and a strong balance sheet.

Dover helps maintain its intellectual property, by investing in R&D:

- 2014 research-and-development expense of $118.4
- 2015 research-and-development expense of $115 million
- 2016 research-and-development expense of $104.5 million
- 2017 research-and-development expense of $125 million

Dover is in good financial condition. It has a long-term credit rating of BBB+ from Standard & Poor's and A3 from Moody's. High credit ratings helps Dover keep its cost of capital low.

Dover is in a fortunate position, in that it generates high levels of cash flow. It can invest 60% of cash flow in acquisitions and capital expenditures, and also return cash to shareholders through dividends and buybacks.

Dover's competitive advantages allow it to maintain consistent profitability each year, even during recessions. Dover's earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $3.22
- 2008 earnings-per-share of $3.67 (14% increase)
- 2009 earnings-per-share of $2.00 (45% decline)
- 2010 earnings-per-share of $3.48 (74% increase)

As a major industrial manufacturer, Dover is a bellwether for the global economy. As should be expected, it is not a highly recession-resistant company.

The deep economic downturn caused Dover's earnings to nose-dive in 2009. However, the company only had one year of declining earnings during the recession. It returned to growth in 2010 and beyond. And its dividends continued to grow during this period of uncertainty.

Valuation & Expected Returns

Dover stock trades for a price-to-earnings ratio of 15.1, using the company's earnings guidance for 2019. Dover held an average price-to-earnings ratio of 16.7 over the past 10 years. Dover stock appears to be undervalued, based on its average valuation multiples.

If Dover stock experiences an expansion of the valuation multiple to our estimate of fair value, it would yield a 1.6% annual boost to shareholder returns over the next five years.

In addition, future returns will be aided by earnings growth and dividends. We expect the company to grow earnings-per-share by 5% per year through 2024. This is a reasonable forecast, as Dover forecasts 3%-5% annual revenue growth, along with additional earnings growth from share repurchases and margin improvements.

Lastly, Dover stock has a dividend yield of 2.2%. Putting it all together, a breakdown of our expected future returns is as follows:

- 5% expected earnings-per-share growth
- 2.2% dividend yield
- 1.6% valuation expansion

In this projection, total shareholder returns could reach 8.8% annualized through 2024. This is a satisfactory--albeit unspectacular--expected rate of return for this Dividend King.

Final Thoughts

Dover has endured a number of challenges over the past decade, including the Great Recession and the oil and gas downturn of 2014-2016. And yet, it continued to raise its dividend each year, no matter what.

Very few companies have this ability, which makes Dover a rare dividend growth stock.

Dover's two largest segments showed solid growth during the last quarter. And, we feel that removing energy from its core business was a prudent move by the company. These factors have the company positioned for growth in future years, making it highly likely that Dover will continue to increase its dividend.

While shares trade at a valuation below their historical norm, we rate Dover as a hold for now due to decent, but not great, potential returns. On a pullback, we would be buyers of this quality industrial name.

Emerson Electric (EMR)

Business Overview

Emerson Electric was founded in Missouri in 1890 by two Scottish brothers, Charles and Alexander Meston, who saw a potential business opportunity in manufacturing reliable electric motors.

The two brothers received a start-up investment from John Wesley Emerson, a former Union army officer, judge, and lawyer. Together, the three formed The Emerson Manufacturing Company.

Since its founding, it has evolved through organic growth as well as strategic acquisitions and divestitures from a regional manufacturer of electric motors and fans into a diversified global leader in technology and engineering. Its global customer base affords it $19 billion in annual revenue and a current market capitalization of $42 billion.

Emerson is organized into two major reporting segments called Automation Solutions and Commercial & Residential Solutions.

Source: Investor Presentation

Automation Solutions helps manufacturers minimize energy usage, waste, and other costs in their processes. The Commercial & Residential Solutions segment makes products that protect food quality and safety, as well as boost efficiency in the production process.

Today, Emerson does business around the world, and has about 75,000 employees.

Growth Prospects

Emerson has just come out of a period of intense transition. The company has endured a difficult few years due to a number of headwinds including a strong U.S. dollar, slowing economic growth rates in China, and the steep decline in oil and gas prices. All of these factors weighed on Emerson by varying degrees, and more recently, oil and gas prices have been a larger issue.

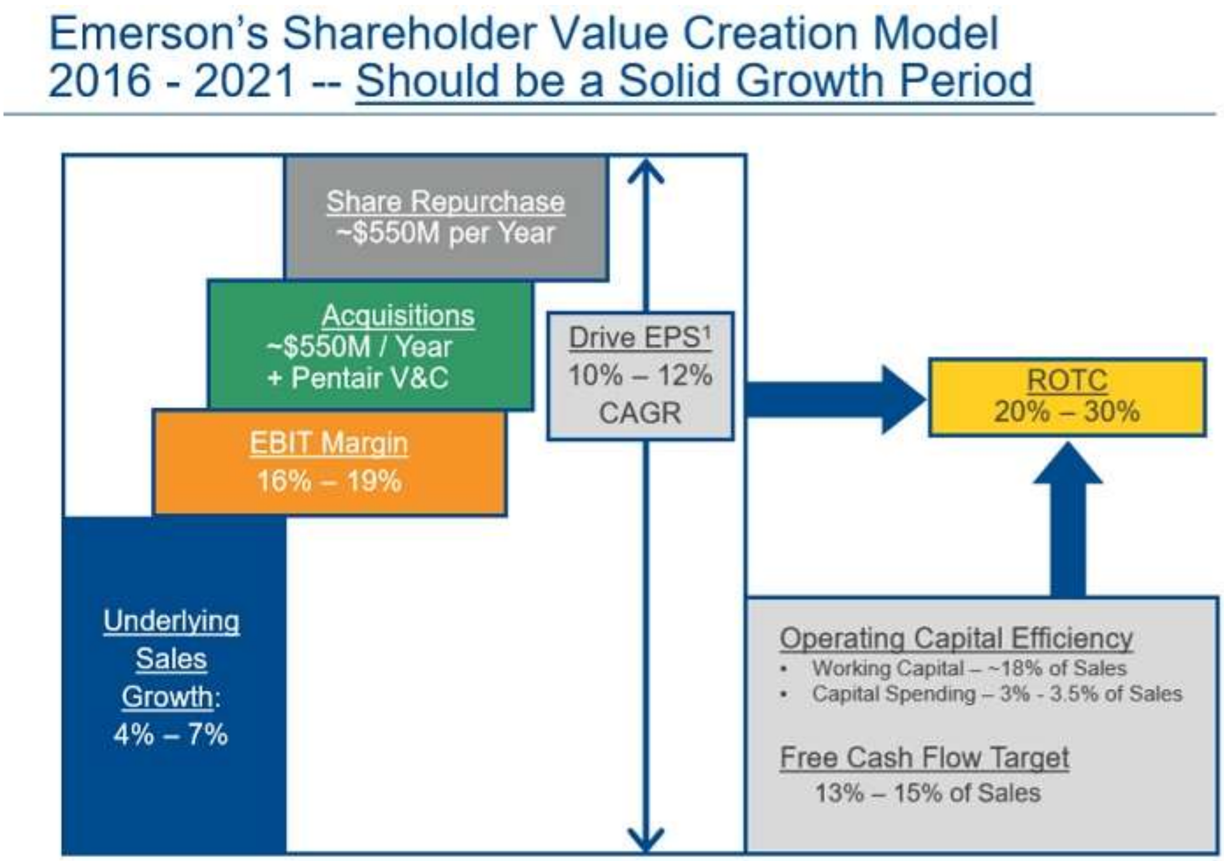
Note: Many of Emerson's customers are in the energy sector, which is why low oil and gas prices affect the company negatively.

As a result, Emerson's revenue results have been very weak in recent years, as fiscal 2018's total revenue was actually *less* than that of fiscal 2014. Part of this is due to nearly constant divestitures as Emerson remade itself, but it has added companies to its portfolio as well during that time. Emerson's performance simply hasn't been very good during this time frame.

In response, Emerson has undertaken a significant restructuring of its business model. First, it slashed costs to keep profits afloat.

The restructuring has resulted in hundreds of millions in additional operating profits hitting Emerson’s bottom line. This has helped boost Emerson's earnings-per-share significantly in the past couple of years, with 2018 earnings-per-share growing 36% over the prior year.

Cost reductions, combined with organic sales growth, acquisitions, and share repurchases, are expected to fuel at least 10% annual earnings growth through 2021.



Source: Investor Presentation

Emerson produced a 5% gain on the top line in fiscal 2018 as well, putting in a sales increase for only the second time since 2013.

Emerson continues to acquire and divest companies in its portfolio to optimize the amount of revenue risk it is taking and focus on longer-term growth opportunities. Recently, Emerson has acquired Advanced Engineering Valves, a manufacturer of innovative valve technology that helps LNG customers operate more efficiently.

In addition, it has acquired the intelligence platforms business from General Electric, affording it the ability to expand its capabilities in machine learning and discrete applications. Acquisitions and divestitures are a way of life for Emerson and the ever-shifting mix of business has been beneficial in recent years.

Emerson's Commercial & Residential Solutions business has typically been the growth driver of the company. However, the Automation Solutions segment has improved meaningfully in recent quarters and is now a growth driver in its own right.

Management expects consolidated order growth in 2019 of 5% to 10% with Automation Solutions actually leading the way. Recent moves to improve that segment's mix have clearly paid off and acquisitions continue to drive order growth as well.

For all of fiscal 2019, Emerson expects earnings-per-share to come in at $3.55 to $3.70, which compares favorably to 2018's earnings-per-share number of $3.46. At the midpoint, that suggests just 5% earnings-per-share growth this year, but Emerson expects its tax rate to move much higher, from 17% to 25%, which will remove 34 cents from earnings-per-share this year. Accounting for some one-time costs that occurred in 2018, total non-operating items will reduce earnings-per-share by ~22 cents this year.

Without those adjustments, Emerson expects to produce ~12% growth in earnings-per-share for 2019, so its strategy appears to be working. While we see 2019 as another strong year of growth, we expect Emerson to produce 5% earnings-per-share growth over full economic cycles.

Its exposure to cyclical industries such as oil and gas is a risk over time, and its spotty performance in recent years - while improving - is a key factor as well. Emerson has made progress on many fronts including revenue growth and margin expansion.

Competitive Advantages & Recession Performance

Emerson’s two main competitive advantages are its global scale, and proprietary technology. Emerson generates high margins and returns on capital thanks to its enormous global distribution network.

Emerson's constant investment in new technology - totaling hundreds of millions of dollars annually - has given the company a leadership position across its two product segments. Its competitive advantages also allow it to navigate recessions better than most industrials.

Emerson’s earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $2.66
- 2008 earnings-per-share of $3.11 (17% increase)
- 2009 earnings-per-share of $2.27 (27% decline)
- 2010 earnings-per-share of $2.60 (15% increase)
- 2011 earnings-per-share of $3.24 (25% increase, new post-recession high)

Emerson performed relatively well during the Great Recession, with only one year of declining earnings. Normally, industrial manufacturers are tied to the health of the global economy. Its resilience during the Great Recession is a credit to its competitive advantages.

Valuation & Expected Returns

Emerson's valuation has come down significantly in recent years, and for the first time in a few years, it is trading at our estimate of fair value. Indeed, the stock trades for 18.4 times the midpoint of earnings-per-share guidance provided by management, which compares to our estimate of fair value at 18.3 times earnings.

Today, the stock is fairly valued. This is a vast change from recent years when the valuation crept into the mid-20s, and was overvalued.

A breakdown of Emerson's historical stock valuations can be seen in the following table:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	14.8	17.8	16.8	18.3	15.8	17.6	18.0	20.6	22.9	20.5	***19.3***	***18.3***
Avg. Yld.	3.9%	2.9%	2.5%	3.3%	3.0%	2.6%	3.3%	3.8%	3.3%	2.7%	***2.8%***	***2.5%***

Looking ahead, we see Emerson as producing ~8% total annual returns for shareholders. This will consist of the current yield near 3%, earnings-per-share growth of 5% and essentially no impact from the valuation as it is at fair value. The stock is certainly much more favorably priced than it has been in the past, but it isn't cheap enough yet for us to call it a buy.

As a result, we think Emerson is a good pick for those seeking income and dividend growth, but those looking for earnings growth or value should look elsewhere. We rate Emerson a hold at today's prices.

Final Thoughts

Emerson is a high-quality business, with a long history of steady growth. It has rewarded shareholders along the way, with more than six decades of annual dividend growth.

Right now may not be the best buying opportunity for the stock. Although the valuation has improved significantly, it is only just trading at fair value. Investors that want to initiate a position would do well to try and wait for a lower valuation.

However, Emerson has a solid 3% dividend yield, and remains a sure bet to increase its dividend each year.

General Dynamics (GD)

Business Overview

General Dynamics was incorporated in 1952, through the combination of the Electric Boat Company, Canadair, and several others.

The company has evolved over the years, to enter new businesses of the future. The biggest transformation came in the 1990's, when General Dynamics started buying technology-oriented companies. General Dynamics currently generates annual sales nearing $40 billion.

The company's revenue stream has been diversified in recent years, and it now no longer relies as much upon the Aerospace segment as it used to.

A breakdown of its segments and their contribution to revenue is below:

- Aerospace (25% of revenue)
- Combat Systems (17% of revenue)
- Information Technology (22% of revenue)
- Mission Systems (13% of revenue)
- Marine Systems (23% of revenue)

These segments all have varying growth outlooks and margin profiles but together, they create a diversified, very profitable stream of revenue for General Dynamics.

The company's Aerospace segment produces aircraft and services them for its customers. It was recently expanded with the acquisition of Hawker Pacific.

The Combat Systems business manufactures combat vehicles, and related weapons systems and munitions. The Information Systems and Technology business sells technologies, to the military, and for civilian, state, and commercial purposes. Mission Systems provides services to the armed forces such as product line management for training.

Lastly, the Marine Systems group builds nuclear-powered submarines and surface combatants for the U.S. Navy, and also Jones Act vessels.

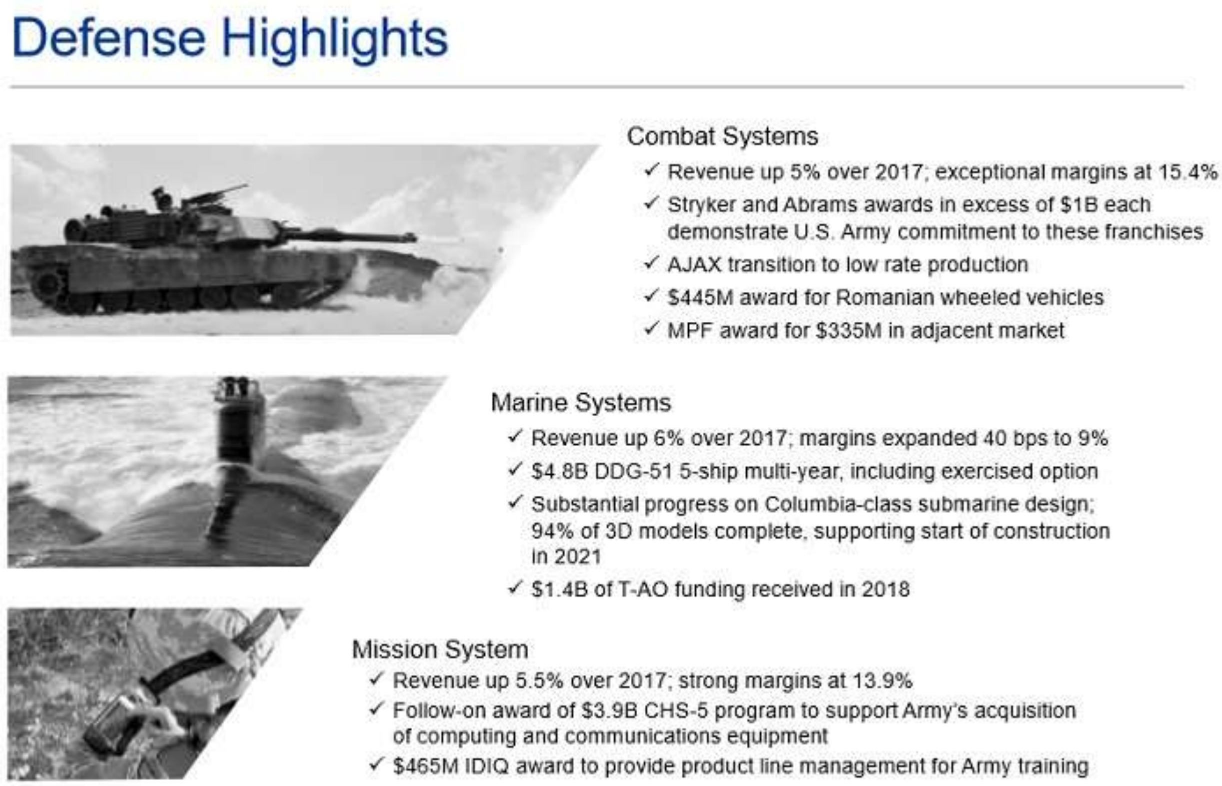
Growth Prospects

General Dynamics has produced strong earnings growth in recent years, and the trend should continue moving forward, although 2019 is slated to produce a modest increase over 2018.

General Dynamics reported fourth-quarter and full-year earnings in late January (1/30/19), and growth was strong. The Aerospace segment saw its 2018 revenue rise 4% and its operating earnings decrease 5.5%. Combat Systems posted a 4.9% gain in revenue and a 2.7% increase in operating earnings.

Information Technology saw its revenue soar 87.5% and its operating earnings gain 63% for the year thanks mostly to the CSRA Acquisition. Meanwhile, Mission Systems saw its revenue rise 5.5% and its operating earnings increase 3.3% during the year.

In all, General Dynamics' defense-related businesses performed well in 2018.



Source: Earnings Presentation

Finally, Marine Systems posted a 6.2% revenue increase and an 11.1% gain in operating earnings, as it was the only reporting segment to boost its operating margins during 2018.

In total, earnings-per-share increased 15% during 2018 thanks primarily to the CSRA acquisition and a lower share count. General Dynamics' average growth rate in the past decade is about 7%, so 2018 came in at roughly double its normal rate of growth.

Moving forward, General Dynamics will continue to benefit from growth in defense spending, both in the U.S. and the international markets.

President Trump has advocated for higher levels of defense spending in the U.S., which has been and will continue to be a tailwind for General Dynamics.

In addition, international markets are likely to continue raising defense spending as well. Geopolitical risk remains elevated across many parts of the world. General Dynamics and its competitors will be the beneficiaries of this risk.

In 2018, General Dynamics generated $2.5 billion in free cash flow and returned $1.8 billion to shareholders via buybacks, while sending another $1 billion via dividends. It boosted the dividend 11% in 2018, marking its 27th consecutive annual dividend increase.

The company believes it will see $11.65 in earnings-per-share this year, representing just 2% growth over 2018.

Financial Guidance

	2019 Guidance	
EPS*	**$11.60 – 11.70**	
	Revenue	**Operating Earnings**
Aerospace	~$9.7B ~145 business jets	Slightly in excess of $1.5B Margin ~15.5%
Combat Systems	$6.5 – 6.6B	$965 – 975M
Information Technology	~$8.3B	Margin ~7.5%
Mission Systems	$4.8 – 4.9B	Margin mid- to high-13%
Marine Systems	~$9.0B	~$770M Margin ~8.5%
GD Consolidated	**~$38.5B**	**~$4.5B**

** Diluted from continuing operations*

Source: Earnings Presentation

General Dynamics has had years of slow or even negative growth in the recent past, so it isn't particularly unusual in what is a very cyclical business.

Management sees ~6% revenue growth as the key driver of earnings in 2019, offset partially by lower margins. In particular, Aerospace margins are set to move materially lower again in 2019, while Marine Systems margins should moderate slightly. We do not believe the growth story for

General Dynamics is dead by any means, but 2019 looks to be a year of transition rather than progress.

Competitive Advantages & Recession Performance

General Dynamics has several competitive advantages. First, it operates in defense, which has very high barriers to entry. Defense companies rely on contracts from the U.S. and foreign governments. A small competitor would have difficulty entering the defense industry and trying to take share.

In addition, General Dynamics has industry-leading brands, such as Gulfstream and Stryker. It has built these brands with significant research and development spending, that totals in the hundreds of millions of dollars annually. Indeed, this is part of the significant barriers to entry for potential competitors.

General Dynamics is built to last. The company performed very well during the last recession:

- 2007 earnings-per-share of $5.10
- 2008 earnings-per-share of $6.13 (20% increase)
- 2009 earnings-per-share of $6.20 (1.1% increase)
- 2010 earnings-per-share of $6.82 (10% increase)

As you can see, the company grew earnings in each year of the recession, including two years of double-digit growth. It would not be easy to find many companies that grew earnings-per-share by 20% in 2008, but General Dynamics did it.

One major reason for the company’s excellent recession performance, is because it sees steady demand for its products and services each year. The world has many dangerous places. Global conflicts are not likely to cease any time soon, regardless of the economic climate. This will drive ever-increasing levels of defense spending, the US included.

And, General Dynamics’ revenue is secured by long-term contracts with its customers, and switching costs are very high, sometimes impossibly so. This also keeps earnings intact during recessions.

Valuation & Expected Returns

General Dynamics stock has a price-to-earnings ratio of 14.8 today, which is well off of its former highs in 2017 in excess of 20. It is also much more in line with the company's historical multiple, which has tended to be around 14 times earnings.

Thus, at its current valuation, General Dynamics is trading only slightly in excess of fair value, making the stock much more attractive than it has been in recent times.

Given the stock's historical multiples as well as the company's forecast slowdown in growth, we see 14 times earnings as fair value.

Using a fair price-to-earnings ratio of 14, and the company's expected 2019 adjusted earnings of $11.65, yields a fair value estimate of $163. With the share price at $173, it is trading slightly in excess of fair value.

Given all of these factors, we see total annual returns of about 9% in the coming years, consisting of the current 2% yield, 8% earnings growth, and a very small headwind from the declining valuation. General Dynamics is nowhere near as expensive as it once was, and we therefore rate the stock a hold.

Final Thoughts

General Dynamics is a high-quality business, with a long history of growth. Geopolitical risk remains a constant, which gives the company a long runway of growth going forward.

General Dynamics is a shareholder-friendly company, and should continue returning significant cash to shareholders through buybacks and dividends.

While the valuation has certainly improved, the stock is still trading slightly above fair value. Combined with the expected growth slowdown in 2019, we view General Dynamics as a strong holding for dividend growth but believe investors should wait for a better opportunity before initiating a position.

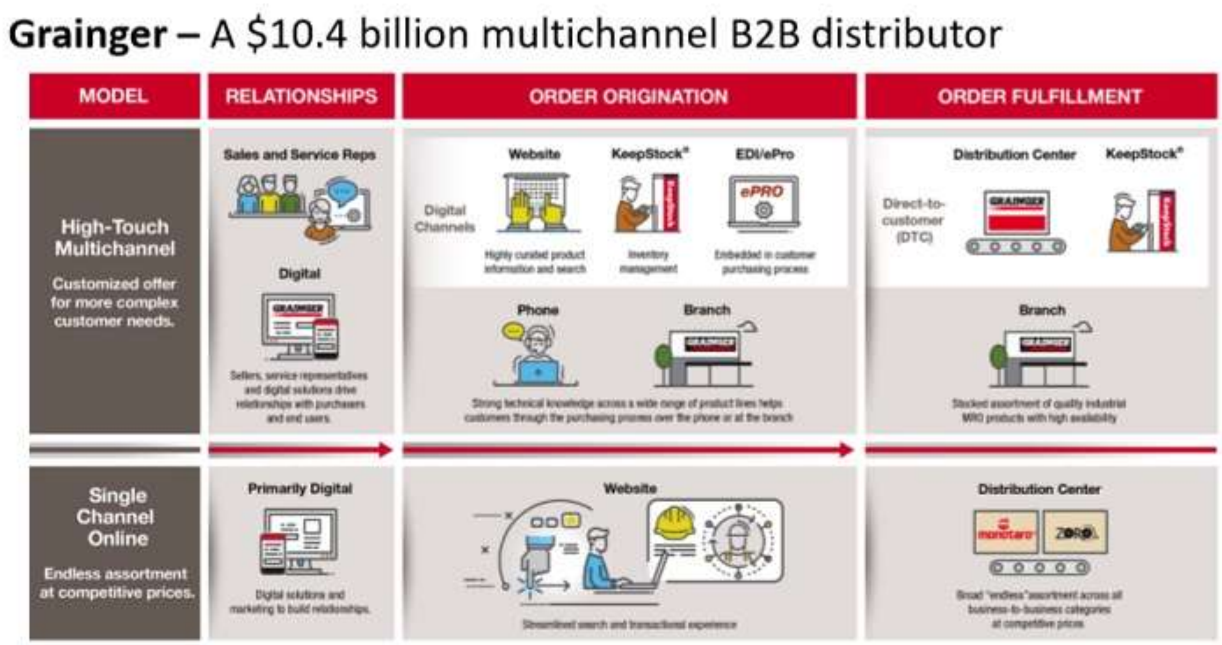
W.W. Grainger (GWW)

Business Overview

Grainger was founded in 1927. Today, it is a large supplier of maintenance, operating, and repair products, or MRO for short. These are products like safety gloves, power tools, ladders, test instruments, and motors. It also offers services such as inventory management.

Grainger has 3 million business and institutional customers worldwide. The majority of customers are large U.S. businesses.

The company generates annual sales above $10 billion. Over half of revenue is derived from the U.S., but Grainger also has operations in Japan, the U.K., Mexico, and Germany. Grainger operates 700+ branches and 30+ distribution centers in North America.



Source: [Investor Presentation]

This is a difficult time for Grainger. Competition is heating up in the MRO supply industry. This has caused pricing deflation in the company's core businesses.

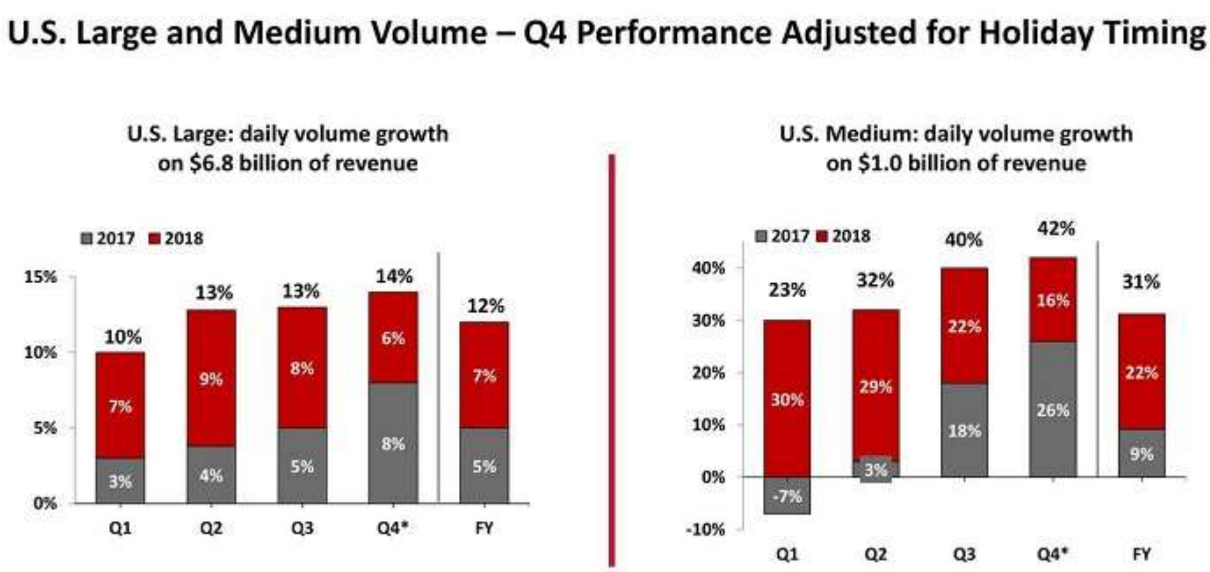
The good news is, Grainger has actively competed on price, and in e-commerce. This has eroded profitability, but volumes are increasing, and Grainger is capturing market share.

The company's willingness to adapt to a new environment, has helped it secure its competitive position. It has returned to growth, and has a promising future ahead.

Growth Prospects

W.W. Grainger reported its fourth quarter and full year earnings results on January 24. Fourth-quarter revenue of $2.76 billion increased 5% compared to the prior year's quarter. Grainger's revenue growth was driven by a 7% volume increase. Its U.S. operations were able to an achieve above-average revenue growth rate of 6%.

Grainger's strategic shift – the company aims to sell higher volumes through reduced prices – has impacted its fourth quarter results, as average selling prices declined, which has resulted in a below-average gross profit growth rate.



Source: Investor Presentation

However, the company managed to lower its operating expenses compared to the prior year's quarter, which allowed it to grow its operating profits by 12% year over year. Grainger's earnings-per-share growth rate was quite outsized, at 35% during the fourth quarter to $3.96, but this included the one-time impact of a lower tax rate. Investors should not expect this growth rate to last.

Grainger's guidance for 2019 looks promising, as management forecasts a net sales growth rate of 4% to 8.5%, with earnings-per-share seen in a range of $17.10 to $18.70. At the midpoint of the guidance range, $17.90, Grainger would grow its earnings-per-share by 7.2%.

This is a much slower growth rate than what Grainger has achieved during 2018, but that was expected, as the one-time impact of a lower tax rate has been lapped.

Another growth catalyst is e-commerce. It has various e-commerce platforms, including MonotaRO in Japan, and Zoro in the United States.

Source: Investor Presentation

Along with internal investments, Grainger has ramped up its digital platform heavily in recent years. All of these catalysts are likely to help Grainger return to earnings growth over the long-term.

Grainger grew its earnings-per-share by 13.7% annually between 2009 and 2018, but this included the impact of the recovery from the financial crisis. Between 2008 and 2018 the earnings-per-share growth rate averaged 10.6%. Backing out the positive one-time impact of a lower tax rate that led to outsized earnings-per-share growth during 2018, the average growth rate declines further.

Grainger's strategic shift of lowering its pricing, thereby creating higher demand and growing its revenues, seems to have worked well during the most recent quarter, as operating profits grew at an attractive pace.

We believe that growth will moderate somewhat, but Grainger should nevertheless be able to grow its sales as well as its profits further throughout the next couple of years.

Competitive Advantages & Recession Performance

Grainger's first competitive advantage is its vast distribution network. It has the ability to offer services such as next-day ground delivery, which help it retain its competitive position.

Grainger is not active in a high-tech industry, but the services that the company provides are essential for other businesses. This makes Grainger’s business relatively resilient during recessions, providing it with the ability to continue raising its dividend each year.

Another competitive advantage is scale. Grainger kept operating expenses flat in the U.S. last quarter, despite strong volume growth. This demonstrates leverage and supply-chain efficiency.

These competitive advantages helped Grainger stay highly profitable during the Great Recession. Earnings-per-share during the economic downturn are as follows:

- 2007 earnings-per-share of $4.94
- 2008 earnings-per-share of $6.09 (23% increase)
- 2009 earnings-per-share of $5.25 (14% decline)
- 2010 earnings-per-share of $6.81 (30% increase)

Grainger only had one year of earnings decline during the Great Recession, in-between two very strong years. The company continued to grow after 2010. This indicates a high-quality business model that can withstand recession relatively well.

Valuation & Expected Returns

Based on Grainger’s expected earnings-per-share of $17.90 for 2019, the stock has a price-to-earnings ratio of 16.8. This is below the average 10-year price-to-earnings ratio, which is 18.5.

A breakdown of Grainger's historical stock valuations can be seen in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	16.0	16.4	16.8	21.1	21.5	20.3	19.0	19.1	17.7	16.6	***16.0***	***18.0***
Avg. Yld.	2.1%	1.9%	1.7%	1.5%	1.4%	1.7%	2.0%	2.2%	2.5%	2.0%	***1.9%***	***1.8%***

Note: Grainger's stock price moved since data from the table was collected. The company's price-to-earnings ratio using expected 2019 earnings-per-share of $17.90 was 16.8 at the time of writing this article.

Our fair value estimate for Grainger is a price-to-earnings ratio of 18.0, which means the stock appears to be undervalued today. Expansion of the valuation multiple to the fair value estimate could yield annual returns of 1.4%. In addition, shareholder returns will be boosted by future earnings growth and dividends.

We expect Grainger to grow its annual earnings-per-share by 7% per year, primarily through revenue growth, modest margin expansion, and share repurchases. The stock also has a current dividend yield of 1.8%. Putting it all together, we expect annual returns of just over 10% per year through 2024.

This is a benefit of investing in highly profitable companies like Grainger; they can continue to grow earnings and pay dividends, even during difficult operating climates.

Final Thoughts

Grainger is a company managed for the long-term. It has encountered difficulties in recent years, but it has gone through many ups and downs in its history.

These challenges have not stopped Grainger from raising its dividend for more than 40 years. The company still has a profitable business and multiple catalysts for future growth.

The stock appears to be slightly undervalued, with a solid dividend and annual dividend increases. We rate the stock a buy for long-term dividend growth investors.

Illinois Tool Works (ITW)

Business Overview

Illinois Tool Works has been in business for more than 100 years. It started out all the way back in 1902, when a financier named Byron Smith placed an ad in the *Economist*. At the time, Smith was looking to invest in a "high class business (manufacturing preferred) in or near Chicago."

A group of inventors approached Smith with an idea to improve gear grinding, and Illinois Tool Works was born.

Today, Illinois Tool Works has a market capitalization of $46 billion, and generates annual revenue of more than $14 billion.

ITW'S INDUSTRY-LEADING OPERATING SEGMENTS

HIGH-QUALITY BUSINESSES THAT IN THE AGGREGATE CAN
GENERATE CONSISTENT AVERAGE ORGANIC GROWTH OF 3 TO 5% AT THE ENTERPRISE LEVEL

	Automotive OEM	Test & Measurement and Electronics	Food Equipment	Welding	Polymers & Fluids	Construction Products	Specialty Products
Organic Growth Target	4 - 6%	3 - 5%	3 - 5%	3 - 5%	2 - 4%	2 - 4%	2 - 4%

Source: Investor Day Presentation

Illinois Tool Works' portfolio is concentrated in product segments that each hold growth potential of 2%+ above the average in their respective markets.

The overarching strategic growth plan for Illinois Tool Works is to continuously reshape its business model, when necessary. The company frequently utilizes bolt-on acquisitions to expand its reach.

At the same time, it has conducted more than 30 divestments in commoditized, low-growth product lines. Illinois Tool Works routinely trims businesses and adds new ones, to maintain a growth trajectory over time.

Growth Prospects

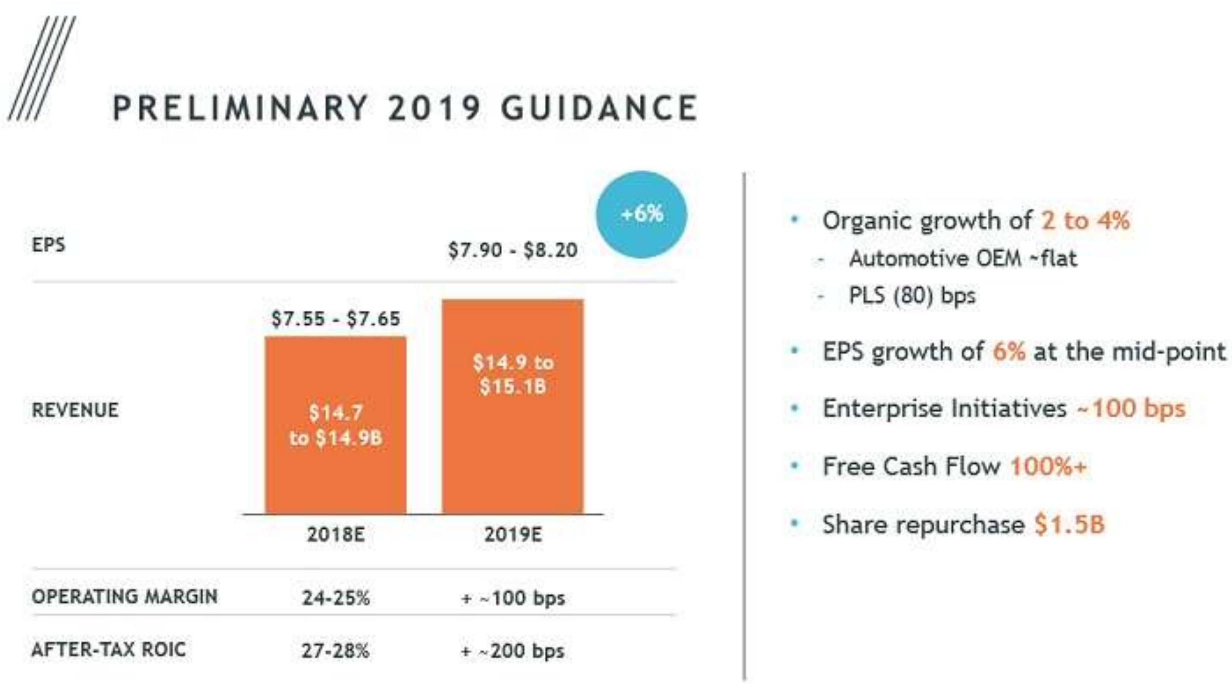
Judging from Illinois Tool Works' financial results, it is clear its strategic growth plan is working just fine.

Illinois Tool Works reported its fourth quarter and full year earnings results on February 1st. For the fourth quarter, the company generated revenue of $3.58 billion, which was 1.4% less than the company's revenues during the previous year's quarter. This revenue decline was expected by the analyst community.

Illinois Tool Works grew its revenues from its Food Equipment business by 4% year over year, with organic growth totaling an even better 5%, the highest during the last four years. The company's Test/Measurement Electronics segment reported a 1% revenue decline.

Despite the revenue decline that Illinois Tool Works suffered from, the company has nevertheless been able to grow its earnings-per-share at a compelling pace of 15% compared to the prior year's quarter, to $1.83. This was possible due to a combination of higher operating earnings (due to margin growth outpacing Illinois Tool Works' revenue decline), a lower tax rate, and the positive impact that the company's share repurchases had on its per-share performance.

Adjusted earnings-per-share increased 10% for the fourth quarter, and 15% for 2018. The upcoming year is expected to be another good one for the company.



Source: Investor Day Presentation

Illinois Tool Works guides for earnings-per-share in a range of $7.90 to $8.20 during fiscal 2019, a projected increase of 6% at the midpoint of guidance.

Competitive Advantages & Recession Performance

Illinois Tool Works has a significant competitive advantage. It possesses a wide economic "moat", which refers to its ability to keep competition at bay. It does this with a massive intellectual property portfolio. Illinois Tool Works holds over 17,000 granted and pending patents.

Separately, another competitive advantage is Illinois Tool Works' differentiated management strategy.

The company has employed a management process called "80/20". This is an operating system that is applied to every business line at Illinois Tool Works.

The company focuses on its largest and best opportunities (the "80"), and seeks to eliminate costs or divest its less profitable operations (the "20").

At the same time, Illinois Tool Works has a decentralized, entrepreneurial corporate culture. This also sets the company apart from the competition. Illinois Tool Works empowers its various businesses with significant flexibility, to customize their own approaches to serving customers in the best way possible.

One potential downside of Illinois Tool Works' business model, is that it is vulnerable to recessions. As an industrial manufacturer, Illinois Tool Works is reliant on a healthy global economy for growth.

Earnings-per-share performance during the Great Recession is below:

- 2007 earnings-per-share of $3.36
- 2008 earnings-per-share of $3.05 (9% decline)
- 2009 earnings-per-share of $1.93 (37% decline)
- 2010 earnings-per-share of $3.03 (57% increase)

That said, the company remained highly profitable during the Great Recession. This allowed it to continue increasing its dividend each year during the recession, even when earnings declined.

And, thanks to its strong brand portfolio, the company recovered quickly. Earnings-per-share soared 57% in 2010. By 2011, earnings-per-share surpassed 2007 levels.

Valuation & Expected Returns

Illinois Tool Works trades for a price-to-earnings ratio of 17.1. After a few years of holding an elevated valuation versus its historical average, Illinois Tool Works' valuation has come down a bit in recent months.

In the past 10 years, the stock held an average price-to-earnings ratio of 16.9. As a result, Illinois Tool Works is currently valued right on par with its historical average valuation. A breakdown of the average price-to-earnings ratio over the past decade is below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	20.1	15.4	13.7	13.9	19.4	18.5	17.0	19.0	21.5	16.7	***16.6***	***17.0***
Avg. Yld.	3.2%	2.8%	2.7%	2.6%	1.7%	2.0%	2.2%	2.2%	1.9%	3.0%	***2.9%***	***3.0%***

Note: Illinois Tool Works' current price-to-earnings ratio is 17.1.

Illinois Tool Works is fairly valued. Aside from changes in the price-to-earnings multiple, future returns will be driven by earnings growth and dividends.

As discussed previously, we expect 8% annual earnings growth over the next five years. In addition, Illinois Tool Works stock has a current dividend yield of 2.9%.

Illinois Tool Works' dividend is a compelling reason to own the stock over the long-term. Not only does it have a strong yield of nearly 3%, but it has also increased its dividend for 55 years in a row. It typically increases its dividend at a high rate, particularly during periods of global economic growth.

In this scenario, total returns would reach nearly 11% per year, a satisfactory rate of return for a Dividend Aristocrat.

Final Thoughts

Illinois Tool Works is a high-quality company, and an even better dividend growth stock. It has a strategic growth plan that is working well, and shareholders have been rewarded with rising dividends for over 50 years.

The stock also has an attractive dividend yield, making it an appealing choice for long-term dividend growth investors. Shares are not extremely undervalued at the moment, and it is likely the company will struggle if and when a recession occurs.

However, Illinois Tool Works has earned its place among dividend royalty.

3M (MMM)

Business Overview

3M's history goes all the way back to 1902, when it was a small mining venture. 3M was originally known as Minnesota Mining and Manufacturing.

Its founders started out with a very simple goal: to harvest corundum from a mine called Crystal Bay. There wasn't much corundum to be mined, but over the next 114 years, 3M grew into one of the biggest industrial conglomerates in the world.

Today, 3M is a diversified global industrial. It manufactures 60,000 products, which are sold in 200 countries around the world.

3M came to dominate the industrial manufacturing industry through a sharp focus on the most attractive market segments. It has invested heavily across its core areas of focus to build a product portfolio that leads the pack.

Source: [Investor Day Presentation]

The business is organized into five major operating segments: Industrial, which produces products such as industrial tapes, abrasives, adhesives and supply chain management software; Safety & Graphics, which manufactures personal protective gear and security products; Healthcare, which supplies medical and surgical products; Electronic & Energy which produces fibers and circuits for use in renewable sources of energy; and Consumer, which sells offices supplies, home improvement products and stationary supplies.

3M generates nearly $33 billion in annual revenue, and each of its five operating segments generates healthy profit margins.

Growth Prospects

3M has generated steady earnings growth in recent periods. In 2018, organic revenue increased 3.2% for the year and earnings-per-share increased 14%, thanks to gains in adjusted operating income margin growth, organic growth in all divisions of the company, a lower tax rate and share repurchases.

2019 is likely to be another year of growth for the company. 3M expects earnings-per-share in a range of $10.45-$10.90. At the midpoint, this would represent 2.1% growth from the prior year. It should be noted that this guidance is down slightly from the company's initial guidance of $10.60 to $11.05 for earnings-per-share. Organic growth is expected in the 1% to 4% range for the current year.

3M going forward demonstrated growth in both domestic and international markets.

U.S. organic sales grew 4.4% in the fourth quarter. This is well above results in recent years for the region. Latin America/Canada continues to be a source of strength for the company, as organic sales increased 5% last quarter. While sales were flat year-over-year in Japan and Western Europe, Canada, Mexico and Brazil grew 5% each. China, on the other hand, grew just 1%.

3M maintains a highly promising outlook over the next few years.

Source: [Investor Day Presentation]

The company expects to generate returns on invested capital above 20% each year through 2023, thanks in large part to a lean cost structure. It also aims for 3%-5% organic revenue growth in constant currency, along with 8%-11% annual earnings-per-share growth.

3M's portfolio optimization, characterized by various acquisitions and divestitures, has made the company leaner and more efficient.

3M expects to generate at least $125 million in annual cost savings each year through 2020. The company also repurchased almost $5 billion worth of its own stock in 2018 and expects to buy back another $2 to $4 billion in 2019.

Competitive Advantages & Recession Performance

To raise dividends for over 50 years, requires multiple durable competitive advantages. For 3M, technology and intellectual property are its biggest competitive advantages.

3M has 46 technology platforms and a team of scientists dedicated to fueling innovation.

Innovation has provided 3M with over 100,000 patents obtained throughout its history, which helps fend off competitive threats.

3M continues to invest heavily in research and development. The company aims to spend ~6% of annual sales on R&D. The company's recent R&D investments are:

- 2014 research-and-development expense of $1.77 billion
- 2015 research-and-development expense of $1.76 billion
- 2016 research-and-development expense of $1.73 billion
- 2017 research-and-development expense of $1.9 billion
- 2018 research-and-development expense of $1.8 billion

3M R&D is so successful in creating new products that approximately 30% of annual sales came from products that didn't exist five years ago.

3M has established itself as an industry leader, across its product segments. Their competitive advantages also help 3M remain profitable, even during recessions.

3M's earnings-per-share during the Great Recession are below:

- 2007 Earnings-per-share of $5.60
- 2008 Earnings-per-share of $4.89 (13% decline)
- 2009 Earnings-per-share of $4.52 (7.5% decline)
- 2010 Earnings-per-share of $5.75 (27% increase)

The company is not immune from recessions, and its earnings-per-share fell in 2008 and 2009. However, it bounced back in 2010. And, it remained steadily profitable throughout the recession, which allowed it to continue raising its dividend.

Valuation & Expected Returns

There is nothing wrong with 3M's business model. In fact, 3M has one of the strongest business models in the entire S&P 500.

Instead, the problem for 3M is that the stock is slightly overvalued today. For example, 3M now expects full-year earnings-per-share of $10.68, at the midpoint of 2019 guidance. At its current share price of $207, the stock is trading at a forward price-to-earnings ratio of 19.4.

This is higher than its average valuation. 3M has held an average price-to-earnings ratio of 17.2 over the past 10 years.

3M is trading at a roughly 13% premium to its historical average. In other words, the stock is currently trading more than 110% above our estimate of fair value.

This doesn't make the stock extremely overvalued, but this does limit gains made from expansion of the P/E multiple. Shareholders would see total annual returns reduced by 2.4% per year if the stock reverted to its average valuation by 2024.

Owners of 3M stock can also see returns from earnings growth and dividends. 3M has experienced earnings-per-share growth of 6.4% over the last decade. A combination of organic growth and share repurchases should allow the company to see this level of growth in future years.

A breakdown of potential returns through 2024 is as follows:

- 6.4% organic EPS growth
- 2.4% multiple reversion
- 2.8% dividend yield

Through earnings growth and dividends, partially offset by a declining valuation multiple, we estimate that 3M can generate a total annual return of 6.8% through 2024. This is a modest expected rate of return, and does not result in a buy recommendation at this time.

Final Thoughts

3M remains a high-quality business, and is likely to continue raising its dividend each year. There are very few companies that can match the company history of dividend growth. 3M has raised its dividend for 60 consecutive years, and will likely continue to increase the dividend each year for many years to come.

However, the current valuation, though not extreme, reduces total return possibilities. 3M remains a strong holding for dividend growth. That said, investors looking to add 3M to their portfolio are encouraged to wait for a pullback in the share price, for a lower stock valuation and higher dividend yield.

Pentair (PNR)

Business Overview

Pentair is based in the U.K., but has large operations across Europe and in the U.S., among other international regions.

The company was formed in 1966. In 1968, Pentair acquired Peavey Paper Mills, which gave it a top position in paper products. Paper fueled the company's growth over the next decade, until management decided to diversify into other product categories.

Pentair's first investment outside of paper products was the acquisition of Porter-Cable, a manufacturer of portable electronic power tools. In the decades since, Pentair has continued to diversify its product line with bolt-on acquisitions.

The company recently spun off its Technical Solutions business and now operates as a pure-play water solutions company.

Source: Investor Presentation

Pentair now operates in three reporting segments:

- Aquatic Systems (37% of revenue)
- Filtration Systems (35% of revenue)
- Flow Technologies (28% of revenue)

The pure-play water company now generates just over $3 billion in revenue, and focuses on improving the availability and quality of water. The spin-off was competed in the second quarter of 2018 and the new business is now called nVent Electric, trading under the ticker NVT.

Growth Prospects

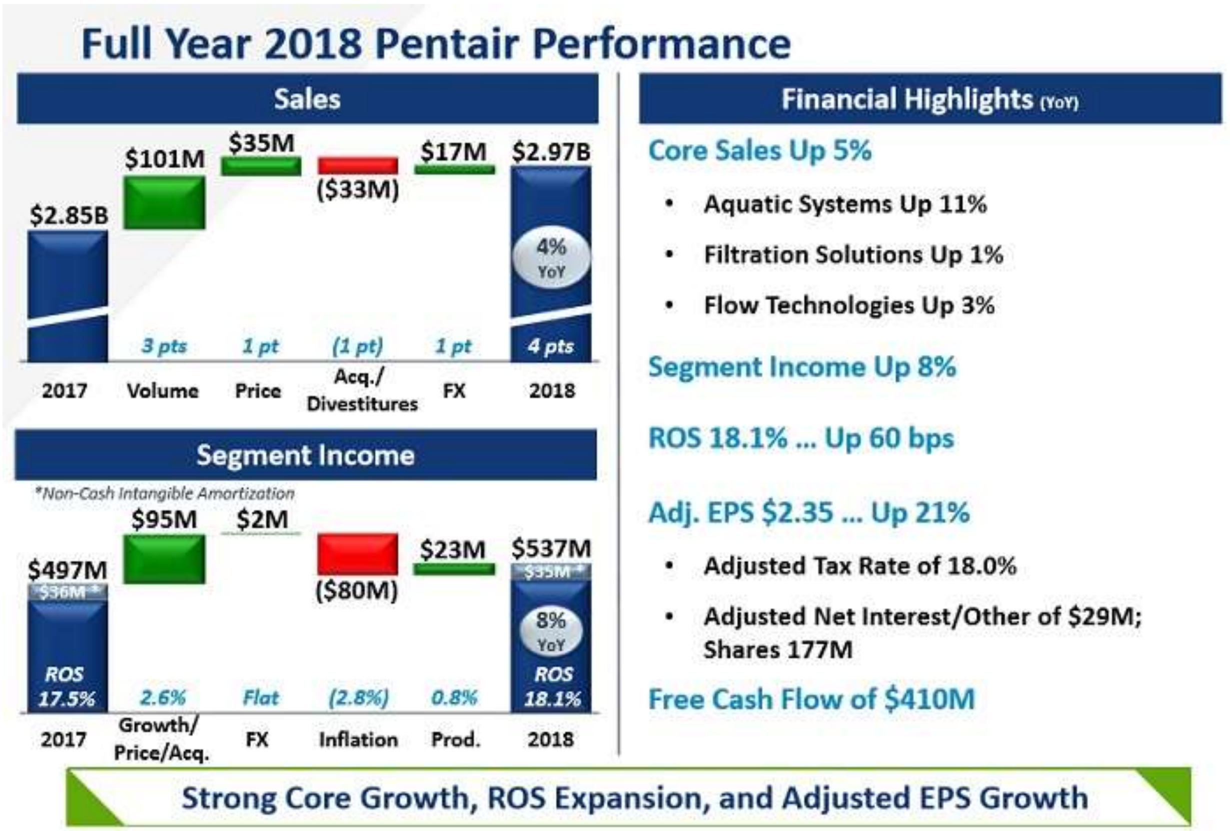
Pentair reported fourth quarter and full-year earnings in late January (1/29/19), and the results were strong once again. Core sales were up 6% on a consolidated basis as the company's Aquatic Systems segment posted a 13% gain. Filtration Solutions was flat and Flow Technologies added 4% to help drive the top line higher.

Pentair continues to see very strong organic growth on a consolidated basis as Aquatic Systems performs very well and offsets relative weakness elsewhere.

Segment income was up 5% on a consolidated basis as the company's return on sales rose 40 bps year-over-year to 18.1%. Aquatic Systems, unsurprisingly, led the way with a 10% gain in segment income. Filtration Systems saw a 7% segment income boost despite flat revenue as its margins improved markedly during the quarter.

The same was not true, however, for Flow Technologies, as its segment income declined 7% despite the 4% boost to the top line.

In total, earnings-per-share came in at $0.60 on an adjusted basis, good for a 21% increase over the comparable period in 2017. For the full year, earnings-per-share was $2.35, a gain of 21% over 2017.



Source: Earnings Presentation

The company also generated $410 million in free cash flow in 2018, which it used to buy back $500 million of shares and return a further ~$125 million in dividends.

Pentair's outlook for 2019 bodes well for the company as it expects adjusted earnings-per-share of $2.55 at the midpoint of its guidance, representing ~9% growth. This will be driven primarily by higher revenue, which will be the result of a small organic revenue gain and a sizable increase from acquisitions in the Filtration Solutions business.

Overall, growth prospects for Pentair remain strong. Indeed, all of its core segments are slated to grow in fiscal 2019, albeit at different rates.

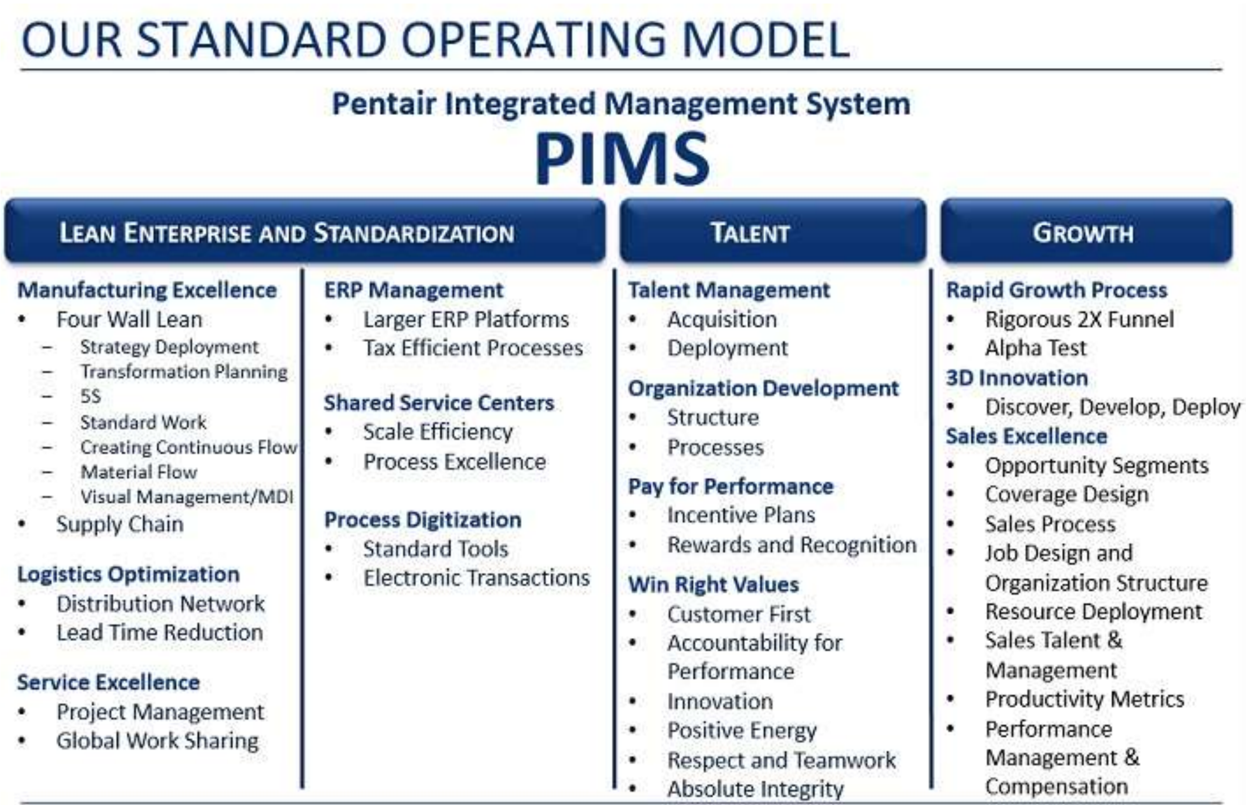
Pentair has already announced two sizable acquisitions this year. In early January, it announced it was buying Aquion for $160 million in cash. Aquion offers a line of water treatment products for the residential and commercial water treatment industry.

Pentair also acquired Pelican Water Systems for $120 million in cash. Pelican Water Systems provides whole home residential water treatment systems. We expect Pentair will continue its long history of seeking to acquire growth, and it is certainly off to a good start in 2019.

Competitive Advantages & Recession Performance

One of the competitive factors that has fueled Pentair's impressive growth, is its lean cost structure. This is no accident; Pentair has employed a strategy called Pentair Integrated Management System, or PIMS, which has enabled its high profit margins.

PIMS enables leaner manufacturing processes and drives efficiency throughout the company's supply chain and distribution. Even though the effort is years old at this point, it continues to permeate the company's strategy today. The impact is a culture and mindset with a relentless focus on cutting costs from its model.



Source: [Electrical Products Group Presentation]

The PIMS is an organization-wide system. It effects talent management by providing employees with the proper incentives and providing all employees with individual responsibility down to the operator level.

Within the PIMS system, the 'Lean Enterprise' system helps to increase profit margins. It drives margin expansion by increasing productivity at manufacturing sites, and helps identify acquisition targets with the highest cost savings opportunities.

Its competitive advantages and high margins allowed the company to remain profitable during the Great Recession of during 2007-2009:

- 2007 earnings-per-share of $2.08
- 2008 earnings-per-share of $2.20 (5.8% increase)
- 2009 earnings-per-share of $1.47 (33% decline)
- 2010 earnings-per-share of $2.00 (36% increase)

As a global industrial manufacturer, Pentair is not immune from recessions. However, it quickly bounced back. Pentair’s earnings-per-share reached a new high in 2011. Given that Pentair is now a pure-play water treatment company, we expect the next recession will have a milder impact on the company's earnings.

Pentair is now focused on services that can be considered needs and not wants, so we believe the company's recession resistance has improved in recent years.

Valuation & Expected Returns

Pentair has a price-to-earnings ratio of 16.4 after the company's fourth-quarter earnings report. This is a fairly low valuation for the stock, given its historical averages. In the past 10 years, Pentair stock traded for an average price-to-earnings ratio of 18.2.

Based upon the company's historical price-to-earnings ratios as well as its projected growth, we've assessed fair value at 18 times earnings. That makes the stock somewhat undervalued today despite the strong performance of 2018 and the company's bright outlook.

Given this, we see the stock as somewhat undervalued, and that will help drive total returns looking forward. In total, we see annual returns of 11% to 12% accruing to shareholders of Pentair, consisting of the 1.8% dividend yield, 6.5% earnings-per-share growth, as well as a ~3% tailwind from a higher valuation.

An expected return above 11% is a very satisfactory rate of return. That is good enough for us to rate the shares a buy given the reasonable valuation, very strong history of dividend increases, and robust growth outlook.

Final Thoughts

Pentair has a strong business model, and competitive advantages. This is particularly true in the company's new, pure-play water model. These qualities have fueled its steady dividend growth over the past four decades and we don't see any reason to believe that won't continue for many years to come.

While Pentair isn't considered tremendously cheap today, it is very reasonably priced, has a decent dividend yield, and it has a promising future outlook. The company should be able to continue increasing its dividend each year. We rates share of Pentair a buy after the strong fourth-quarter report and 2019 outlook.

Roper Technologies (ROP)

Business Overview

Roper designs and develops software, including both software-as-a-service and licensed technology, and engineered products and solutions.

Roper has a diverse portfolio of products and services, which it provides to a multitude of sectors, including healthcare, transportation, food, energy, water, and education.

Roper focuses on four main business segments:

- RF Technology (43% of revenue)
- Medical & Scientific Imaging (29% of revenue)
- Industrial Technology (16% of revenue)
- Energy Systems & Controls (12% of revenue)

The core RF Technology business provides radio frequency identification—or RFID—communication technology, software, and information solutions. This is a booming technology, that has a variety of uses, including toll and traffic systems, security and access control, campus card systems, card readers, and more.

Source: [Investor Presentations]

The Medical & Scientific Imaging segment offers products and software used in medical applications, and high-performance digital imaging.

Industrial Technology includes water and fluid handling pumps, leak testing equipment, flow measurement and metering equipment, and water meter products.

Lastly, the Energy Systems & Controls segment produces control systems, testing equipment, industrial valves and controls, and inspection and measurement products.

Growth Prospects

Roper is in the unique position of generating strong growth, across all of its businesses. For example, total revenue increased 11% in 2018. Organic growth improved 8% for the year.

All four operating segments posted revenue growth in that time, led by 15% revenue growth for the Industrial Technology segment. Organic growth for this segment was 14% due to strong demand for products.

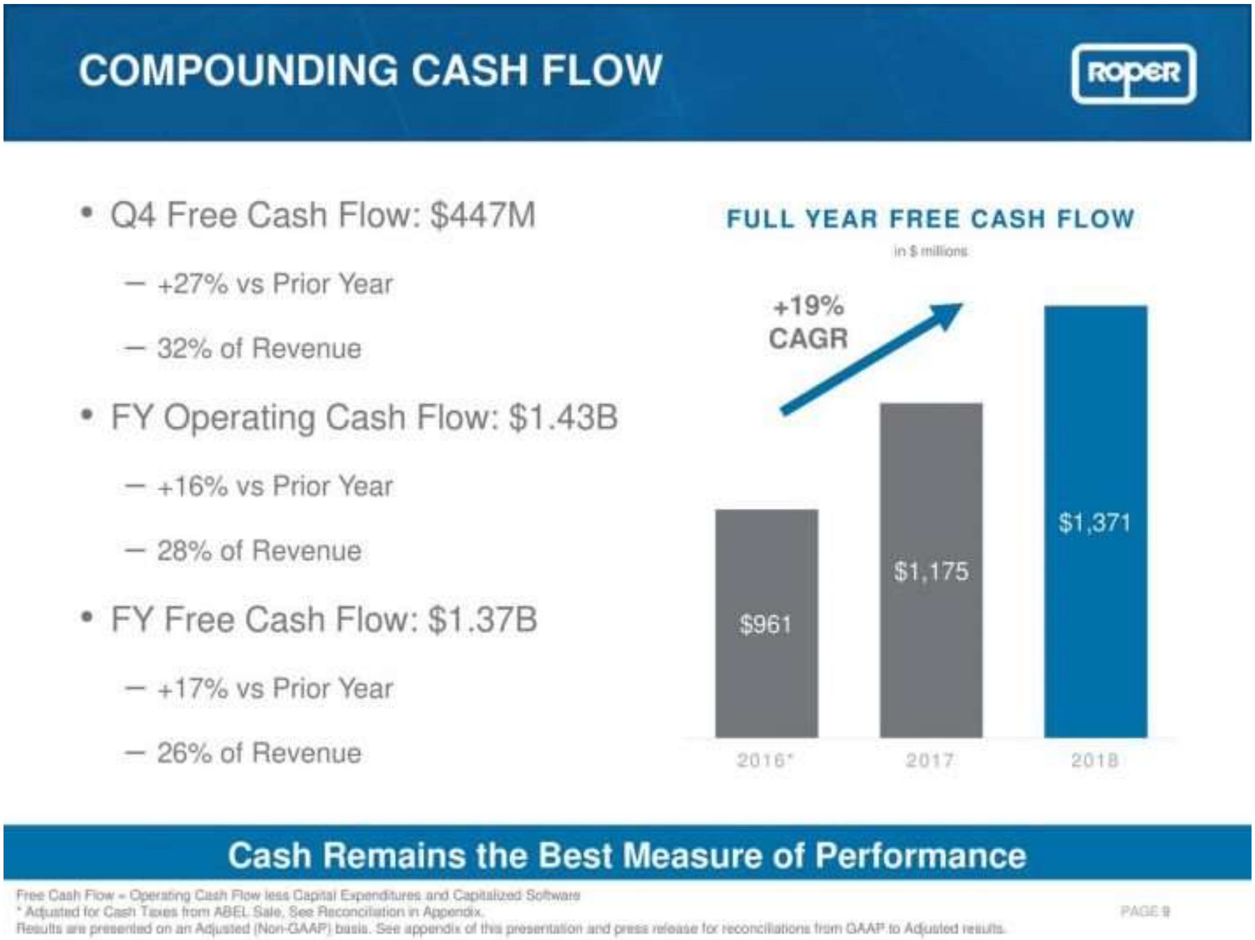
RF Technology revenue soared 13% for 2018. Organic growth was 6% for this segment, led by Software Business organic growth of 8%. Network expansion and market share gains aided growth for this segment as well.

Revenues for the Medical & Scientific Imaging segment grew 8%, with organic growth of 7%. Long term care solutions and gains in niche medical applications were the primary drivers of growth.

Energy Systems & Controls grew 9%, with 7% segment organic growth. Upstream applications and broad based industrial end markets helped improve revenues.

Naturally, such strong revenue growth has greatly benefited Roper’s bottom line. The company beat analyst expectations on earnings-per-share and revenue, in all four quarters of 2018. In addition, operating cash flow rose 16% during the year and 27% during the quarter, compared with the same period in the previous year.

Free cash flow increased 19% in 2018.



Source: Investor Presentation

Roper has generated excellent growth over the past several quarters, and its growth should continue moving forward. The company sees earnings-per-share of $12 to $12.40 for 2019. This includes a $0.25 negative impact from Roper's pending Imaging divestitures.

At the midpoint of this guidance, this is a 3.3% improvement from 2018. Organic growth should be 3% to 5%.

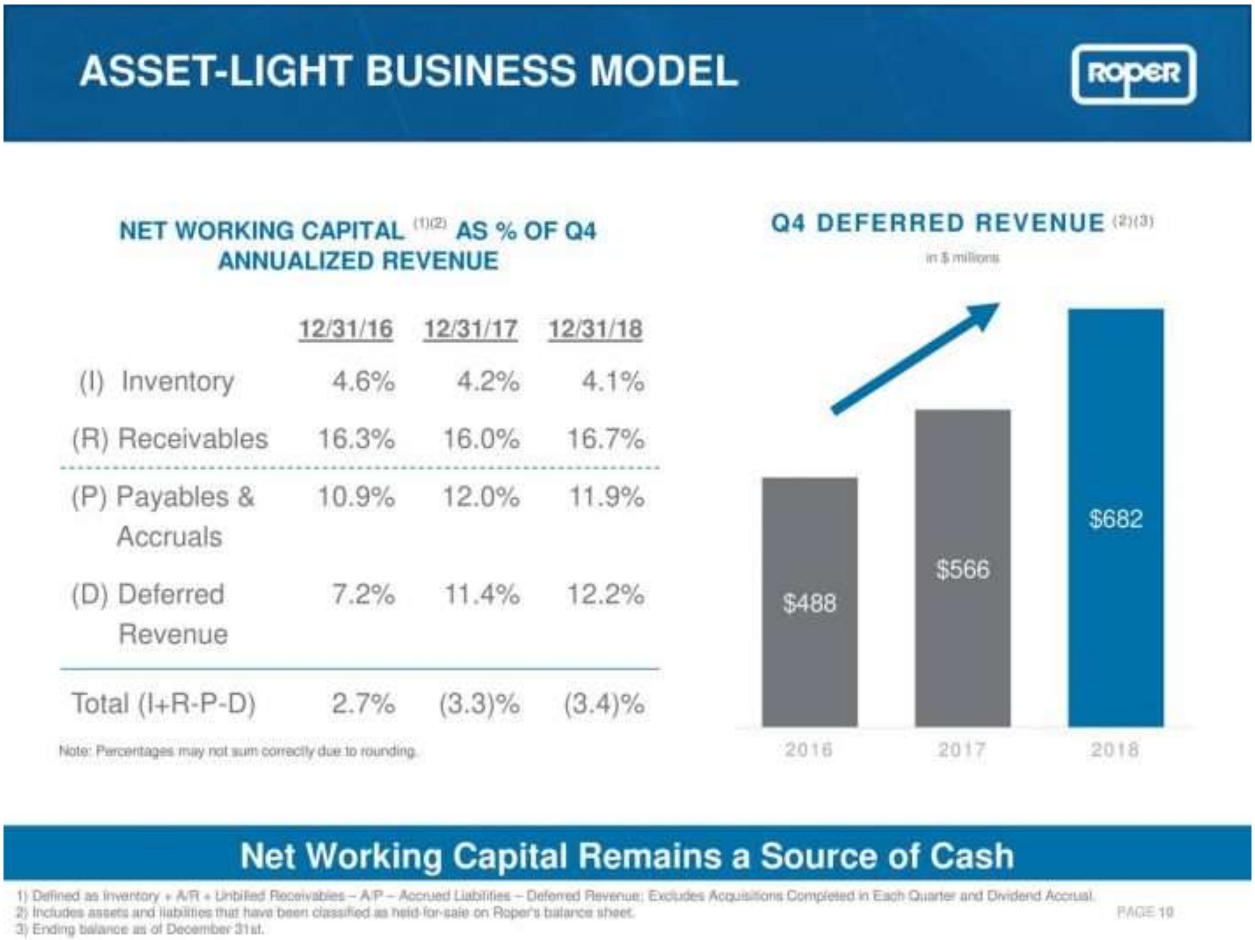
Acquisitions are a key component of Roper’s growth strategy. It spent $8.6 billion on acquisitions, from 2011 to 2016.

Such a high level of acquisitions can be a red flag, if the company paid too high a price for under-performing businesses. But in this case, Roper’s acquisitions clearly built value.

Roper looks for other high-margin companies, with high levels of recurring revenue. The bulk of the spending was focused on RF application software, as well as medical software and services.

Competitive Advantages & Recession Performance

Over the past 15 years, Roper pursued an asset-light business model, with a specific focus on software and engineered products and services. The company adopted this strategy to expand margins, by reducing capital expenditure needs, while also generating recurring revenue. This resulted in much stronger cash conversion over time.



Source: [Investor Presentation]

For example, Roper generated a total of $1.0 billion of free cash flow, in the five-year period spanning 2003 to 2007. It generated over $4 billion in cumulative free cash flow, from 2013 to 2017. In 2018, free cash flow was nearly $1.4 billion.

In 2018, Roper gross margins improved 90 basis points to 63.5%. Approximately half of total revenue in 2018 was recurring.

This provides Roper with tremendous competitive advantages. Its high margins and operational efficiency provide it with lots of cash flow that can be invested to stay ahead of the competition.

Roper is a cyclical business. It has the capacity for very strong growth when the economy is expanding, but it also struggles during recessions. Earnings-per-share during the Great Recession are shown below:

- 2007 earnings-per-share of $2.68
- 2008 earnings-per-share of $3.06 (15% increase)
- 2009 earnings-per-share of $2.58 (16% decline)
- 2010 earnings-per-share of $3.34 (29% increase)

As you can see, Roper is not a highly recession-resistant company. Earnings-per-share declined 16% in 2009. If the economy were to enter a recession in the years ahead, Roper could see earnings decline.

While Roper's earnings exhibited volatility, it still grew overall, from 2007 to 2010. As the U.S. recovered from the Great Recession, earnings continued to grow.

Roper has grown earnings-per-share at a rate of 16% annually from 2009 to 2018. Accounting for the likelihood of a steep decline in profitability in the event of a recession, we expect Roper to grow earnings-per-share at a rate of 8% annually through 2024.

Valuation & Expected Returns

Roper is a high-quality company, with strong growth prospects, thanks to the high level of demand for its technology. It should not come as a surprise, that the stock holds a premium valuation. Shares currently trade for a price of $312.

Using the company's earnings guidance for the current year, Roper trades for a price-to-earnings ratio of 25.6, which is above the S&P 500 Index average of 21.3. It is also significantly above its own valuation over the past 10 years.

Over the past decade, Roper held an average price-to-earnings ratio of 21.7. As a result, the stock is valued at a premium of approximately 18%, to its average price-to-earnings ratio in the past 10 years.

Given that the company is highly susceptible to changes in the economy, we have a target price-to-earnings ratio for 2024 of 19. If shares were to revert to this target valuation, annual returns would be reduced by 5.8% over this time. Potential overvaluation is a risk that investors could consider before buying the stock.

The company is still likely to generate returns moving forward, from earnings growth and dividends. A potential breakdown of future returns is as follows:

- 8% earnings-per-share growth
- 0.6% dividend yield
- 5.8% multiple reversion

In this scenario, total returns would reach 2.8% per year over the next five years.

Final Thoughts

Roper has a high-quality business model. High single-digit earnings growth is not an unreasonable assumption moving forward. The stock is also a Dividend Aristocrat, and 10%+ annual dividend increases are also possible, thanks to the company's high earnings growth rate.

However, with a price-to-earnings ratio well above its historical and our target valuation, and a dividend yield below 1%, Roper does not seem to be an attractive purchase for value and income investors at the moment.

Stanley Black & Decker (SWK)

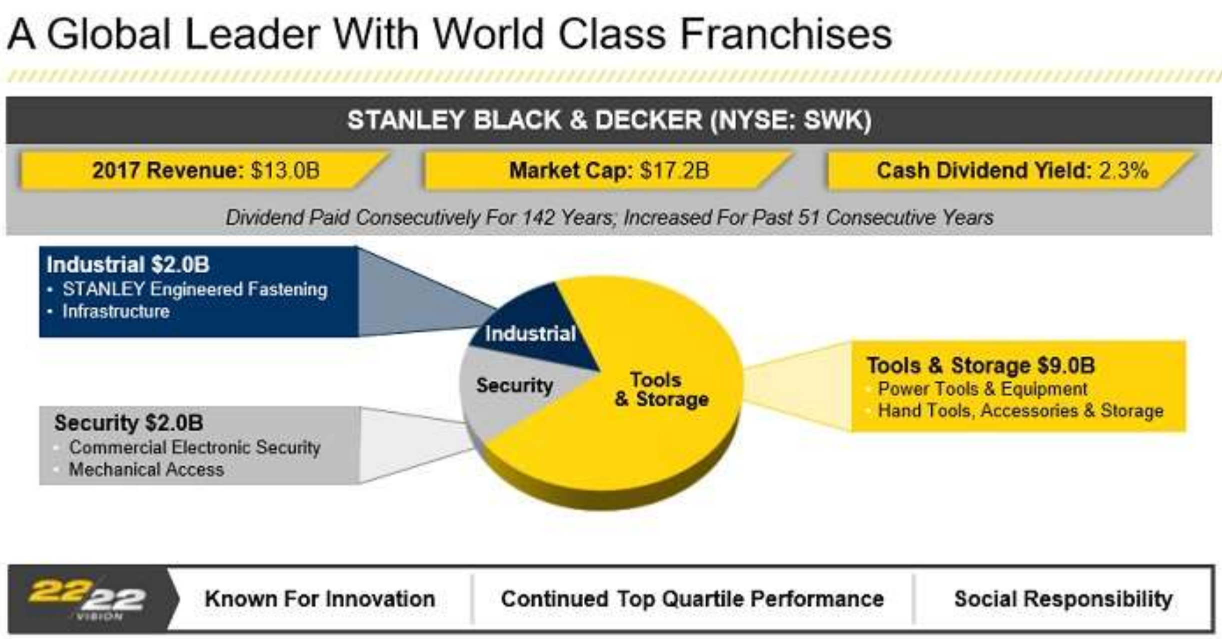
Business Overview

Stanley Black & Decker is the result of Stanley Works' $3.5 billion acquisition of Black & Decker in 2009. Stanley Works and Black & Decker were both named after their respective founders.

Stanley Works was formed in 1843, when Frederick Stanley started a small shop in New Britain, Connecticut, where he manufactured bolts, hinges, and other hardware. His products developed a reputation for their quality.

Meanwhile, Black & Decker was started by Duncan Black and Alonzo Decker in 1910. Like Stanley, they opened a small hardware shop. In 1916, they obtained a patent to manufacture the world's first portable power tool.

Over the next 174 years, Stanley Black & Decker has steadily grown into one of the world's largest industrial products manufacturers.



Source: Investor Presentation

Its main products include hand tools, power tools, and related accessories. It also produces electronic security solutions, healthcare solutions, engineered fastening systems, and more.

Revenue growth has accelerated over the past 16 years. Today, Stanley Black & Decker has a market capitalization of $19.3 billion, and annual sales of more than $14 billion. It operates three business segments, which are Tools & Storage, Security, and Industrial products.

In October of last year, Stanley Black & Decker announced that products from its hand tools and storage portfolio will be available exclusively at Home Depot (HD). The company has produced excellent growth rates in recent years, due in large part to an aggressive acquisition strategy.

Growth Prospects

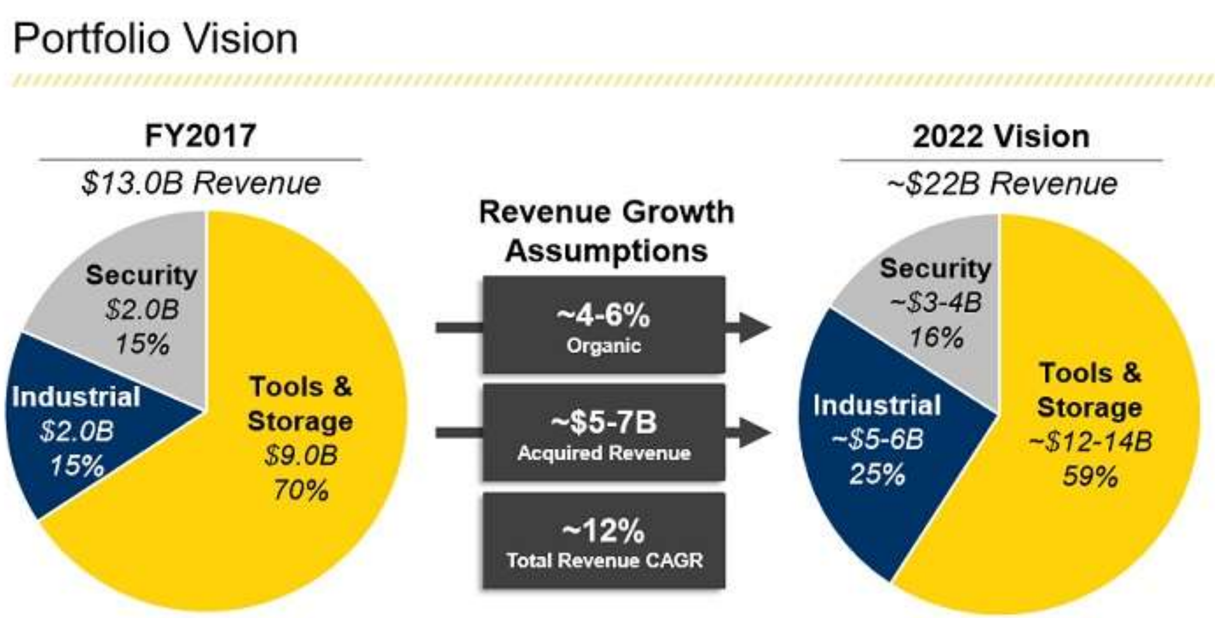
Stanley Black & Decker's growth prospects are promising. The company had a solid 2018. The company earned $2.11 per share in the fourth quarter of 2018, beating estimates by a penny, but declining 3.2% from the prior year. Revenue improved 5% to $3.6 billion, also beating estimates.

Sales volumes increased 5% while acquisitions added 2% and price increases contributed 1% to quarterly results. Growth was partially offset by a 3% currency translation headwind. In addition, tariffs and increased commodity costs were a headwind during the quarter.

Earnings-per-share for the full year came to $8.15, a nearly 10% increase from 2017. Revenue grew 8% to $14 billion, including 5% organic growth in 2018.

The Tools & Storage and Industrial segments led the way last quarter. Tools & Storage revenue increased 4% in the fourth quarter, along with 14% growth in industrial product revenue. This more than offset a 1% decline in security product revenue.

Acquisitions have played a key role in the company's growth in recent years, and remain a critical component of the company's growth strategy going forward.



Source: Investor Presentation

Recent acquisitions have helped shape Stanley Black & Decker's product portfolio. For example, in 2017 Stanley Black & Decker closed on the $1.95 billion acquisition of the Tools business of

Newell Brands. This acquisition strengthened the company's foothold in tools, and added the high-quality Irwin and Lenox brands to the product portfolio.

Not only that, but in 2017 Stanley Black & Decker also acquired the legendary Craftsman brand from Sears Holdings (SHLD) for $900 million. Both deals were immediately accretive to the company's bottom line in 2017. The Craftsman brand is expected to add $1 billion in revenue by 2021.

Acquisitions continued in 2018. Last August (8/7/18) Stanley Black & Decker acquired International Equipment Solutions Attachments Group, or IES Attachments, for $690 million. Once approved, this acquisition will add to Stanley Black & Decker's presence in industrial markets.

IES Attachments provides heavy equipment attachments tools for off highway applications. This division provides leading brands such as Paladin, Genesis and Pengo. Almost 60% of revenues for IES Attachments is related to aftermarket services.

Not yet done with acqusitions for the year, Stanley Black & Decker took a 20% stake in MTD Products for $234 million. MTD Products is a privately held manufacturer of outdoor power equipment. Stanley Black & Decker has the option to acquire the remaining 80% of MTD Products starting July 1st, 2021. The company expects that this investment could add as much as $0.10 to earnings-per-share in 2019.

For 2019, Stanley Black & Decker expects 4% organic revenue growth. Adjusted earnings-per-share are expected in a range of $8.45-$8.55. At the midpoint, this would represent 5% growth from the previous year.

The market reacted negatively to the company's guidance, sending shares lower by 16%. This reaction was likely due to tariffs, commodity inflation and currency translation decreasing earnings-per-share results by as much as $1.00 in 2019. It should be noted that shares of Stanley Black & Decker have already recovered $11, or 9.4%, since the last financial release.

Stanley Black & Decker is attempting to offset this decline with cost controls. The company is removing costs from its business, and with acquisition-related cost synergies, should see a positive benefit of $1.05 to earnings this year.

Looking longer-term, management has a plan to continue growing into the next decade. By 2022, Stanley Black & Decker expects revenue to approach $20 billion, driven by a mix of organic growth, and growth from acquisitions.

The company plans to invest more heavily in its Industrial segment, which is on track to generate 25% of total revenue by 2022.

Competitive Advantages & Recession Performance

Stanley Black & Decker's main competitive advantages are its brand portfolio, and global scale. Innovation and scalability are at the core of the company's growth strategy.

It has a leadership position in each of its three product categories. Its brand strength gives the company pricing power, which leads to high profit margins.

And, it is relatively easy for the company to scale up its brands, thanks to distribution efficiencies.

To retain these competitive advantages, Stanley Black & Decker is constantly investing in product innovation. The company's research & development expense is as follows:

- 2014 research-and-development expense of $174.6 million
- 2015 research-and-development expense of $188 million
- 2016 research-and-development expense of $204.4 million
- 2017 research-and-development expense of $204.4 million

That said, Stanley Black & Decker is not immune from recessions. Earnings declined significantly in 2008 and 2009. As an industrial manufacturer, Stanley Black & Decker is reliant on a strong economy and a financially-healthy consumer.

Stanley Black & Decker's earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $4.00
- 2008 earnings-per-share of $3.41 (15% decline)
- 2009 earnings-per-share of $2.72 (20% decline)
- 2010 earnings-per-share of $3.96 (46% increase)

Despite the steep decline in earnings from 2007-2009, Stanley Black & Decker recovered just as quickly. Earnings-per-share increased another 32% in 2011, and reached a new high. Earnings have continued to grow in the years since.

Valuation & Expected Returns

Using the current share price of $128 and expected earnings-per-share for 2019 of $8.55, Stanley Black & Decker has a price-to-earnings ratio of 14.9. This is below the ten-year average valuation of 15.7 that the stock has held since 2008.

A breakdown of Stanley Black & Decker's historical valuation multiples can be seen in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	14.1	14.7	12.9	15.2	16.3	16.2	17.1	17.2	20.5	13.5	***13.7***	***15.7***
Avg. Yld.	3.4%	2.3%	2.4%	2.5%	2.4%	2.3%	2.1%	2.0%	1.7%	2.4%	***2.2%***	***2.0%***

Note: Stanley Black & Decker's current price-to-earnings ratio is 14.9.

Stanley Black & Decker stock appears to be slightly undervalued, with a little room for further expansion of the price-to-earnings ratio. If the stock's valuation were to expand to met its historical average by 2024, investors would see an additional 1.1% added to annual returns over this period of time.

Going forward, returns will be comprised of earnings growth and dividends. In the past 10 years, Stanley Black & Decker increased earnings-per-share by 8% compounded annually. Due to organic growth and acquisitions, we feel that this growth rate is sustainable.

The stock has a current dividend yield of 2.1%. Based on this, total returns would reach approximately 11.2% per year, consisting of valuation multiple expansion, earnings growth, and dividends. This is a satisfactory rate of return and shows Stanley Black & Decker earns a buy recommendation.

Final Thoughts

Stanley Black & Decker is not a high-yield stock, but it has all of the qualities of a strong dividend growth stock. It has a top position in the industry, strong cash flow, and durable competitive advantages.

The company has a positive growth outlook, which bodes well for the dividend. The stock appears slightly undervalued today, and it is very likely Stanley Black & Decker will continue to hike its dividend each year for the foreseeable future.

And, the stock is still expected to produce total returns of up to 10% per year over the next five years. This makes Stanley Black & Decker an attractive stock for long-term dividend growth investors.

United Technologies (UTX)

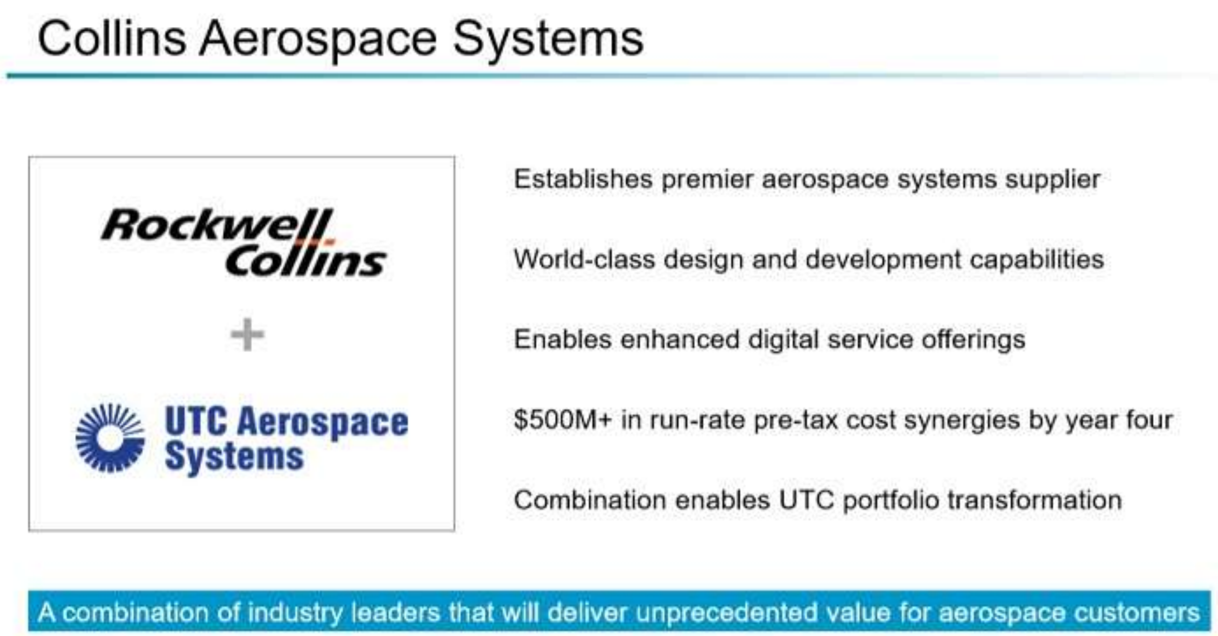
Business Overview

United Technologies was founded in 1934. Today, the company has more than 200,000 employees around the world, and the stock has a market capitalization of nearly $100 billion.

United Technologies is a commercial aerospace and defense company. For the time being, United Technologies is composed of four business divisions: Pratt & Whitney, which manufactures and services engines for commercial and military customers; Otis, the world's largest producer and servicer of elevators and escalators; UTC Climate, which produces HVAC equipment; and UTC Aerospace, which creates aerospace and industrial products.

This is a period of great change for United Technologies. After spinning offing certain businesses, United Technologies will be composed of two business divisions: Pratt & Whitney and Collins Aerospace Systems, which creates aerospace and industrial products.

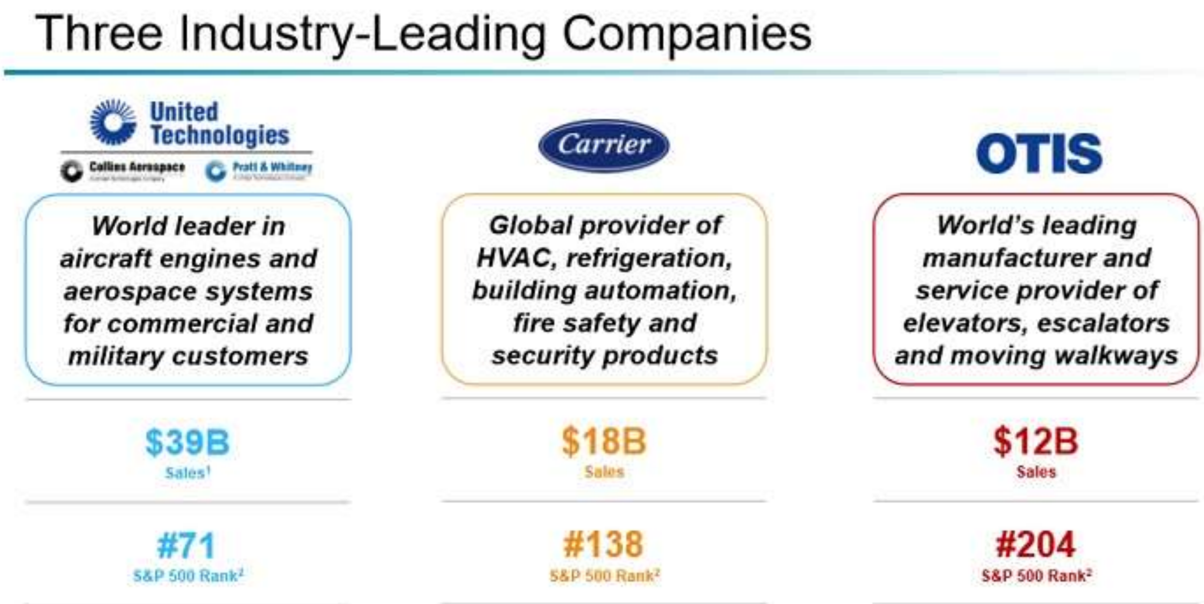
The company's $30 billion acquisition of Rockwell Collins closed on November 26th of last year.



Source: Investor Presentation

This purchase helped to diversify United Technologies' aerospace business as well as add approximately $8 billion in annual sales.

Separately, United Technologies announced near the end of last November that it would be spinning off certain low growth businesses in order to focus on Aerospace and Defense. Otis, the company's elevator and escalator business, will become an independent entity under the same name. The company's Climate, Controls and Security businesses will take the Carrier name.



Source: Investor Presentation

These portfolio moves were made to focus United Technologies' operations on its most attractive areas of growth. By making the company leaner and more efficient, United Technologies believes it can produce higher margins and greater earnings growth in the years ahead.

Growth Prospects

The aerospace and defense industries have seen a renaissance in recent years. Air travel is expected to double in the next two decades. Only 20% of the world's population has flown by airplane. It is expected that more people will be able to travel by air as the middle class grows in emerging markets.

In addition, the world's fleet of airplanes is quite old. Boeing (BA), the world's largest manufacture of commercial airplanes, expects that the world will need as many as 43,000 new planes over the next twenty years.

Defense spending has also increased. The U.S. had a defense budget of $700 billion for fiscal year 2019. That spending is expected to increase in future years as well.

Taking these factors into account, it is no surprise that United Technologies aerospace business has performed very well recently. The company released financial results for the fourth quarter and fiscal year 2018 on January 23rd. Adjusted earnings-per-share (EPS) grew 18% to $1.95 for the quarter. Adjusted EPS for the year improved 14% to $7.61. For reference, EPS grew just 1.2% annually from 2013 to 2017.

While a lower adjusted effective tax rate (22.1% for 2018 vs 27.8% for 2017) explains a portion of this increase, 8% organic revenue growth was a major driver for results last year. United Technologies' remaining businesses post-spin off - Pratt & Whitney (22%) and Collins Aerospace Systems (9%) - showed organic growth rates above the company average.

United Technologies has increased EPS at an annual rate of 3% for the past ten years.

Competitive Advantages & Recession Performance

As just described, United Technologies core businesses performed very well in the last year. Sales for the company grew 11% in 2018 and management expects sales for 2019 to improve at least 13.5%, with organic growth in the range of 3%-5%.

Pratt & Whitney had revenue growth of 24% in the fourth quarter. Commercial engine manufacturing was higher by 74% as the company experienced a surge in large commercial engine deliveries. Total Geared Turbofan deliveries nearly doubled in the fourth quarter while military sales increased 17%. Aftermarket services were up 11%.

The company expects to deliver ~2,500 Geared Turbofan engines over the next three years, so aftermarket services should increase as United Technologies install base grows.

While United Technologies has done well recently, the company's results were mixed during the last recession.

- 2007 earnings-per-share of $4.27
- 2008 earnings-per-share of $4.90 (14.8% increase)
- 2009 earnings-per-share of $4.12 (16% decrease)
- 2010 earnings-per-share of $4.74 (15% increase)

Industrial companies depend on a growing economy in order to perform well. A global recession would likely cause customers to pause large purchases. With this in mind, United Technologies actually held up fairly well during the last recession. The company remained profitable throughout the Great Recession, and quickly surpassed pre-recession earnings levels by 2010.

We caution, however, that the company will be less diversified after the completion of the Otis and Carrier spin offs, which could effect earnings results.

United Technologies’ products, like elevators and jet engines, are in high demand when the economy is growing. One item investors need to be aware of is that United Technologies does a significant amount of business in China, especially its Otis division. A prolonged trade war with China could impact the company’s earnings results.

Overall, United Technologies is not a highly recession-resistant business. Earnings-per-share would likely decline in the event of a recession over the next few years, although the company should remain profitable and continue to pay its dividend even during an economic downturn.

Valuation & Expected Returns

Based on the recent closing price of $116 and expected EPS for 2019 of $7.85, shares of United Technologies trade with a price-to-earnings ratio of 14.8. This compares favorably to the average price-to-earnings ratio of 20.4 for the S&P 500. United Technologies has a ten-year average price-to-earnings ratio of 15.3.

A breakdown of United Technologies' historical valuation can be seen in the table below:

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.1	13.4	15.0	14.6	14.7	16	16.4	17.0	15.3	17.7	***17.9***	***15.3***
Avg. Yld.	2.1%	2.8%	2.4%	2.3%	2.6%	2.2%	2.1%	2.4%	2.6%	2.3%	***2.3%***	***2.6%***

Note: "Now" in the table above refers to 2018 numbers. The price-to-earnings calculation of 14.8 reflects 2019 expected earnings-per-share of $7.85.

As a result, shares of United Technologies appear to be slightly undervalued on a forward price-to-earnings basis. If shares were to revert to their average valuation, shareholders would see an additional 0.7% in annual returns through 2024.

United Technologies can generate returns from earnings growth and dividends as well. A breakdown of total returns is as follows:

- 3% earnings growth
- 0.7% multiple expansion
- 2.6% yield

We expect a relatively modest earnings growth rate of 3% over the next five years. While United Technologies is a high-quality business with a leadership position in the industry, we acknowledge the various risks facing the future outlook of the company.

Potential risk factors include integration risk with the large Rockwell Collins acquisition, geopolitical risk, and the risk of a global economic slowdown. In total, United Technologies could offer shareholders an annual return of 6.3% through 2024.

Final Thoughts

United Technologies is in the process of transforming itself. After acquiring Rockwell Collins and separating its low growth businesses, the company is poised for future growth. Focusing on its aerospace and defense businesses will likely put United Technologies in a position to succeed in future years.

In addition, the company recently became a Dividend Aristocrat and offers an above market yield. This could make the stock an attractive option for income investors.

That being said, we find that shares of United Technologies only offer a mid-digit total return at the moment. While we like the company's growth prospects going forward as well as the long history of dividend growth, we rate this stock as a hold due to a fairly low rate of expected growth, as well as a fairly valued share price. That said, United Technologies would become a more attractive stock--and possibly a buy--on a meaningful pullback in the share price.

Health Care Dividend Aristocrats

Abbott Laboratories (ABT)

Business Overview

Abbott Laboratories is a diversified healthcare corporation with a market capitalization of $119.96 billion. The company was founded in 1888 and is headquartered in Lake Bluff, Illinois.

The company operates in four main segments:

- Nutritional Products
- Branded Generic Pharmaceuticals
- Diagnostics
- Medical Devices

The company's Nutrition Products segment is characterized by market leadership. It is the #1 pediatric nutrition provider in the United States and some other geographies. Moreover, the segment's performance has improved considerably in recent years as operating margin has improved in each and every year since 2011.

Source: Investor Presentation, page 3

The company's Branded Generic Pharmaceuticals segment is focused on emerging markets, with an emphasis on BRIC countries (Brazil, Russia, India, and China).

The company's Diagnostics segment is geographically more diverse than the Branded Generic Pharmaceuticals segment. About 30% of the segment's revenue is generated in the United States while 30% is generated in non-US developed markets and 40% is generated in emerging markets. Similar to the Nutrition segment, the Diagnostics segment has seen significant operating margin improvements over the last several years.

Abbott Laboratories' last segment is the Medical Devices unit. This segment was significantly bolstered in recent times by the St. Jude Medical acquisition, which helped the segment to grow sales by nearly 43% in the most recent quarter. The company's high-quality product portfolio and the acquisition of St. Jude should fuel strong growth for the next several years.

Growth Prospects

Over time, Abbott Laboratories has shown the capability to reliably grow its adjusted earnings-per-share. Abbott Laboratories spun-off AbbVie (ABBV) in 2013, and both businesses have performed well since the spin-off. If an investor had held onto their shares of both companies, their per-share earnings would total $8.01 in 2017. This is up significantly from the $4.99 (growth of 8.4% per year) of adjusted earnings-per-share reported by the combined company in 2012.

Looking ahead, Abbott Laboratories has two major growth prospects that will help its business to become increasingly more profitable over the years to come.

The first is the aging population, both domestically and within the United States. In 2017, the percent of the global population that exceeded age 65 was 8.7%. This proportion is expected to reach 16.7% in 2050.

Source: Investor Presentation, page 5

The second broad tailwind that will benefit Abbott Laboratories is the company's focus on the emerging markets. This is particularly true for its Branded Generic Pharmaceuticals segment.

Many of the countries that this segment is focused on spend a very small proportion of their overall GDP on healthcare, a rate that is expected to increase in the future.

The aging domestic population combined with the rather low focus on healthcare spending in emerging market countries should leave Abbott Laboratories plenty of room to grow for the foreseeable future.

Competitive Advantages & Recession Performance

Abbott Laboratories' competitive advantage is two-fold. The first component is its remarkable brand recognition among its consumer medical products, particularly in its Nutrition segment. Led by noteworthy products like the Ensure meal replacement supplement, Abbott Laboratories brands allows its sales to stand strong through even the worst economic recessions.

The second component of Abbott's competitive advantage is its focus on research and development. The company's R&D expense over the last several years is shown below:

- 2014 research & development expense: $1.3 billion
- 2015 research & development expense: $1.4 billion
- 2016 research & development expense: $1.4 billion
- 2017 research & development expense: $2.2 billion

Abbott Laboratories' investment in research & development show that the company is willing to play the long game, building out its product pipeline and improving its long-term business growth prospects.

Abbott also has a competitive advantage that comes from its laser-sharp focus on shareholder value. In many ways, this starts at the top of the business via the leadership of Miles D. White. Mr. White, a Stanford-educated mechanical engineer and businessman by training, is nearing his 20-year anniversary as Abbott's Chief Executive Officer.

As a large, diversified healthcare business, Abbott Laboratories is extraordinarily recession-resistant. The company actually managed to increase its adjusted earnings-per-share during each year of the 2007-2009 financial crisis.

- 2007 earnings-per-share of $2.84
- 2008 earnings-per-share of $3.03
- 2009 earnings-per-share of $3.72
- 2010 earnings-per-share of $4.17

Abbott Laboratories remarkably managed to grow its earnings-per-share during the global financial crisis – one of the most economically difficult time periods on record. At the same time, the company's share count increased. Abbott Laboratories didn't use share repurchases to grow earnings-per-share, they were simply more profitable during a tumultuous time. We expect this recession-resistant Dividend Aristocrat to perform similarly well during future downturns in the business environment.

Valuation & Expected Total Returns

When Abbott Laboratories reported third-quarter earnings in October, the company narrowed its full-year adjusted earnings-per-share guidance to $2.87-$2.89. This performance forecast gives investors a benchmark by which to assess the company's current valuation.

Abbott Laboratories is currently trading at $68/share. Using this price combined with the midpoint of the company's guidance ($2.88) gives a price-to-earnings ratio of 23.6.

Abbott Laboratories' has traded with an average price-to-earnings ratio of 19 over the past five years. The current valuation is noticeably higher than its long-term average. If shares revert to our fair value estimate of 19, this would reduce total returns by 4.2% per year. While right now may not be the best time to purchase shares of this high-quality business, total return may still be satisfactory particularly when adjusted for the low-risk nature of Abbott's business model.

The other major component of Abbott Laboratories' future total returns will be the company's earnings-per-share growth. As we've seen, the company has a proven ability to grow earnings in the high-single-digits each year. We expect that this growth is likely to continue and investors can reasonably expect 6.5% in annual adjusted earnings-per-share growth moving forward.

Lastly, Abbott's total returns will receive a boost from the company's dividend payments. After increasing its dividend 14.3% in mid December, Abbott Laboratories now pays a quarterly dividend of $0.32 which yields 1.9% on the company's current stock price of $68.

In sum, Abbott Laboratories' expected total returns will be composed of:

- 6.5% earnings-per-share growth
- 1.9% dividend yield
- 4.3% multiple reversion

Total expected total annual returns are forecast at 4.1% through 2024.

Final Thoughts

Abbott Laboratories has many of the characteristics of an appealing dividend investment. It has a recession-resistant business model that allows it to continue growing earnings-per-share through various economic environments. It also has a long history of steadily increasing dividend payments.

While the company's current valuation exceeds its long-term average, Abbott Laboratories remains a strong hold and we recommend that investors buy this high-quality stock on any notable dips.

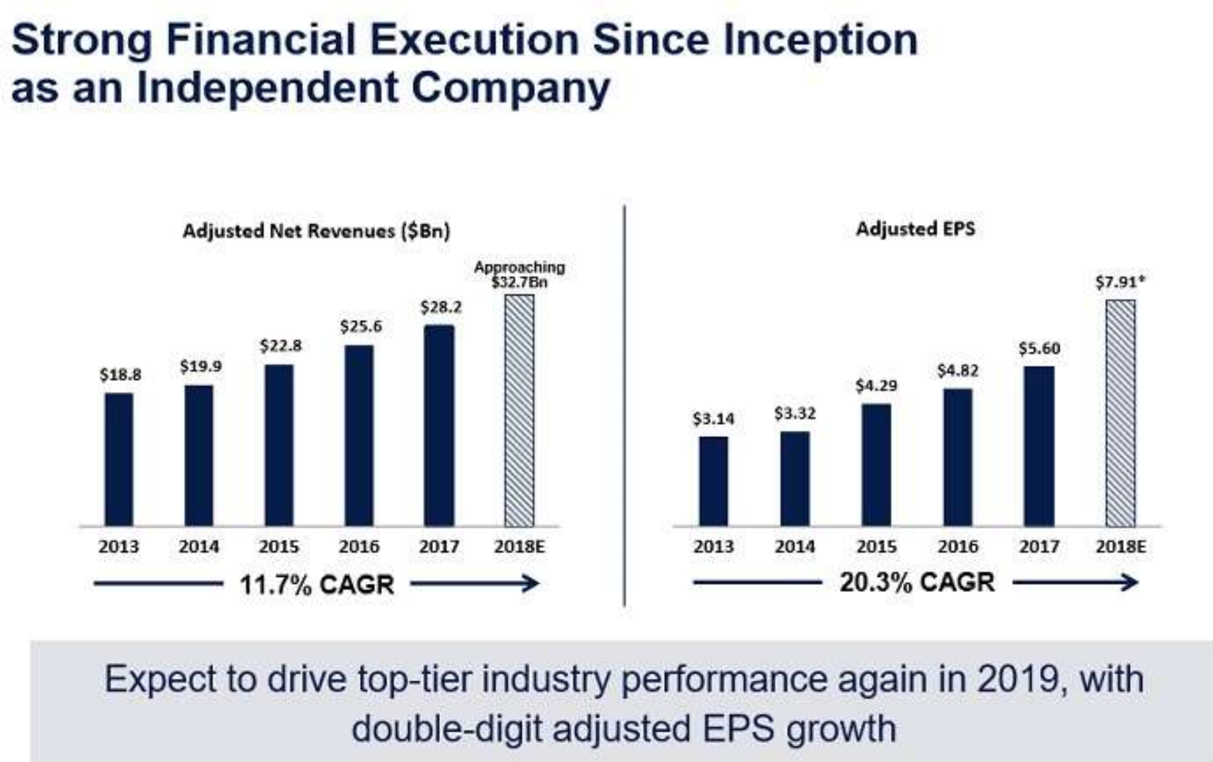
AbbVie (ABBV)

Business Overview

AbbVie is a global pharmaceutical giant. It has a $119 billion market capitalization, and sells its products in more than 170 countries across the world. AbbVie began trading as an independent company in 2013, after it was spun off from fellow pharmaceutical Dividend Aristocrat, Abbott Laboratories (ABT).

Today, AbbVie focuses on one main business segment—pharmaceuticals. It focuses on a few key treatment areas, including immunology, oncology, and women's health.

The company has seen excellent growth since it was spun off from Abbott. AbbVie now generates annual revenue of nearly $33 billion.



Source: Investor Presentation

Since the spin-off from Abbott, AbbVie has produced 12% annual revenue growth and over 20% annual earnings growth. Humira has been the major reason for AbbVie's huge growth. Humira is a multi-purpose drug, and is the top-selling drug in the world.

AbbVie reported its fourth quarter and full year earnings results in late January (1/25/19). The company was able to generate revenues of $8.3 billion during the fourth quarter, which was 7.4% more than AbbVie’s revenues during the fourth quarter of fiscal 2017.

AbbVie’s revenue growth was primarily driven by strong growth from Imbruvica, which grossed sales of $1.0 billion, which was 42% more than the drug’s sales during the previous year’s quarter.

Humira remained the world’s best-selling drug, and AbbVie’s most important drug by far, but its growth rate slowed down to just 0.5%. Humira seems to be in a slow-to-no growth stage, but the drug will remain AbbVie’s most important cash cow over the coming years.

AbbVie earned $1.90 per share during the fourth quarter, which was 28% more than the company’s earnings-per-share during the fourth quarter of the previous year.

Both AbbVie’s revenues as well as its earnings-per-share were slightly lower than what the analyst community forecasted, which led to a 6% share price decline on the day of the earnings release. AbbVie generated earnings-per-share of $7.91 during fiscal 2018, which was 41% more than AbbVie’s earnings-per-share during fiscal 2017.

Along with the fourth quarter earnings release, AbbVie management announced that the company sees earnings-per-share falling into a range of $8.65 to $8.75 during fiscal 2019.

Growth Prospects

The major risk for global pharmaceutical manufacturers is patent loss. When a particular drug loses patent, the market is typically flooded with competition, especially for the world’s top-selling products. Investors can see what happened to Pfizer (PFE) after Lipitor lost patent protection as an example of the impact of patent risk.

For AbbVie, its biggest risk is the competition about to hit its flagship drug Humira, a multi-purpose drug that is used to treat a variety of conditions. Some of these include rheumatoid arthritis, plaque psoriasis, Crohn’s disease, ulcerative colitis, and more.

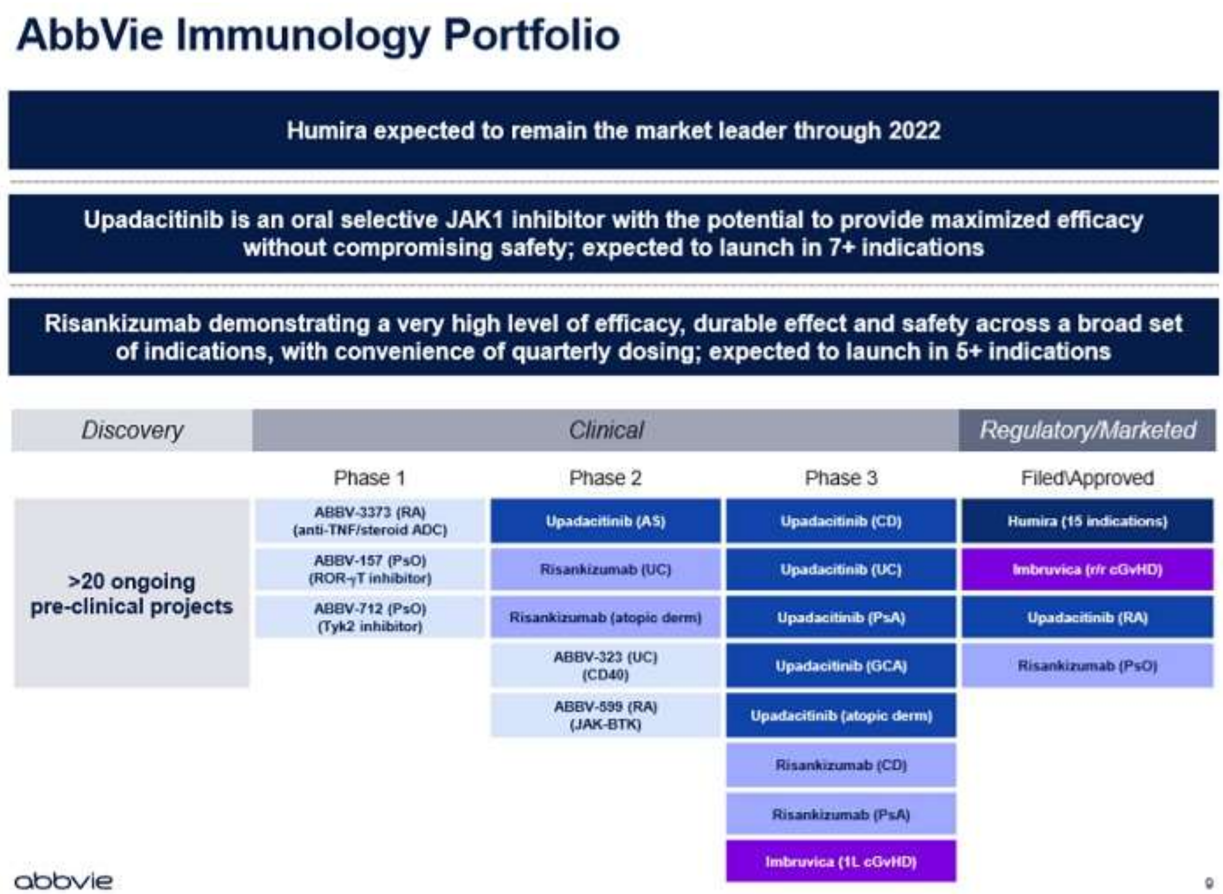
Humira generated over $19 billion in sales last year for AbbVie, meaning loss of exclusivity poses a significant risk for the company going forward.

Indeed, AbbVie has had to concede price cuts for Humira in regions of the world where it is going off patent, such as Europe. On last quarter’s conference call with analysts, AbbVie CEO Rick Gonzalez acknowledged that discounting in Europe has been "on the higher end" of what the company had expected, with Humira prices being slashed from 10%-80% depending on the country.

In addition, AbbVie will face biosimilar competition to Humira in the U.S. starting in 2023. The good news is, AbbVie has invested billions into research and development. As a result, the company has a large portfolio of new products that should offset any sales declines from the competitive threats to Humira.

Its two biggest areas of growth going forward will be hematologic oncology, and next-generation immunology. AbbVie's oncology business is currently a $4 billion-a-year franchise, with potential to reach $9 billion in sales by 2025.

Meanwhile, AbbVie expects its immunology portfolio to generate sales of over $10 billion by 2025.



Source: [Investor Presentation]

AbbVie has reached six settlements related to Humira competitors. All licenses agreed to thus far will begin in 2023, led by Amgen (AMGN) in January that year. Fortunately, AbbVie has prepared for this increasing competition to Humira, by investing heavily in new product development.

This investment is about to pay off—sales from products other than Humira cumulatively totaled nearly $10 billion last year. The company expects to launch 20 new products or indications by

2020. AbbVie expects non-Humira product sales to exceed $16 billion by 2020, and $35 billion by 2025.

Share buybacks will also add to AbbVie's future earnings growth. Since the company is highly profitable and generates significant free cash flow, it can afford to invest in growth and also return cash to shareholders. On December 13th AbbVie announced a new $5 billion share repurchase authorization.

Continued buybacks help boost earnings. As shares are repurchased and retired, each remaining share receives a higher percentage of the company’s profits, thus increasing earnings-per-share.

Combined, these growth catalysts are expected to result in 9%-10% adjusted earnings growth each year over the next five years.

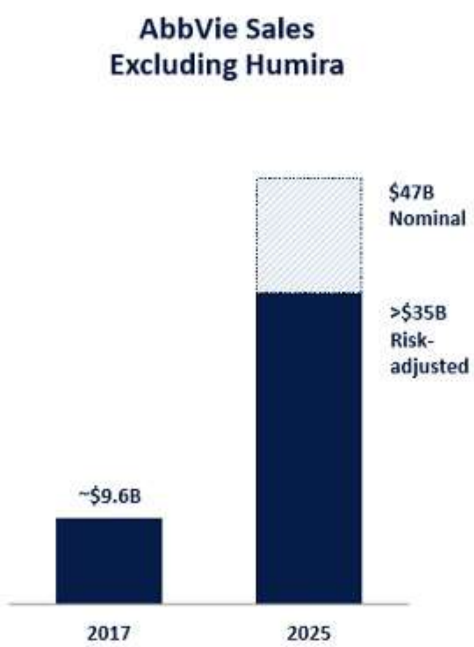
Competitive Advantages & Recession Performance

The most important competitive advantage for AbbVie, and any pharmaceutical company, is its patent portfolio. Pharmaceutical giants need to spend heavily to innovate new drugs and therapies, when one of their blockbusters loses patent protection.

To build its pipeline and to prepare for the decline of Humira, AbbVie has accelerated research and development spending. AbbVie spent nearly $5 billion on R&D last year alone.

Fortunately, this spending is starting to show positive results, as AbbVie has a robust pipeline.

Embedded Within AbbVie Is a Platform with Market Leading Growth Prospects



Key Assets	Launch	Indication Expansion
Imbruvica	✓	2017 - 2021
Venclexta	✓	2018 - 2022
Mavyret	✓	N/A
Zinbryta	✓	N/A
Rova-T	Late 2018/Early 2019 (3L+ SCLC)	2019 - 2023+
Elagolix	2018 (Endometriosis)	2020
Upadacitinib	2019 (RA)	2021 - 2023
Risankizumab	2019 (Psoriasis)	2021 - 2023

On track for more than 20 new drug or indication approvals by the end of 2020

Source: Strategic Update

It is unclear how AbbVie itself performed during the Great Recession, as it was still part of Abbott Laboratories. However, it stands to reason the company would hold up fairly well during the next recession.

Prescription drugs and medical supplies are necessities, with stable demand. Consumers often cannot choose to go without healthcare, even when the economy is in a downturn. As a result, investors can reasonably assume AbbVie's profits would experience a modest decline during a recession.

Valuation & Expected Returns

AbbVie is expected to generate adjusted EPS of $8.70 for 2019. At the midpoint of AbbVie's earnings guidance, the stock is currently trading for a price-to-earnings ratio of 9.2.

AbbVie is valued considerably below the S&P 500 Index, which has an average price-to-earnings ratio well above 20. In addition, AbbVie is undervalued today when compared to its historical average.

Since the spin-off from Abbott, AbbVie has held an average price-to-earnings ratio of 13.8.

It could be argued AbbVie deserves a significantly higher valuation than it currently holds, given its high-quality business and strong growth prospects. Even with the competition facing Humira, AbbVie stock looks undervalued, as the company can still generate growth from its new product portfolio.

As a result, we view AbbVie stock as considerably undervalued. If the P/E ratio expands to our fair value estimate of 13.0, it would increase annual shareholder returns by approximately 7.2%.

In addition, shareholder returns will be boosted by earnings growth and dividends. We expect AbbVie to generate 9%-10% annual EPS growth over the next five years, consisting mostly of revenue growth and share repurchases.

Lastly, AbbVie stock offers a current dividend yield of 5.4%. This is a very high yield, at more than double the average dividend yield of the S&P 500 Index.

In all, AbbVie's total expected returns could exceed 22% per year through 2024. This is a very attractive potential rate of return, which makes AbbVie one of our highest-conviction buy recommendations.

Final Thoughts

AbbVie is a very high-quality business, with a strong pharmaceutical pipeline and growth potential. It is also a shareholder-friendly company that returns excess cash flow to investors through stock buybacks and dividends.

AbbVie, as with all pharmaceutical companies, faces a significant challenge in replacing lost Humira sales as it faces competition in the U.S. and Europe. Fortunately, the company has prepared for this with heavy R&D investments. From this, it has created a large portfolio of new products that should keep AbbVie's growth intact.

With expected returns above 22% per year going forward, AbbVie is an excellent buy for long-term value and income investors.

Becton, Dickinson & Company (BDX)

Business Overview

Both Becton Dickinson and C.R. Bard have long operating histories. C.R. Bard was founded in 1907 by Charles Russell Bard, an American importer of French silks, after he began importing Gomenol to New York City. At the time, Gomenol was commonly used in Europe, and Mr. Bard used it to treat his discomfort from tuberculosis.

By 1923, C.R. Bard was incorporated. Later, it developed the first balloon catheter, and slowly expanded its product portfolio.

Meanwhile, Becton Dickinson has been in business for more than 120 years. Today, the company employs more than 40,000 employees in over 50 countries. The company generated $16 billion in revenue in fiscal year 2018. Approximately 55% of annual sales come from the U.S., with the remaining 45% derived from international markets.

With the addition of C.R. Bard, Becton Dickinson now has three segments: Medical (54% of sales for FY 2018), Life Sciences (27% of sales) and Intervention (19% of sales) , which houses products manufactured by Bard. The company sells products in several categories within these businesses. Some of its core product categories include diagnostics, infection prevention, surgical equipment, and diabetes management.

Source: Annual Shareholder Meeting

At the time of the acquisition, Becton Dickinson's revenue growth had slowed to a low single digit growth rate. Revenue growth accelerated to 32% in 2018, thanks largely to the acquisition of C.R. Bard. On a comparable, currency-neutral basis, revenues improved 5.8%. While Bard added a significant amount to revenues for the last fiscal year, Becton Dickinson's growth rate also improved.

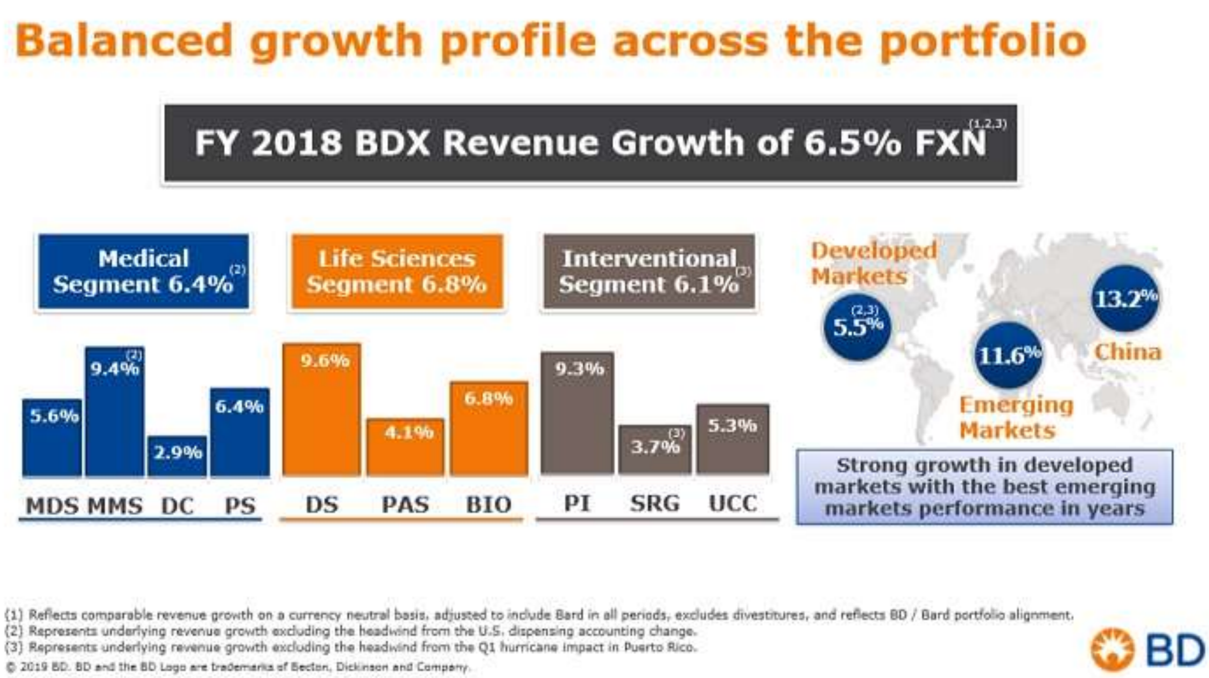
Comparable revenues for the Medical segment improved 10.1% for the fourth quarter and 5.6% for 2018. All of the individual divisions within Medical showed growth during the year. The company expanded operating margin by 350 basis points to 25.3% for 2018. Overall, earnings-per-share increased 16% to $11.01 in fiscal 2018.

Fiscal 2019 is off to another good start in ots most recent quarter. Becton Dickinson's revenue increased 35% (including the with C.R. Bard acquistions) and 5.2% on a comparable basis (excluding the C.R. Bard acquisition) versus the same quarter a year ago . Earnings-per-share grew 9% over the same time period, and the company expects earnings-per-share to grow 10% in fiscal 2019.

Growth Prospects

Going forward, the merger presents even more growth opportunities for Becton Dickinson. The combined company has annual revenue of approximately $16 billion. And, after adding C.R. Bard, Becton Dickinson’s total addressable market in medication management increased by $20 billion.

Becton Dickinson has been able to enter several new growth categories with C.R. Bard in tow, in the U.S. and around the world.



Source: Annual Shareholder Meeting

First, there are healthcare associated infections, which Becton Dickinson estimates costs patients nearly $10 billion every year.

According to Becton Dickinson, one out of every 15 patients acquires an infection during care. The newly combined company will be able to treat these unaddressed conditions, specifically in surgical site infections, blood stream infections, and urinary tract infections caused by catheters.

Next, C.R. Bard has helped expand Becton Dickinson's oncology and surgery products, in biopsies, meshes, biosurgery, and infection prevention devices. After the merger, Becton Dickinson has an oncology and surgery business generating annual sales of $1.5 billion.

Lastly, the acquisition boosts Becton Dickinson's international presence, particularly in medical technology. The company already generates nearly half of its annual sales from outside the U.S.

Over the long-term, the acquisition provides Becton Dickinson the opportunity to expand its reach in new therapeutic areas. The company is targeting investment in diabetes, peripheral vascular disease, and chronic kidney disease.

C.R. Bard also opens up expansion opportunities in emerging markets such as China. Last quarter, comparable sales outside the U.S. rose 8.7%.

Along with organic growth, the acquisition should boost Becton Dickinson's earnings. In its first-quarter financial report, the company reiterated its guidance of 10% growth for the full year. From 2019-2020, management expects earnings growth in the mid-teens, thanks to revenue growth and operating margin expansion.

Competitive Advantages & Recession Performance

Becton Dickinson has significant competitive advantages, including scale and a vast patent portfolio. These competitive advantages are due to high levels of investment spending.

Becton Dickinson's research and development spending in the past several years is as follows:

- 2014 research-and-development expense of $550 million
- 2015 research-and-development expense of $632 million
- 2016 research-and-development expense of $828 million
- 2017 research-and-development expense of $774 million
- 2018 research-and-development expense of $1 billion

Becton Dickinson is coming off a multi-year period of elevated research and development spending. This spending has certainly paid off, with strong revenue and earnings growth over the past several years. The company has obtained leadership positions in their respective categories because of product innovation, a direct result of R&D investments.

These competitive advantages provide the company with consistent growth, even during economic downturns. Becton Dickinson steadily grew earnings during the Great Recession. Becton Dickinson's earnings-per-share during the recession are as follows:

- 2007 earnings-per-share of $3.84
- 2008 earnings-per-share of $4.46 (16% increase)
- 2009 earnings-per-share of $4.95 (11% increase)
- 2010 earnings-per-share of $4.94 (0.2% decline)

Becton Dickinson generated double-digit earnings growth in 2008 and 2009, during the worst years of the recession. It took a small step back in 2010, but continued to grow in the years since, along with the economic recovery.

The ability to consistently grow earnings each year of the Great Recession, which was arguably the worst economic downturn in decades, is extremely impressive.

The reason for its strong financial performance, is that health care patients need medical supplies. Patients cannot choose to forego necessary healthcare supplies. This keeps demand steady from year to year, regardless of the condition of the economy.

Becton Dickinson has a unique ability to withstand recessions, which explains its 40+ year history of consecutive dividend increases.

Valuation & Expected Returns

Shares of Becton Dickinson are currently trading at a price $243. Using the company's earnings-per-share guidance of $12.10 for fiscal year 2019, the stock has a price-to-earnings ratio of 20.1. Becton Dickinson's stock trades nearly in line with the valuation of the S&P 500 index.

A complete breakdown of Becton Dickinson's historical average price-to-earnings ratios can be seen in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	13.7	14.9	14.5	14.1	15.6	18.1	19.5	18.4	19.4	22.7	***19.9***	***18.4***
Avg. Yld.	1.9%	2.0%	2.0%	2.4%	2.2%	1.9%	1.7%	1.7%	1.6%	1.6%	***1.2%***	***1.4%***

Over the last decade, earnings-per-share have grown at a rate of 7.8%. We estimate that with C.R. Bard, Becton Dickinson can grown earnings-per-share by 10% annually. Applying this estimate to the long term average valuation, we have 2024 target valuation of 18.4 for the stock.

Valuation isn't the only factor in estimating total returns. Becton Dickinson's stock will generate returns from earnings growth and dividends as well.

Capital investments have fueled Becton Dickinson’s historical returns, and should continue to do so. The company is in the enviable position of generating enough cash flow for capital expenditures, dividends, and debt reduction, with cash left over.

A potential breakdown of total returns is as follows:

- 10% earnings-per-share growth
- 1.3% dividend yield
- 1.8% valuation reversion

Based on this outlook, Becton Dickinson could generate 9.5% in total returns through 2024.

As far as dividends, Becton Dickinson remains a quality dividend growth stock. It has a very secure payout, with room for growth. The company currently pays an annual dividend of $3.08 per share. Based on 2019 earnings guidance, Becton Dickinson will likely have a dividend payout of approximately 25.5% for the current year.

This is a very low payout ratio. It leaves plenty of room for sustained dividend growth moving forward, particularly since earnings will continue to grow. The last two increases have been just 2.7%, far below the company's double-digit average rate over the previous decade. This is due to the amount of cash that Becton Dickinson used to purchase C.R. Bard.

Becton Dickinson provides a low dividend yield, which is roughly half the 2% average yield of the S&P 500 Index. This might make the stock unattractive for retirees, or investors who prefer higher levels of income today. However, its dividends will add up over the long term due to the annual dividend increases.

Final Thoughts

Becton Dickinson's business continues to perform very well. The company posted solid growth rates, both with and without the addition of C.R. Bard last fiscal. Given the positive growth outlook for the healthcare industry, we feel that Becton Dickinson has room for strong earnings growth.

In addition, Becton Dickinson has a high likelihood of annual dividend increases for many years. That said, the stock has a relatively low dividend yield of 1.3%, which is well below the average yield of the S&P 500 Index.

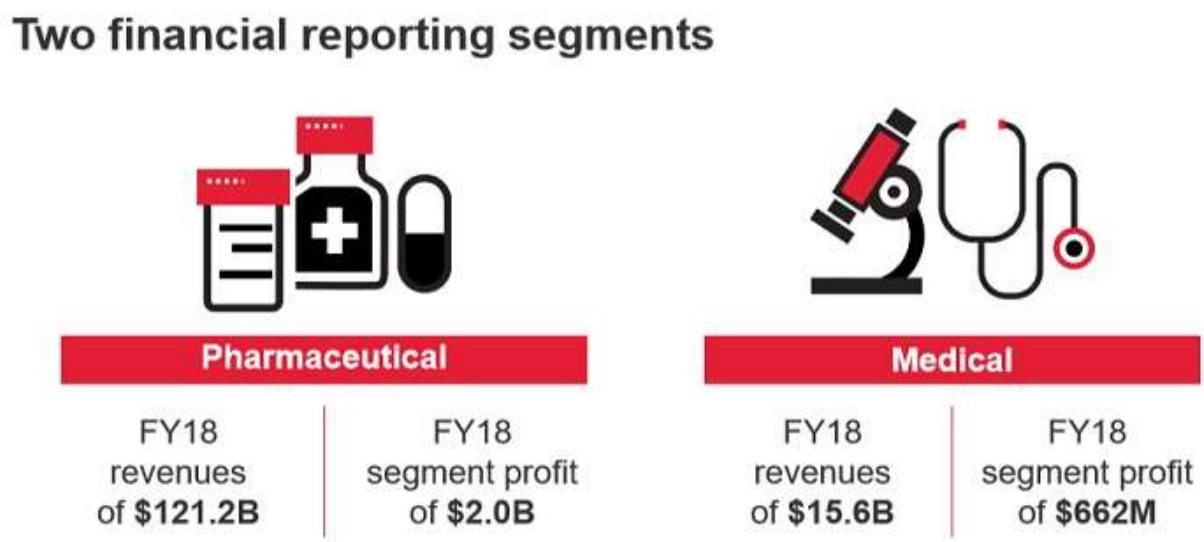
Furthermore, Becton Dickinson stock appears to be overvalued today, which negatively impacts its future return potential. As a result, we rate shares as a hold at current prices, and recommend investors interested in Becton Dickinson wait for a pullback before buying shares.

Cardinal Health (CAH)

Business Overview

Cardinal Health was founded in 1971. Today, it is a giant in the healthcare supply industry. It has approximately 50,000 employees, operates in over 40 countries, and generates annual revenue of approximately $137 billion.

The company has two operating segments: Pharmaceutical and Medical. The Pharmaceutical segment is by far the company's largest, as it represents nearly 90% of total revenue.



Source: [Investor Presentation]

The pharmaceutical segment distributes branded and generic drugs and consumer products. It distributes these products to hospitals and other healthcare providers. The medical segment distributes medical, surgical, and laboratory products to hospitals, surgery centers, clinical laboratories, and other service centers.

The business climate for Cardinal Health is challenged. Falling drug prices have negatively impacted margins in the company's core pharmaceutical segment.

As a result, Cardinal Health's strong performance slowed last year. Higher selling volumes pushed revenue up 5% in fiscal 2018, but Cardinal Health's adjusted earnings-per-share declined 7.4%, to $5.00 for the year.

One of the biggest challenges for Cardinal is drug price deflation, driven by increased shipments of generics. Negative pricing effects drove margin erosion in the pharmaceutical segment last year, and could continue to do so if political and competitive pressure on drug prices remains.

Adding to this concern are reports that e-commerce retail giant Amazon (AMZN) is preparing to enter the medical supply business. Amazon's nearly $1 billion acquisition of online pharmacy PillPack last year was widely viewed as a precursor to a bigger move into the healthcare industry.

Given these challenges, it is even more impressive that Cardinal Health grew revenue in fiscal 2018, and should return to earnings growth over the long-term.

Growth Prospects

On February 7th, 2019 Cardinal Health released second-quarter results for fiscal year 2019. For the quarter, Cardinal Health reported revenue of $37.7 billion, a 7% increase compared to the $35.2 billion posted in the same quarter of fiscal year 2018.

On the bottom line, adjusted earnings-per-share totaled $1.29 versus $1.51 in the year ago period, a 15% year-over-year decline.

Both of the company's segments saw deteriorating profitability last quarter. Revenue increased 8% in the Pharmaceutical segment, but segment operating profit declined by 14%.

Q2 FY19 pharmaceutical segment results

	Q2 FY19 ($M)	Q2 FY18 ($M)	YoY change
Revenue	$33,740	$31,146	8%
Segment profit	$443	$514	(14)%
Segment profit margin	1.31%	1.65%	-34 bps

Drivers:

Revenue

+ Pharmaceutical Distribution and Specialty Solutions customers
- Divestiture of the China distribution business

Segment profit

- Impact from the company's generics program performance
+ Specialty Solutions performance

Source: Investor Presentation

The Medical segment, which had previously been growing at a fast rate, also disappointed last quarter. Medical segment revenue declined 1%, with operating profit down 14% for the quarter.

Cardinal Health's earnings-per-share result left a lot to be desired last quarter. However, the company raised its adjusted earnings-per-share guidance for the full fiscal year to a range of $4.97 to $5.17 (from $4.90 to $5.15 previously).

At the midpoint of earnings-per-share guidance--approximately $5.07 for fiscal 2019--Cardinal Health expects 1%-2% earnings growth this year.

There are multiple catalysts to return to even stronger earnings growth rates going forward. One of them is acquisitions.

Cardinal Health acquired the Patient Recovery business from Medtronic (MDT) for $6.1 billion, which will broaden the company's product offerings. Cardinal Health management expects the Patient Recovery acquisition to add $0.55 to earnings-per-share in 2019.

The result of this investment is that Cardinal Health now has a huge branded portfolio, which consists of nearly 12,000 product SKUs, in 850 categories.

Another important catalyst for a return to growth is moderating price deflation, growth in specialty products, and cost cuts. First, price deflation in pharmaceuticals has eased as of late. In the most recent recent quarter, Cardinal Health noted the rate of deflation in generics was less than at the same time last year.

Stabilization of pricing is boosted by the company's joint venture with CVS Health (CVS), called Red Oak Sourcing. Joining forces helps the two companies negotiate better generic pharmaceutical prices.

Specialty products are another emerging area of growth. Over the past several years, Cardinal Health has grown its specialty products business from $1 billion in annual sales to $15 billion.

Competitive Advantages & Recession Performance

The biggest competitive advantage for Cardinal Health is its distribution capability, which makes it very difficult for competitors to successfully enter the market.

Cardinal Health distributes its products to nearly 85% of U.S. hospitals. It also serves more than 26,000 pharmacies, as well as over 10,000 specialty physician offices and clinics. It also serves over 6,700 laboratories with more than 53,000 laboratory products. The company's home healthcare business serves nearly 3 million patients, with more than 45,000 products.

And, Cardinal Health operates in a stable industry with high demand. The company should remain steadily profitable, as there will always be a need for pharmaceutical products to be distributed.

However, Cardinal Health is not immune from recessions. Its earnings-per-share declined significantly during the Great Recession:

- 2007 earnings-per-share of $3.41
- 2008 earnings-per-share of $3.80 (11% increase)
- 2009 earnings-per-share of $2.26 (40% decline)
- 2010 earnings-per-share of $2.22 (1.8% decline)

That said, the 2009 spin-off of CareFusion distorted Cardinal Health's GAAP earnings that year. The core business still performed relatively well, and earnings returned to growth in 2011 and beyond.

Since people will always need their medications and healthcare products, regardless of the economic climate, Cardinal Health could be considered more recession-resistant than the average company.

Valuation & Expected Returns

Based on anticipated adjusted earnings-per-share of $5.07 for fiscal 2019, Cardinal Health stock has a price-to-earnings ratio of 10.4. Cardinal Health is currently valued well below its 10-year average price-to-earnings ratio of 14.2.

Our fair value estimate is a price-to-earnings ratio of 14.0, which indicates the stock is severely undervalued today. This very low valuation reflects a high degree of market pessimism.

If the company can return to positive earnings growth, it could easily justify a higher valuation. This is why we believe a price-to-earnings ratio of 14.0 is a reasonable estimate of fair value. Expansion of the stock valuation could fuel annual returns of 6.1% through 2024.

In addition to multiple expansion, future returns will be generated from earnings growth and dividends.

We expect Cardinal Health to grow earnings-per-share by 5% per year, primarily from revenue growth and share repurchases, with a modest decline in margins. The company has reduced its share count by 2.1% per year on average from 2014 through 2018.

Lastly, the stock has an attractive current dividend yield of 3.6%. And, as a Dividend Aristocrat, Cardinal Health is likely to continue raising its dividend each year. The company's dividend is highly secure, with a projected dividend payout ratio of 38% for fiscal 2019.

Putting all the pieces together, we expect total returns of nearly 15% per year over the next five years, driven by multiple expansion, earnings growth, and dividends. This is a high rate of return for Cardinal Health, earning a buy recommendation from Sure Dividend.

Final Thoughts

The economics of the healthcare distribution industry have deteriorated over the past year. This has impacted all the major players, including Cardinal Health.

Fortunately, Cardinal Health continues to grow revenue. And while margin erosion has led to declining earnings, the company has put in place a number of initiatives that should return it to positive earnings growth going forward.

High-quality companies like Cardinal Health have withstood difficult periods before, and will do so again. The factors impacting the stock in the short-term may represent a great buying opportunity for this Dividend Aristocrat.

Johnson & Johnson (JNJ)

Business Overview

J&J is a global healthcare giant. It has a market capitalization of $360 billion, and generates annual revenue of more than $81 billion.

Today, J&J operates in more than 60 countries and employs 134,000 people. It is a massive company, with more than 250 subsidiary companies.

In all, it manufactures and sells health care products through three main segments:

- Pharmaceuticals (50% of sales)
- Medical Devices (33% of sales)
- Consumer Health Products (17% of sales)

It has a diversified business model, with strong brands across its three core operating segments.

Source: [Earnings Presentation]

J&J is one of the largest companies in the world, but it started from very humble beginnings. It was founded all the way back in 1886 by three brothers, Robert, James, and Edward Johnson. The company was incorporated the following year.

In 1888, the three brothers published a healthcare manuscript titled "Modern Methods of Antiseptic Wound Treatment", which would quickly become the leading standard for antiseptic surgery techniques.

The same year, the three brothers began selling first aid kits, which also became the standard-bearer at the time.

Over the following decades, the company steadily brought new products to market. Soon, the company was the leading manufacturer across several healthcare categories, including baby powder, sanitary napkins, dental floss, and more.

In many cases, the Johnson brothers created products that were the first of their kind. J&J is still a leading manufacturer of consumer healthcare products.

The consumer franchise is broken up into six broad categories. Its most popular consumer brands include Band-Aid, Tylenol, Listerine, Johnson's, and Neutrogena. Johnson's, Neutrogena, and Listerine each generate more than $1 billion in annual sales. The consumer products business is highly profitable, and is a source of stability for J&J.

Not all the recent news related to J&J has been positive. On December 14th, Reuters released research stating that the company knew its baby powder could be contaminated with asbestos. After examining documents, the report stated that the company discussed ways to address the issue between 1971 and the early 2000s.

J&J has strongly denied this report, but the company has more than 12,000 product liability lawsuits related to its baby powder. The stock declined 10% the day of the Reuters report.

On December 19th, a Missouri circuit court judge dismissed a motion by the company to reverse its $4.7 billion jury award to plaintiffs claiming that its talc products caused their ovarian cancer. An appeal by J&J is likely to occur.

Growth Prospects

J&J's pharmaceutical segment is its strongest area of growth. This segment has recently generated much higher growth rates than medical devices or consumer products.

For example, J&J had adjusted earnings-per-share of $8.18 in 2018, which represented 12.1% growth from the previous year. Organic revenue increased 5.5% for 2018. The pharmaceutical segment led the way, growing revenue 12.4% for the year. Revenue for medical devices and consumer products grew by just 1.5% and 1.8%, respectively.

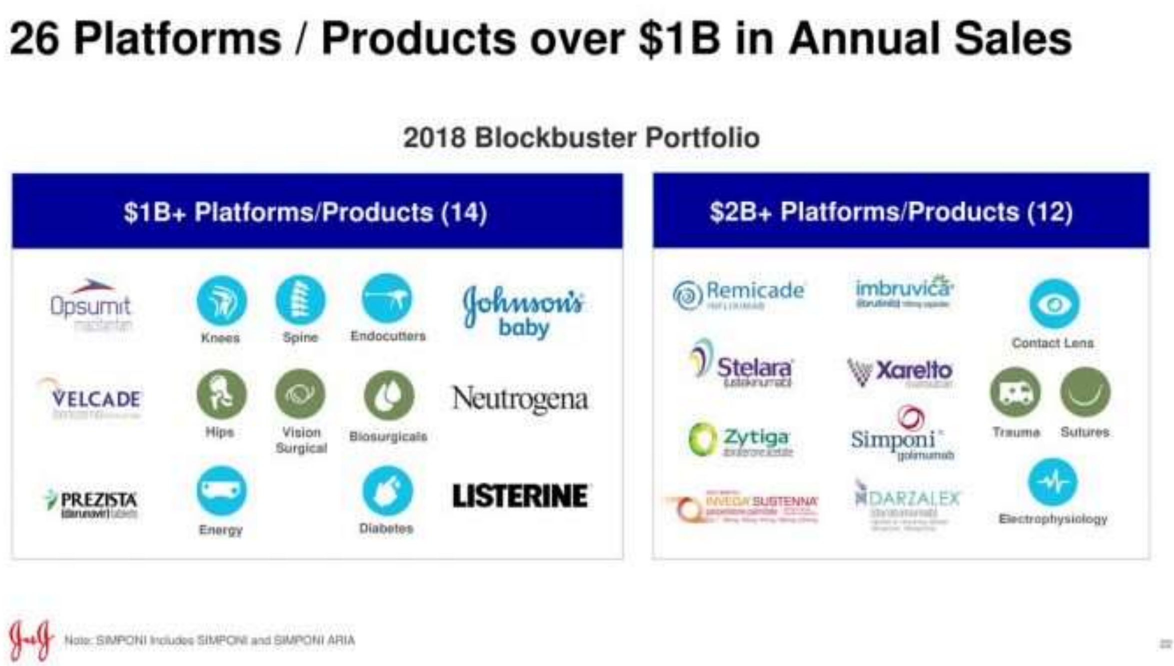
Source: [Earnings Presentation]

Within the pharmaceutical segment, two of the company's best-performing areas continue to be oncology and immunology. Oncology sales rose by nearly 25% in constant currency last year, while the immunology segment grew by 9.7% in 2018.

In oncology, *Darzalek* experienced revenue growth of 63% on a year-over-year basis. *Darzalek* treats multiple myeloma. International sales more than doubled for this drug during 2018. *Imbruvica*, which treats certain types of lymphoma, grew revenues by more than 38%. J&J shares royalties with *Imbruvica* with fellow Dividend Aristocrat AbbVie (ABBV).

Stelara, which treats immune-mediated inflammatory diseases, had worldwide revenue growth of 29% during the year. Revenues for *Simponia / Simpona Aria*, which treats rheumatoid arthritis, increased 13.7% in 2018, with 17.5% growth in international markets.

J&J's pharmaceutical pipeline is a positive growth catalyst. The company has a robust pipeline of new products.



Source: [Earnings Presentation]

By 2021, J&J expects to file at least 10 new products, each with annual sales potential of $1 billion or more.

It also sees the potential for 40 line extensions to existing products by then. Of these 40 extensions, 10 have potential for more than $500 million in annual revenue.

J&J is no stranger to acquisitions, big or small. In 2016, the company completed 14 acquisitions or licensing deals. Moving forward, the $30 billion acquisition of Actelion is the most important individual acquisition.

Actelion is a standalone R&D company, and will help J&J continue its long history of innovation. Actelion's R&D focuses on rare conditions with significant unmet need, such as pulmonary arterial hypertension. Actelion's key products Uptravi and Opsumit had revenue growth of 40% and 17%, respectively, in 2018. Both products treat high blood pressure.

The deal was immediately accretive to adjusted earnings. Management forecasts a 1% annual revenue bump from the acquisition, with earnings growth of 2%-3% thanks to cost synergies.

Competitive Advantages & Recession Performance

J&J's most important competitive advantage is innovation, which has fueled its amazing growth over the past 130 years.

J&J’s strong cash flow allows it to spend heavily on research and development. R&D is critical for a health care company, because it provides product innovation. J&J’s R&D spending over the past few years is as follows:

- 2014 research-and-development expense of $8.5 billion
- 2015 research-and-development expense of $9.0 billion
- 2016 research-and-development expense of $9.1 billion
- 2017 research-and-development expense of $10.6 billion
- 2017 research-and-development expense of $11 billion

R&D is also necessary to stay ahead of the dreaded “patent cliff”. Patent expirations can cause blockbuster drugs to deteriorate rapidly, once a flood of competition enters the market.

J&J’s aggressive R&D investments have resulted in product innovation and a robust pharmaceutical pipeline, which will help produce growth for years to come.

And, J&J’s excellent balance sheet provides a competitive advantage. J&J ended last quarter with $19.7 billion in cash and marketable securities. It is one of only two U.S. companies with a ‘AAA’ credit rating from Standard & Poor’s, along with Microsoft (MSFT).

J&J’s brand leadership and consistent profitability allowed the company to navigate the Great Recession very well. Earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $4.15
- 2008 earnings-per-share of $4.57 (10% increase)
- 2009 earnings-per-share of $4.63 (1% increase)
- 2010 earnings-per-share of $4.76 (3% increase)

As you can see, the company increased earnings in each year of the recession. This helped it continue raising its dividend each year, even though the U.S. was going through a steep economic downturn.

Investors can be reasonably confident that the company will increase its dividend each year moving forward.

Valuation & Expected Returns

J&J stock has sold off recently due to allegations that the company knew that its baby powder contained asbestos. While the stock has recovered somewhat in 2019, shares are still well off their 52-week high.

J&J expects the midpoint of earnings-per-share for 2019 to be $8.58. Using the current share price of $133, the stock's forward price-to-earnings ratio is 15.5. This is slightly below the stock's 10-year average price-to-earnings ratio of 15.8.

A breakdown of J&J's historical price-to-earnings ratios can be seen in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Avg. P/E	12.5	13.1	12.7	13.1	15.6	17.7	18.2	19.1	20.9	16.7	*15.0*	*15.8*
Avg. Yld.	3.3%	3.4%	3.5%	3.6%	3.0%	2.7%	3.0%	2.8%	2.6%	2.6%	*2.8%*	*2.7%*

If shares were to revert to their average price-to-earnings ratio by 2024, investors would see an additional 0.4% added to annual returns over this time period.

J&J's earnings increased by approximately 6% each year, over the past 10 years. We expect the company to match this level of earnings growth over the next five years.

The following is our forecast for expected total annual returns through 2024.

- 6% earnings-per-share growth
- 0.4% multiple expansion
- 2.7% dividend yield

We expect that J&J can offer investors a total annual return of 9.1% per year over the next five years.

Final Thoughts

J&J has more than 50 years of consecutive dividend increases under its belt. There are very few certainties in the stock market, but one of them is that J&J will increase its dividend each year.

The company has plenty of future growth, thanks to a strong pipeline and its recent acquisitions.

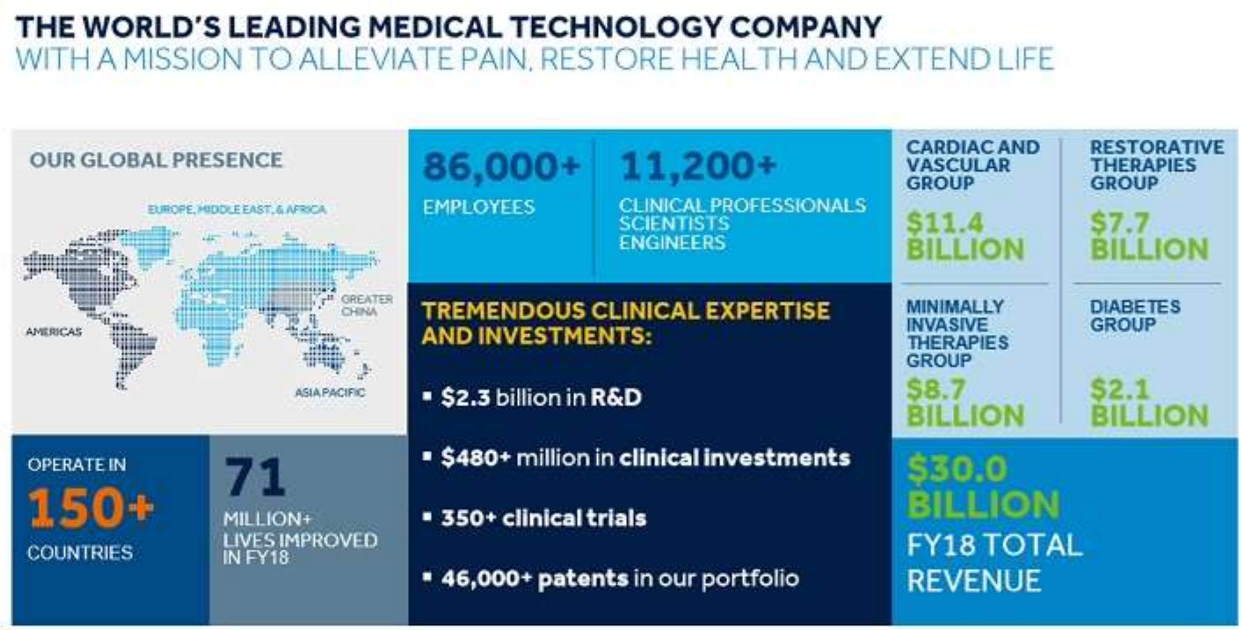
The one blemish on J&J is the headline risk, regarding the possibility of asbestos in the company's baby powder. That said, the company remains a high-quality hold for dividend growth.

Medtronic (MDT)

Business Overview

Medtronic was founded in 1949 as a medical equipment repair shop by Earl Bakken and his brother-in-law, Palmer Hermundslie. Today, Medtronic is one of the largest healthcare companies in the world. It has a market capitalization of $118 billion.

Medtronic PLC is the largest manufacturer of biomedical devices and implantable technologies in the world. The company serves physicians, hospitals and patients in more than 150 countries and has over 86,000 employees.



Source: [Investor Presentation]

Medtronic currently has four operating segments: Cardiac and Vascular Group, Minimally Invasive Therapies Group (MITG), Diabetes Group and Restorative Therapies Group. It's on pace to generate ~$30 billion in revenues and ~$7 billion in profits this year.

On November 20th, Medtronic reported financial results for the fiscal 2019 second quarter. The top line came in at $7.48 billion for the quarter, a 6.1% increase, with GAAP earnings-per-share of $0.82 and non-GAAP earnings (mostly related to an amortization charge) of $1.22, a 14% year-over-year increase.

The Cardiac and Vascular Group grew sales 3.1% to $2.58 billion, the MITG segment increased sales by 4.9% to $2.05 billion, Restorative Therapies grew sales 7% to $1.99 billion and the Diabetes Group increased sales 26.2% to $583 million.

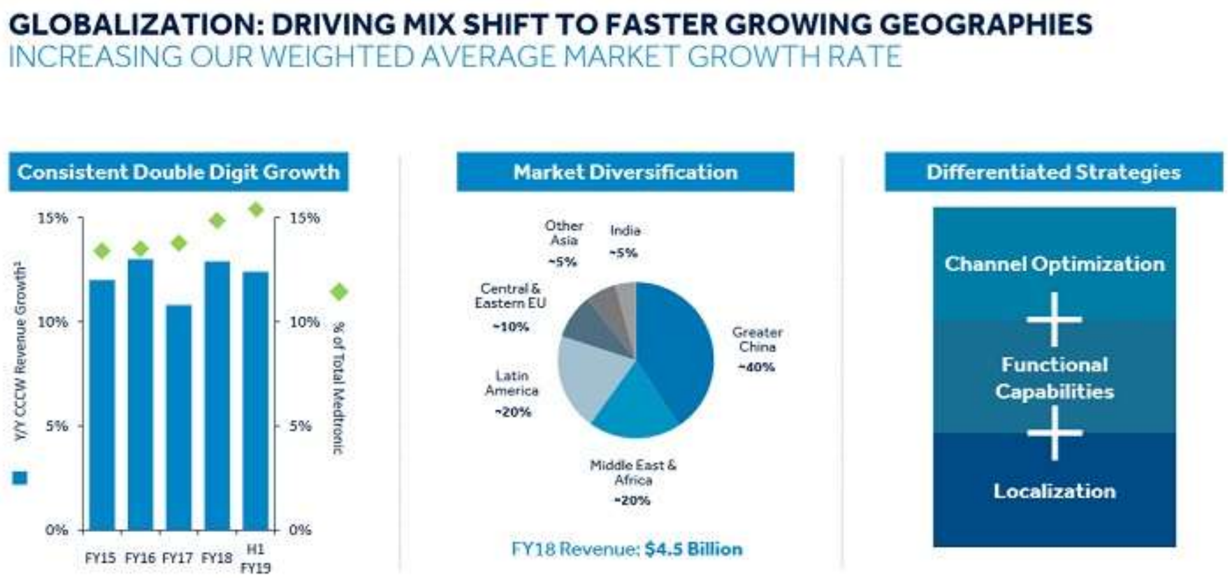
Medtronic also updated its fiscal year 2019 guidance. The company increased its organic revenue growth guidance from a range of 4.5% to 5.0%, to a range of 5.0% to 5.5%. Full year EPS guidance is unchanged at $5.10 to $5.15.

The current fiscal year is likely to be another year of steady growth for Medtronic. And, thanks to the favorable economics of the U.S. healthcare industry, Medtronic should enjoy many years of growth up ahead.

Growth Prospects

Medtronic is investing in growth, both organically and through acquisitions. The first catalyst for Medtronic is the aging population. There are over 70 million Baby Boomers in the U.S., those aged 51-69 years. Thousands of people are entering retirement every day. Combined with longer life expectancy and rising healthcare spending, the operating environment is very attractive for Medtronic.

Medtronic also has a major growth opportunity in new geographic markets. Specifically, Medtronic has a presence in several emerging markets, such as China, India, Africa, and more. These countries have large populations and high economic growth rates.



Source: [Investor Presentation]

Medtronic's emerging-market revenue has consistently grown at a double-digit rate over the past seven years. Revenue from the emerging markets increased 13.5% last quarter, more than five percentage points higher than Medtronic's growth rate in the United States.

While the U.S. currently accounts for over half of Medtronic's revenue, the emerging markets represent just 15% of total company sales. This leaves plenty of growth potential left for Medtronic in the developing world.

Another growth catalyst for Medtronic is acquisitions. The largest single acquisition for Medtronic was its $50 billion acquisition of Covidien in 2015. The acquisition presented significant growth potential for Medtronic.

Covidien is also a medical device maker, with a focus on hospital supplies. The deal lets Medtronic broaden and diversify its product portfolio.

Medtronic has a long history of successful acquisitions. In fiscal 2017, Medtronic completed 5 bolt-on acquisitions, for a total of $1.5 billion. Acquisitions are an important part of Medtronic's growth strategy.

Competitive Advantages & Recession Performance

The main competitive advantage for Medtronic is its research and development capabilities. The company spends heavily on R&D each year, which provides it with product innovation.

Medtronic's R&D investments over the past few years are as follows:

- FY 2016 R&D expense of $2.2 billion
- FY 2017 R&D expense of $2.2 billion
- FY 2018 R&D expense of $2.3 billion

The result of all this spending is that the company has a huge intellectual property portfolio with over 46,000 awarded patents. This has allowed Medtronic to build a strong product pipeline across each of its business segments.

In addition, Medtronic benefits tremendously from global scale. The company operates in over 150 countries around the world. It has the operational flexibility to generate industry-leading profit margins, which helps fuel its growth.

Another competitive advantage for Medtronic is that it operates in a defensive industry. Consumers often cannot choose to forego medical treatments, even when the economy goes into recession.

Medtronic's earnings-per-share during the Great Recession are as follows:

- 2007 earnings-per-share of $2.61
- 2008 earnings-per-share of $2.92 (12% increase)
- 2009 earnings-per-share of $3.22 (10% increase)
- 2010 earnings-per-share of $3.37 (5% increase)

Medtronic had the rare achievement of earnings growth each year during the recession. This demonstrates its recession-resistant business model. Medtronic should be able to continue growing its dividend each year, in both economic recessions and expansions.

Valuation & Expected Returns

Based on expected earnings-per-share of $5.12 in fiscal 2019, Medtronic stock trades for a price-to-earnings ratio of 17.2. The current valuation of the stock is significantly below that of the broader S&P 500 Index, but Medtronic's valuation is above its own long-term average.

A breakdown of Medtronic's historical price-to-earnings ratio can be seen in the table below:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	14.1	12.3	11.0	10.7	11.3	14.6	16.1	17.3	17.7	17.3	***18.0***	***15.0***
Avg. Yld.	1.5%	2.1%	2.4%	2.6%	2.5%	2.0%	1.8%	2.0%	2.1%	2.2%	***2.2%***	***2.8%***

In the past 10 years, Medtronic stock held an average price-to-earnings ratio of 14.2. However, we feel Medtronic deserves a slightly higher valuation than the 10-year average. Our fair value estimate is a price-to-earnings ratio of 15, which represents a reasonable valuation for a blue-chip industry leader.

Still, Medtronic shares appear to be overvalued today. If the stock valuation retraces to our fair value estimate, the corresponding multiple contraction would reduce annual shareholder returns by approximately 2.7% per year.

Fortunately, Medtronic stock will offset its overvaluation with earnings growth and dividends. Medtronic grew its earnings-per-share by 5.3% annually in the past 10 years. We expect 6% annual earnings growth for Medtronic through 2024.

Medtronic’s cash distributions will also contribute to returns. Medtronic routinely repurchases shares and it has hiked its dividend for 41 consecutive years. With a payout ratio near 40%, and a positive growth outlook, there is plenty of room for Medtronic to increase its dividend each year.

The combination of valuation changes, 6% annual earnings growth, and Medtronic's 2.3% dividend yield result in total expected returns of 5.6% per year through 2024. This is a solid rate of return, but not enticing enough to warrant a buy recommendation today.

Final Thoughts

Medtronic has virtually all of the qualities dividend growth investors should look for. It possesses a highly profitable business, a leadership position in its core markets, and durable competitive advantages. It also has multiple catalysts for future growth, and the ability to keep growing its dividend even during recessions.

Medtronic has increased its dividend for 41 consecutive years, including a 9% increase in 2018.

The only negative aspect of investing in Medtronic stock today is the valuation. We believe Medtronic is a slightly overvalued stock today. As a result, value investors should wait for a pullback before buying the stock. That said, Medtronic remains a high-quality holding for long-term dividend growth investors.

Consumer Discretionary Dividend Aristocrats

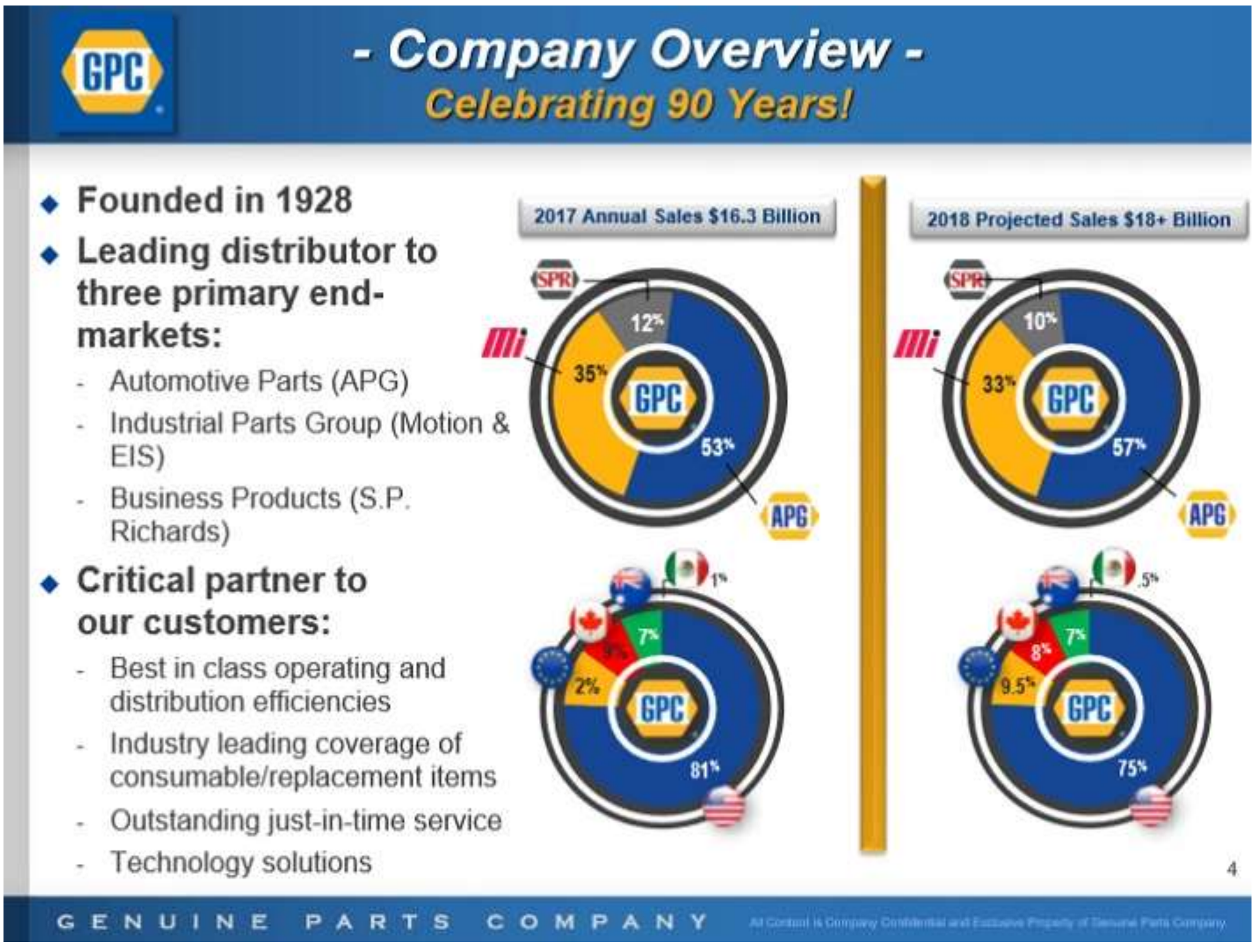
Genuine Parts Company (GPC)

Business Overview

Genuine Parts traces its roots back to 1928, when Carlyle Fraser purchased Motor Parts Depot for $40,000. He renamed it, Genuine Parts Company. The original Genuine Parts store had annual sales of just $75,000, and only 6 employees.

Today, Genuine Parts has the world's largest global auto parts network, with over 6,700 NAPA stores in North America and over 2,000 stores in Europe. Genuine Parts generated over $18 billion of revenue in 2018.

Genuine Parts is a distributor of automotive replacement parts, industrial replacement parts, office products, and electrical materials.



Source: Investor Presentation

It operates four segments, led by automotive parts, which houses the NAPA brand.

The industrial parts group sells industrial replacement parts to MRO (maintenance, repair, and operations) and OEM (original equipment manufacturer) customers. Customers are derived from a wide range of segments, including food and beverage, metals and mining, oil and gas, and health care.

The office products segment distributes business products in the U.S. and Canada. Customers include office products dealers, office supply stores, college bookstores, office furniture dealers, and more.

Genuine Parts also distributes electrical and electronic materials to original equipment manufacturers and industrial assembly firms.

Genuine Parts reported third-quarter earnings on 10/18/18 and showed another strong performance. Revenue increased 15% for the quarter, driven by acquisitions. Comparable sales, which measures sales at retail stores open at least one year, rose 4.3% from the same quarter a year ago.

The core Automotive business continued to lead the way with 23% growth. Adjusted earnings-per-share increased 29% thanks to revenue growth, margin expansion, and share repurchases.

Growth Prospects

Genuine Parts is primed for success, as the environment for auto replacement parts is highly positive. Consumers are holding onto their cars longer and are increasingly making minor repairs to keep cars on the road for longer, rather than buying new cars. As average costs of vehicle repair increase as a car ages, this directly benefits Genuine Parts.

According to Genuine Parts, vehicles aged six years or older now represent over 70% of cars on the road. This bodes very well for Genuine Parts.

Genuine Parts' primary strategy to generate growth has historically been acquisitions. It frequently acquires smaller companies, in the U.S. and in the international markets, to boost market share in existing categories or expand in new areas. Genuine Parts has made several acquisitions over the course of its history.

Source: [Investor Presentation]

For example, Genuine Parts [acquired] of Alliance Automotive Group for $2 billion. Alliance is a European distributor of vehicle parts, tools, and workshop equipment. This was an attractive acquisition, as Alliance Automotive holds a top 3 market share position in Europe's largest automotive aftermarkets: the U.K., France, and Germany. The deal added $1.7 billion of annual revenue to Genuine Parts, along with additional earnings growth potential from cost synergies.

The results of Genuine Parts' growth strategy speak for themselves. The company has generated record sales and earnings-per-share in seven out of the last 10 years.

Source: [Investor Presentation]()

Acquisitions will continue to fuel growth in the years ahead. Last year, Genuine Parts acquired Hennig Fahrzeugteile, a Germany-based supplier of light and commercial vehicle parts. The acquisition expanded Genuine Parts' reach in Europe, and also gave it further exposure to the commercial market. Genuine Parts expects the acquired company will boost its annual sales by $190 million.

The company has consistently generated growth over the long term. Future earnings growth is still attainable, through organic growth, acquisitions, and share repurchases.

Competitive Advantages & Recession Performance

The biggest challenge facing the retail industry right now, is the threat of e-commerce competition. But automotive parts retailers such as NAPA are not exposed to this risk.

Automotive repairs are often complex, challenging tasks. NAPA is a leading brand, thanks in part to its reputation for quality products and service. It is valuable for customers to be able to ask questions to qualified staff, which gives Genuine Parts a competitive advantage.

Genuine Parts has a leadership position across its businesses. All four of its operating segments represent the #1 or #2 brand in its respective category. This leads to a strong brand, and steady demand from customers.

Genuine Parts' earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $2.98
- 2008 earnings-per-share of $2.92 (2.0% decline)
- 2009 earnings-per-share of $2.50 (14% decline)
- 2010 earnings-per-share of $3.00 (20% increase)

Earnings-per-share declined significantly in 2009, which should come as no surprise. Consumers tend to tighten their belts when the economy enters a downturn.

That said, Genuine Parts remained highly profitable throughout the recession, and returned to growth in 2010 and beyond. There will always be a certain level of demand for automotive parts, which gives Genuine Parts' earnings a high floor.

Valuation & Expected Returns

Based on expected 2018 earnings-per-share of $5.70, Genuine Parts has a price-to-earnings ratio of 17.5. Our fair value estimate for Genuine Parts is a price-to-earnings ratio of 17.0. As a result, Genuine Parts is slightly overvalued at the present time.

A breakdown of Genuine Parts' historical valuation multiples can be seen in the following table:

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.9	13.8	14.4	15.1	15.2	18.6	19.3	19.5	20.8	19.2	***17.8***	***17.0***
Avg. Yld.	3.8%	4.6%	3.8%	3.3%	3.2%	2.7%	2.6%	2.7%	2.8%	3.0%	***2.8%***	***3.1%***

A declining valuation multiple would negatively impact future returns to the tune of 0.6% per year over the next five years. Fortunately, Genuine Parts' future earnings growth and dividends will more than offset a slightly overvalued share price.

We expect Genuine Parts to grow its earnings-per-share by 6.1% annually over the next five years. The stock has a 2.9% current yield, which is significantly higher than the average yield of the S&P 500 Index. And, Genuine Parts raises its divided each year, including a 6.7% increase in 2018.

The combination of valuation changes, earnings growth, and dividends is expected to result in annual returns of 8.4% per year through 2024.

Final Thoughts

Genuine Parts does not get much coverage in the financial media. It is far from the high-flying tech startups that typically receive more attention. However, Genuine Parts is a very appealing stock for investors looking for stable profitability and reliable dividend growth.

The company has a long runway of growth ahead, due to favorable industry dynamics. It should continue to raise its dividend each year, as it has for the past 62 years.

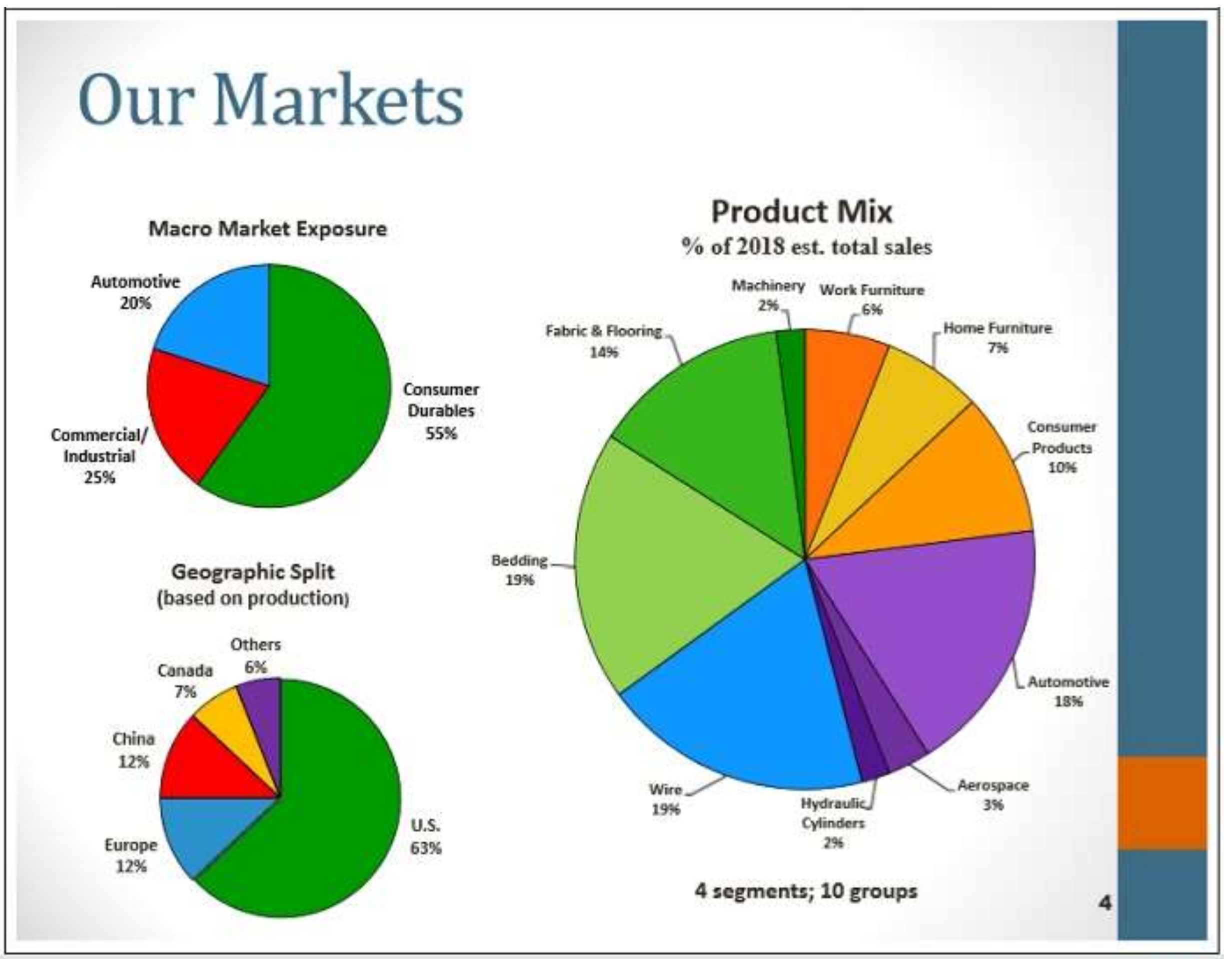
Today is not the best time to buy shares of Genuine Parts, as the stock appears to be slightly overvalued. Still, the stock is expected to generate satisfactory returns of 8%-9% per year, including a solid dividend yield of nearly 3%. This makes Genuine Parts a suitable holding for dividend growth investors.

Leggett & Platt (LEG)

Business Overview

Leggett & Platt is a diversified manufacturing company. It was founded all the way back in 1883 when an inventor named J.P. Leggett created a bedspring that was superior to the existing products at that time.

Today, Leggett & Platt designs and manufactures a wide range of products, including bedding components, bedding industry machinery, steel wire, adjustable beds, carpet cushioning, and vehicle seat support systems. It designs and manufactures products found in many homes and automobiles. The company has a diversified business, both in terms of product mix and geographic split.



Source: [Investor Presentation]

In late October (10/25/18) Leggett & Platt reported third-[quarter] sales of $1.1 billion, up 8% from the same quarter last year. Organic revenue increased 6%, including 2% volume growth, indicating strong demand for Leggett & Platt's products. The company noted growth across multiple product categories, including U.S. Spring, Automotive, Adjustable Bed, Aerospace, Steel Rod, and Work Furniture. Acquisitions, net of divestitures, contributed an additional 2% to quarterly sales growth.

Leggett & Platt generated earnings-per-share of $0.67 for the quarter, up 10% year-over-year. Sales growth was the primary reason for the double-digit earnings growth last quarter, along with higher profit margins in the Steel Rod businesses. Tax reform and share repurchases also helped boost earnings, partially offset by higher raw materials and transportation costs.

Leggett & Platt later released an update for an expected fourth-quarter charge of approximately $16 million pre-tax, approximately half of which is non-cash. The charge pertains to the company's Fashion Bed and Home Furniture segments, and is related to a restructuring of these operations. The charge will reduce GAAP earnings-per-share by $0.19 for the fourth quarter, although adjusted results are expected to remain unaffected.

We maintain a positive long-term growth outlook for Leggett & Platt.

Growth Prospects

Leggett & Platt aims for at least 6% annual revenue growth. To reach its goal, the company will utilize a multi-faceted approach. First, acquisitions will help boost growth. Leggett & Platt has a long-held policy of acquiring smaller companies to expand its market dominance in existing categories, or to branch out into new areas.

Leggett & Platt continues to pursue bolt-on acquisitions, such as the recent $1.25 billion purchase of Elite Comfort Solutions.

Source: [Investor Presentation]

The acquisition of Elite Comfort Solutions will significantly expand Leggett & Platt's exposure to specialty foam and other hybrid bed products. Elite Comfort Solutions generated $611 million in sales last year. And, it has EBITDA margins above that of Leggett & Platt, so the acquisition is expected to be accretive to earnings starting in 2020.

Share repurchases will also help maintain earnings growth. At quarter-end, Leggett & Platt had 130.4 million shares outstanding, a 1.1% reduction over the last 12 months.

Another key component of Leggett & Platt's earnings growth strategy is cost controls. It continuously evaluates its portfolio to ensure it is investing in the highest-growth opportunities, and it is not afraid to divest low-margin businesses with poor expected growth. For low-growth or low-margin businesses, it either improves performance, or exits the category. The company also drives cost reductions across the business, including in selling, general, and administrative expenses, and distribution costs.

Leggett & Platt has been able to reach its long-term growth targets thanks in large part to its significant competitive advantages in the core industries in which it operates.

Competitive Advantages & Recession Performance

Leggett & Platt has established a wide economic "moat", meaning it has several operational advantages, which keep competitors at bay. First, the company enjoys a leadership position in the industry, which allows for scale. Globally, Leggett & Platt has 17 business units, with 130 manufacturing facilities across 19 countries.

Leggett & Platt also benefits from operating in a fragmented industry, which makes it easier to establish a dominant position. In most of its product markets, there are few, or no, large competitors. And when a smaller competitor does achieve significant market share, Leggett & Platt can simply acquire them, as it did with Elite Comfort Solutions.

Leggett & Platt also has an extensive patent portfolio, which is critical in keeping competition at bay. Leggett & Platt has impressive intellectual property, consisting of approximately 1,500 patents issued and nearly 1,000 registered trademarks.

Together, these competitive advantages help Leggett & Platt maintain healthy margins and consistent profitability. That said, the company did not perform well during the Great Recession.

Earnings-per-share during the Great Recession are shown below:

- 2006 earnings-per-share of $1.57
- 2007 earnings-per-share of $0.28 (82% decline)
- 2008 earnings-per-share of $0.73 (161% increase)
- 2009 earnings-per-share of $0.74 (1% increase)
- 2010 earnings-per-share of $1.15 (55% increase)

This earnings volatility should not come as a surprise. As primarily a mattress and furniture products manufacturer, it is reliant on a healthy housing market for growth. The housing market collapsed during the Great Recession, which caused a significant decline in earnings-per-share in 2007.

Leggett & Platt is also reliant on consumer confidence, as roughly two-thirds of furniture purchases in the United States are replacements of existing products. When the economy enters a downturn, consumer confidence typically declines.

It also took several years for Leggett & Platt to recover from the effects of the Great Recession. Earnings continued to rise after 2007, but earnings-per-share did not exceed 2006 levels until 2012. This demonstrates that Leggett & Platt is not a recession-resistant business.

Fortunately, the company maintains a strong financial position, which allows it to remain profitable and continue increasing dividends each year, even during recessions. The company had a debt-to-EBITDA ratio of 2.3x at the end of last quarter, along with a net-debt-to-capital ratio below 40%.

Valuation & Expected Returns

Using the midpoint of management guidance, Leggett & Platt is expected to generate earnings-per-share of $2.45 for 2018. Based on this, the stock trades for a price-to-earnings ratio of 16.4, compared with our fair value estimate of 18.0.

We believe a higher stock valuation is warranted, due to the company's steady growth over many years, and long dividend history. Leggett & Platt also has positive earnings growth expectations going forward. Expansion of the stock valuation multiple could boost annual returns by 1.9% through 2024.

Combining valuation changes with 6.0% expected annual earnings growth and the 3.8% dividend yield, we expect total returns of nearly 12% per year for Leggett & Platt stock over the next five years. This is a strong rate of return for a blue-chip company.

Final Thoughts

Leggett & Platt has utilized a proven growth strategy, that has been successful for over 130 years. The company is highly profitable, and has a solid 3% dividend yield.

With an operating history of more than 100+ years, a 3%+ dividend yield, and dividend increases for 47 years in a row, Leggett & Platt has also earned a place on our list of "blue-chip" stocks. You can see the full list of blue-chip stocks here.

As a result, Leggett & Platt is an attractive stock for investors interested in stable dividend growth stocks.

Lowe's (LOW)

Business Overview

Lowe's was founded in 1946. In the 73 years since, it has grown into the #2 home improvement retailer, behind only The Home Depot (HD). Lowe's generates $72 billion in annual sales.

The company operates more than 2,300 stores in the U.S., Canada, and Mexico. Lowe's offers a wide range of products, for maintenance, repair, remodeling, and decorating the home. It has a wide selection of leading national brands, as well as a large number of private brands.

This is a difficult time for most retailers. The brick-and-mortar industry is under fierce pressure from e-commerce competition. Lowe's has shrugged off the poor performance of the broader retail industry. It continues to perform well, as consumers remain willing and able to spend on their homes.

And, whereas consumers are all-too-willing to shop for many items online, they still value the in-store shopping experience for home improvement products. This is how Lowe's has continued to grow over the past few years, even though many other retailers are struggling.

Lowe's comparable-store sales have increased for years since the Great Recession, and are expected to rise 2.5% in fiscal 2018.

Sales growth has come from higher transaction counts and ticket sizes. Lowe's reported its third-quarter financial results on November 18th. Revenue of $17.4 billion increased 3.9% from the same quarter last year. Average ticket size grew 2.3%, but the number of transactions declined 0.8% for the quarter.

Source: [Earnings Presentation]

Revenue growth was driven by 1.5% comparable sales growth, which measures stores open at least one year. Online sales rose 12%, reflecting the company's aggressive investments in building its own e-commerce platform to help compete against Amazon in the increasingly important digital space.

Profit margins compressed slightly last quarter, due to higher transportation and labor costs, which dragged on earnings. Earnings-per-share declined 1% in the third quarter, to $1.04 per share. The company returned $1.01 billion to shareholders last quarter through dividends and share repurchases.

The company also updated guidance for the full year. Fiscal 2018 revenue is expected to increase 4%, including 2.5% comparable sales growth. Lowe's also expects to open eight net new stores.

Lowe's is expected to post mid-teens earnings-per-share growth in fiscal 2018, comparable to recent years. A lower tax rate is helping but Lowe's also continues to see operating leverage from rising revenue and prudent expense controls. This margin expansion is something we expect will continue for the foreseeable future, but only if comparable sales continue to rise.

Lowe’s has benefited from several fundamental tailwinds. The economy continues to grow, as does the housing market. Rising wages and home prices, as well as interest rates, are incentivizing more consumers to invest in their current homes rather than move. These tailwinds should continue to fuel growth for Lowe's in the years ahead.

Growth Prospects

Lowe’s opens a small amount of new stores each year, so that is not a meaningful driver of growth. However, it continues to find ways to capitalize on strong housing and construction spending, and we see these as growth drivers moving forward.

The U.S. economy continues to grow. Positive GDP growth is arguably the most important economic indicator for Lowe's, as the company is highly reliant on consumer spending. Other important economic indicators for Lowe's - which include the unemployment rate and housing prices - are trending in a positive direction as well.

In 2018 home prices neared or surpassed their pre-Great Recession peak of 2007 in many regions of the U.S. This is keeping homeowners in their houses longer, and thus, they spend on improvements instead of selling and buying anew.

Outside of the U.S., Lowe’s has targeted Canada as a key growth market. In 2016, Lowe’s acquired Canadian home improvement retailer Rona, for $2.3 billion. Adding Rona gave Lowe’s access to the attractive Canadian home improvement market, which grew at a 4% annual rate from 2014 to 2018. Rona’s footprint is concentrated in Quebec, which is home to 25% of the country’s home improvement market.

Lowe's has enjoyed not only the sales growth that came with the Rona acquisition, but synergies as well, totaling hundreds of millions of dollars annually. The Canada business continues to perform well and Lowe's is investing in that country to fuel future growth as the core U.S. business is maturing somewhat.

Lastly, Lowe’s is building its own digital platform, to keep up with e-commerce retailers. The company’s omni-channel strategy is working, as comparable sales increased 12% on lowes.com last quarter. This is a marked slowdown from prior years, but this is to be expected given that the web business is much larger than it used to be.

The combination of opening new stores in the U.S., continued expansion in e-commerce, and growth in Canada should allow Lowe's to reach its financial targets.

Competitive Advantages & Recession Performance

The retail industry typically does not offer many competitive advantages. This is a highly challenging retail environment, as the rise of Amazon and other Internet retailers threatens to undercut brick-and-mortar stores.

Consumers have shifted spending dollars toward e-commerce for the convenience and low prices. However, Lowe’s is a specialty retailer, which provides it with a competitive advantage.

Home improvement projects are often complex. Consumers are willing to travel to stores, to inspect products in person, and ask questions to staff members. This has helped protect home improvement retailers from Amazon thus far.

In addition, Lowe’s has the scale to compete on price, even with Internet retailers. Lowe’s operates in an industry that is essentially a duopoly; Lowe’s dominates home improvement retail along with competitor Home Depot.

Lowe’s has the scale to reap significant efficiencies in distribution, and with suppliers. It can leverage its size to keep costs low, which it can then pass on to customers in low prices. This helps drive operating leverage.

That said, Lowe’s is not immune from recessions. Consumer spending typically declines during economic downturns. Lowe’s depends on a financially-healthy consumer and housing/construction market. The Great Recession was a particularly steep downturn, which took a significant toll on Lowe’s bottom line.

Lowe’s earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $1.86
- 2008 earnings-per-share of $1.49 (20% decline)
- 2009 earnings-per-share of $1.21 (19% decline)
- 2010 earnings-per-share of $1.44 (19% increase)

Lowe’s earnings fell sharply during the recession, but the company still remained profitable. This helped it continue increasing its dividend each year. And, it bounced back just as quickly: by 2013, Lowe’s earnings-per-share had surpassed 2007 levels.

Valuation & Expected Returns

Lowe’s has a price-to-earnings ratio of 18.4. This is in excess of our fair value estimate of 17 times earnings, so we see the stock as slightly overvalued after a recent rally. We believe a lower price-to-earnings ratio is prudent given that comparable sales are slowing and that the risk of recession is rising as the economic recovery enters its 10th year.

A breakdown of Lowe's historical stock valuation can be seen below:

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	15.1	16.8	16.1	14.1	17.3	20.4	19.8	21.8	18.6	18.7	***16.8***	***17.0***
Avg. Yld.	1.5%	1.7%	1.8%	2.2%	2.0%	1.6%	1.6%	1.5%	1.8%	1.9%	***2.2%***	***1.9%***

Note: Lowe's price-to-earnings ratio currently sits at 18.4.

Lowe's stock currently trades above our fair value estimate. As a result, a declining price-to-earnings ratio could reduce future returns by approximately 1.6% per year. In addition to valuation changes, Lowe’s returns will consist of earnings growth and dividends.

We see longer-term earnings-per-share growth at 8% annually, combined with the current 2% yield, and a slight headwind from a declining valuation. That would produce overall total annual returns in the 8.4% range, which is certainly respectable, but only good enough to warrant a hold recommendation at current prices.

The dividend remains at less than 40% of earnings, so there is certainly plenty of room for additional growth in the coming years. We see Lowe's as one of the better large cap dividend growth stocks in the market today, but the stock appears overvalued at the present time.

Final Thoughts

Lowe's has a relatively low dividend yield, but it makes up for this with high dividend growth rates. The company consistently provides double-digit dividend growth each year. The current environment is difficult for retail, but Lowe's operates in a niche that should withstand e-commerce competitors.

Lowe's is still growing sales and earnings, which should allow for continued dividend growth. And, it has a low dividend payout ratio, which also supports high dividend increases. The stock may not be enticing for investors interested in high yields, but Lowe's remains a strong dividend growth stock.

McDonald's (MCD)

Business Overview

McDonald's was founded in 1954, by Ray Kroc and his partners, Dick and Mac McDonald. Together, they formed the McDonald's System Inc. In 1960, Kroc bought the exclusive rights to the McDonald's name.

With a market cap of almost $141 billion, McDonald's is the largest publicly-traded fast food company in the world. It operates over 36,000 locations, in more than 100 countries around the world. The company generates over $24 billion in annual sales.

Revenues come primarily from franchise fees. McDonald's has accelerated its franchising over the past several years. While this effort has led to year-over-year revenue declines for the past few quarters, it has allowed McDonald's to expand its profitability. The company's most recent quarter showed a sales decline of 6.6%, to $5.4 billion. Global same-store-sales, however, increased 4.2%, above consensus estimates of 3.7% growth. Earnings-per-share increased 19% to $2.10. Profit growth was attributed to higher franchise fees, a lower tax rate, and share repurchases.

Past years were difficult for McDonald's. Earnings-per-share declined more than 13% from 2013 to 2014. It wasn't until 2016 that the company produced earnings-per-share results that were above 2013's total. But now that McDonald's has gotten back on track, its momentum should continue.

Growth Prospects

McDonald's performance has improved, due in large part to the strategic initiatives put in place to restore growth. These initiatives are working well, and put McDonald's in a good position to continue growth moving forward.

First, McDonald's announced new menu offerings, including all-day breakfast, and the McPick 2 promotions. A renewed focus on providing value to customers has helped restore traffic. U.S. same-store-sales were up 2.4% in the third quarter, helped by higher menu prices and the increased traffic. International markets have shown even more growth. Led by the U.K., Australia and France, 'international lead markets' saw growth of 5.4%. High growth markets had a 4.6% increase in same-store-sales, well above the 2.8% growth analysts were looking for.

In addition, McDonald's underwent a new wave of refranchising. Just a few years ago, a majority of McDonald's revenue (62%) came from company-owned stores. But McDonald's has flipped this around, and in the most recent quarter, more than 53% of revenues came from franchised restaurants. More than 4,000 restaurants have been refranchised over the past two years. McDonald's has a target of refranchsing nearly 95% of its restaurants over the long run.

The company expects to open at least 2,000 new stores over the next five years. Through the end of the third quarter, 375 new McDonald's restaurants have already been opened in 2018. McDonald's expects to earn $7.60 per share in 2018, which would be 14.1% growth from the previous year. This would be another year of strong earnings growth. We estimate that the company can grow earnings-per-share at a rate of 5.9% per year through 2024.

Competitive Advantages & Recession Performance

McDonald’s enjoys several competitive advantages that separate it from its industry peers.

First, it is the largest publicly-traded fast food company in the world. It has enormous scale, which allows it to keep prices low.

And, it has a very strong brand. According to Forbes, McDonald’s is the #7 most-valuable brand in the world, worth over $37 billion.

One of the big reasons why McDonald’s continues to increase its dividend year in, and year out, is because it has a defensive business model.

When the economy takes a downturn, consumers tighten their belts, particularly when it comes to dining. Rather than go to higher-priced sit-down restaurants, consumers will often shift down to fast food during a recession.

It seems strange, but from this perspective, McDonald’s actually benefits from recessions. For evidence of this, its earnings-per-share during the Great Recession are shown below:

- 2007 earnings-per-share of $2.91
- 2008 earnings-per-share of $3.67 (26% increase)
- 2009 earnings-per-share of $3.98 (8% increase)
- 2010 earnings-per-share of $4.60 (16% increase)

McDonald’s grew earnings in each year of the recession, at a double-digit compound annual rate. This is highly impressive, and speaks to its recession-resistant business model.

Investors can be reasonably assured the company can continue raising the dividend, even if another recession hits.

Valuation & Expected Returns

McDonald’s stock has generated huge returns in recent years. The stock has almost doubled since the beginning of 2015. Using the current share price of ~183 and expected earnings-per-share for 2018 of $7.60, the stock has a price-to-earnings ratio of 24.1. This is above the stock's five-year average price-to-earnings ratio of 20.

If shares were to revert to their average valuation, annual returns would be reduced by 3.7% through 2023.

Therefore, McDonald's appears to be slightly overvalued, based on relative comparisons to the broader market, as well as to its own historical average. The following table shows McDonald's average price-to-earnings ratio over the past 10 years.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	15.8	14.4	15.4	15.9	17.3	17.5	20.0	20.2	21.1	22.3	***23.3***	***20.0***
Avg. Yld.	2.8%	3.6%	3.2%	3.0%	3.1%	3.2%	3.4%	3.4%	3.0%	2.6%	***2.6%***	***2.7%***

Investors cannot rely on continued expansion of the price-to-earnings ratio to drive returns. Going forward, returns will be generated from earnings growth and dividends.

In the past 10 years, McDonald's grew earnings-per-share by 5.9% compounded annually. With its turnaround well underway, this could be a reasonable baseline of expectations going forward.

A potential breakdown of future returns is below:

- 5.9% earnings growth
- 3.7% multiple reversion
- 2.5% dividend yield

From this, total returns would reach approximately 4.7% per year through 2023. The relatively low expected return is due entirely to McDonald's stock valuation, which is high at the present time.

Final Thoughts

McDonald's has paid a dividend for over 40 years in a row. Over those four decades, it has had to reinvent itself from time to time, to stay on top of changing consumer trends.

It recently had to do this once again, but the results have been very encouraging. Same-store-sales and earnings are growing, which is powering McDonald's dividend growth.

That being said, investors aren't likely to see sizable gains with the high valuation of the stock. Investors should wait for a pullback before adding McDonald's.

Target (TGT)

Business Overview

Target is a discount retail giant. It has a market capitalization of almost$37 billion. Today, it operates more than 1,800 stores in the U.S., as well as an e-commerce business. It has a diverse product lineup, and sales reached nearly $72 billion last year.

This is a difficult period for all of retail. The escalating threat of Internet retailers is disrupting the entire brick-and-mortar retail industry.

Target saw a 7.2% decline in earnings-per-share from 2016 to 2017, though this was below the company's expected 20% drop. The company stated that it would need to spend in order to turn things around. The good news is, the turnaround appears to be taking shape just a year later. Target expects earnings-per-share to increase by more than 16% for 2018.

While Target has struggled in the past year, the company has done fairly well in the recent term.

The company reported third quarter results on 11/20/2018. Same-store-sales grew 5.1% during the quarter. While the company failed to meet comparable sales projections of 5.5%, Target did show fairly robust growth, especially considering that just a few years ago sales were declining or showed weak growth.

Earnings-per-share of $1.09 missed estimates by $0.02, but this total represented 20% growth from the third quarter of 2017. Revenue grew 5.6% to $17.6 billion.

Target expects to earn $5.40 in 2018, 16.1% higher than 2017's total of $4.65. We estimate that the company can offer 6% annual earnings growth through 2023.

Growth Prospects

Target has performed better in 2018 than it did in the two previous years. Going forward, there is a good chance the company can sustain its turnaround. It has launched several initiatives to return to growth.

First, the company continues redeveloping hundreds of stores. It is modernizing layouts, and adding new product categories. By 2019, it will have revamped over 600 stores, accounting for one-third of its total store count.

Another avenue for growth is e-commerce. The rise in e-commerce initially caught many retail companies, including Target, flat footed. Target has really revamped its online offerings and has seen incredible growth rates. The most recent quarter saw digital sales grow by almost 50%, which is higher than growth rates in previous quarters (digital sales are accelerating). Digital sales boosted comparable store sales by 1.9% in its most recent quarter.

Another major growth catalyst for Target is its small stores. These are stores with much less square footage, in places that cannot provide the necessary space to build a large store.

Target's small stores are being opened under the CityTarget and TargetExpress banners. They are located in areas that see high traffic, such as densely-populated large cities and college campuses. By 2019, Target expects to open over 100 small stores, tripling the number of small stores currently in operation.

These improvements require significant capital expenditures, so much so that operating income decreased 3% during the third quarter. It can be argued that these costs will position Target for growth in the future. They are also likely to decrease over time.

Competitive Advantages & Recession Performance

Target operates in a difficult industry. Retail is highly competitive. For consumers, retail brands often take a back seat to price and convenience.

This is why Target has invested so heavily in store redevelopment. That has enabled the company to retain its brand strength, even in a fiercely competitive industry. Most importantly, it has massive distribution and scale capabilities, which allow it to keep prices low.

In addition, Target operates in a defensive niche of the retail business. Discount retail tends to hold up relatively well during economic downturns, when consumers will typically shift from higher-priced retailers.

Target's earnings-per-share during the Great Recession are as follows:

- 2007 earnings-per-share of $3.33
- 2008 earnings-per-share of $2.86 (14% decline)
- 2009 earnings-per-share of $3.30 (15% increase)
- 2010 earnings-per-share of $3.88 (17% increase)
- 2011 earnings-per-share of $4.28 (10% increase)

Target was remarkably resilient during the Great Recession. It suffered a 14% decline in 2008, but followed this with three consecutive years of double-digit earnings growth.

Valuation & Expected Returns

One of the appealing aspects of Target is its low valuation. Based on the current share price of ~$71 and the company's adjusted earnings-per-share guidance of $5.40 for 2018, Target has a price-to-earnings ratio of just 13.1. Meanwhile, the S&P 500 Index has an average price-to-earnings ratio of 20.5.

Perhaps more importantly, the company has a 10-year average price-to-earnings ratio of 14.9. The following table illustrates Target's average price-to-earnings ratios over the past 10 years.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	16.2	12.8	13.9	11.9	13.7	20.7	14.7	16.6	14.6	14.2	*12.4*	*14.9*
Avg. Yld.	1.3%	1.6%	1.6%	2.2%	2.2%	2.4%	3.0%	2.8%	3.2%	4.0%	*3.8%*	*3.1%*

If shares were to revert to their average valuation, then holders of Target's stock would see an additional 2.6% in annual returns through 2023.

In addition, Target can generate returns from earnings growth and dividends. A breakdown of total returns is as follows:

- 6% earnings growth
- 2.6% multiple expansion
- 3.6% dividend yield

In total, Target could offer shareholders an annual return of 12.2% through 2023. This is a strong rate of return, and Target's status as a Dividend Aristocrat and Dividend King makes it even more appealing as a dividend growth stock.

Final Thoughts

There is no question Target has struggled in recent years, but the company appears to have righted itself. Same-store-sales were up more than 5% in the third quarter. This is a healthy growth rate, particularly in a highly competitive environment for the retail industry.

Store improvements along with robust digital sales have the company positioned well for the future.

We feel that the current share price offers investors the potential for double digit annual returns over the next five years. We rate Target stock as a buy for dividend growth investors.

V.F. Corporation (VFC)

Business Overview

V.F. Corp is a giant in the apparel industry. Its annual sales exceed $12 billion, but the company has humble beginnings. It started all the way back in 1899, and has seen many twists and turns in the nearly 120 years since.

The company was first started by John Barbey and a group of investors. Together, they created the Reading Glove and Mitten Manufacturing Company.

During the 1960's, the company adopted its current name, V.F. Corp. It has a highly diverse product portfolio, with many category-leading brands.

The current environment is challenging for V.F. Corp, due to a difficult retail climate. Mall traffic is declining, which has hurt brick-and-mortar retailers, many of which carry V.F. Corp's products.

Despite the company's early struggles in this environment, V.F. Corp has seen earnings and revenue growth over the last year. The company recently reported third quarter financial results. The company's earnings-per-share of $1.30 was a nearly 30% improvement from the prior year.

Source: Earnings Presentation

Results were also $0.20 above what analysts had been expecting. Revenue grew 8% to $3.94 billion, $70 million above estimates.

While the company struggled with earnings-per-share and revenue growth in both 2016 and 2017, V.F. Corp seems to have turned the corner over the past year or so. The company has topped estimates for both earnings-per-share and revenue growth over the past four quarters.

Growth Prospects

V.F. Corp has four avenues for future growth, which include acquisitions, divestitures, focus on core brands and growth through e-commerce.

The company completed its $820 million purchase of Williamson-Dickie Manufacturing Co on October 2nd, 2017. V.F Corp's work segment, which includes Dickies, was higher by 5% during the most recent quarter. Growth for the work segment was largely due to international strength and an increase in direct-to-consumer sales. Dickies is one of six billion-dollar brands for the company.

The acquisition should continue to boost growth for the next several years.

Second, V.F. Corporation has announced that it is spinning off its Wrangler, Lee and outlet businesses into a separate company called Kontoor Brands, Inc. Jeans has been a very tough business for V.F. Corp. Sales for Wrangler brands were down 2% in the most recent quarter while Lee brands were down 9%. Removing these under performing brands will allow V.F. Corp to focus on its core brands.

V.F. Corp expects continued growth across all channels in 2019.

Source: Earnings Presentation

And the company's core brands are performing very well. Vans brands experienced a 25% increase in sales during the most recent quarter. This is the second consecutive quarter of at least 25% growth. Revenues for The North Face brand were higher by 14%, with 16% growth in the U.S. and 23% growth in Asia.

V.F. Corp is also posting compelling growth rates for direct-to-consumer (up 10%) and digital sales (up 24%). These growth rates are very similar to what the company has seen in recent quarters. It took the company some time to adjust to changing behaviors in consumer spending, but V.F. Corp appears to have figured out how to reach today's customers.

Competitive Advantages & Recession Performance

There are a few key competitive advantages that have fueled V.F. Corp's impressive growth for so many years. First, are its strong brands. The company has several billion-dollar brands that lead their respective categories. This gives the company pricing power.

In addition, V.F. Corp benefits from operating in a steady industry. Many of the products V.F. Corp sells—such as workwear-have not changed much, if at all, in the past 100 years.

These qualities help V.F. Corp remain profitable, even during recessions. For example, V.F. Corp kept on raising its dividend through the Great Recession, thanks to its consistent profitability.

The company's earnings during the Great Recession are below:

- 2007 earnings-per-share of $1.35
- 2008 earnings-per-share of $1.39 (3% increase)
- 2009 earnings-per-share of $1.29 (7% decline)
- 2010 earnings-per-share of $1.61 (25% increase)

V.F. Corp experienced a mild earnings decline in 2009, but returned to strong growth in 2010 and beyond. The company has increased earnings-per-share at a rate of 8.3% over the past ten years.

Valuation & Expected Returns

After third quarter results, V.F. Corp updated its guidance. The company now expects to earn $3.73 per share, up from $3.65 previously. If achieved, this would be a 21% improvement from the prior year.

Trading near a price of $82, this gives the stock a price-to-earnings ratio of 22. We have a 2023 target valuation of 18x earnings. If shares were to revert to our target average, then annual returns would be reduced by 3.9% through 2023.

Shares of V.F. Corp have a current dividend yield of 2.5%. Given the $1.89 in dividends paid to shareholders in 2018 and the company's earnings-per-share guidance for $3.73, the payout ratio is 50.7%.

Overall, the company’s total returns are expected to come from the following sources:

- 8.3% earnings-per-share growth
- 3.9% valuation reversion
- 2.5% dividend yield

We expect a total annual return of 6.9% through 2024. This is a fairly low rate of return, because of the high valuation of the stock. From a growth and dividend perspective, V.F. Corp. is a great stock. It is simply overvalued at the present time.

Final Thoughts

V.F. Corp has overcome some of the short-term challenges that it faced due to the decline of shopping malls. The company has acquired assets that fit in well with its business and is spinning off those that don't.

The company has also seen impressive growth rates in its core brands, like Vans and The North Face, as well as in the areas of e-commerce. This has V.F. Corp in a strong position for the future.

That being said, our projected total annual return of 6.9% is just not enough for us to recommend buying shares of V.F. Corp at the moment. If shares were to pullback, we would strongly recommend that investors consider adding the apparel maker to their portfolio.

Financials Dividend Aristocrats

Aflac (AFL)

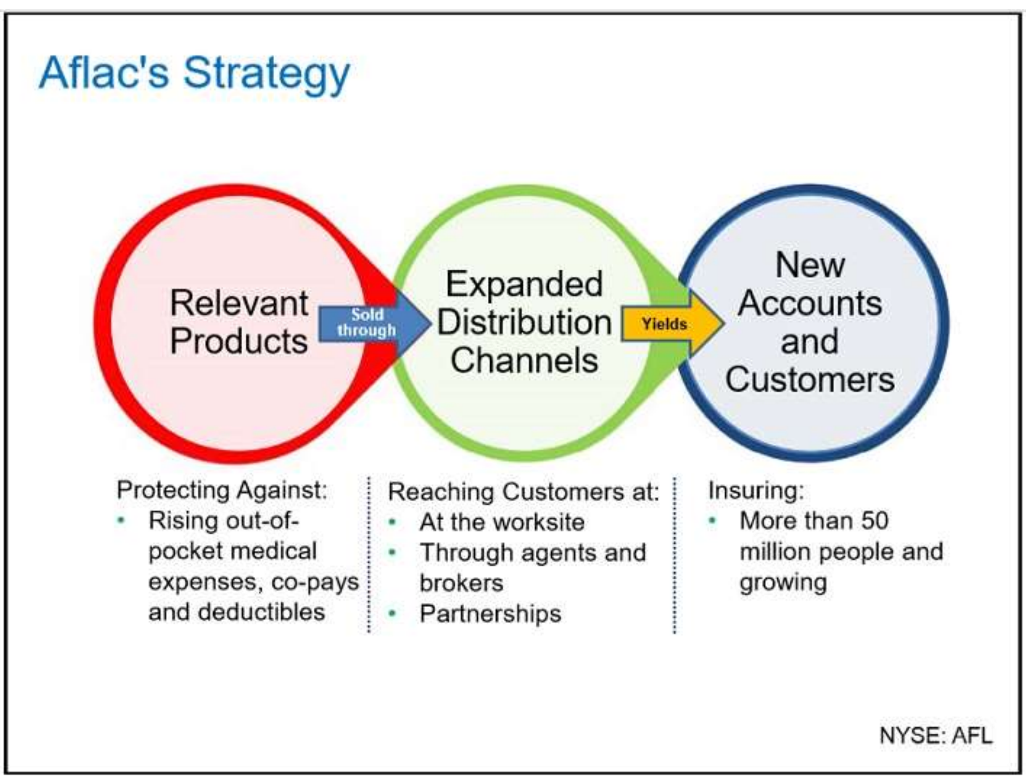
Business Overview

Aflac was formed in 1955, when three brothers—John, Paul, and Bill Amos—came up with the idea to sell insurance products that paid cash if a policyholder got sick or injured. In the mid-twentieth century, workplace injuries were common, with no insurance product at the time to cover this risk.

Today, Aflac has a wide range of product offerings, some of which include accident, short-term disability, critical illness, hospital indemnity, dental, vision, and life.

The company specializes in supplemental insurance, which pays out to policy holders if they are sick or injured, and cannot work. Aflac operates in the U.S. and Japan, with Japan accounting for approximately 70% of the company's premium income. Because of this, investors are exposed to currency risk. Aflac's earnings will fluctuate, in part based on exchange rates between the Japanese yen and the U.S. dollar. When the yen rises against the dollar, it helps Aflac because each yen earned becomes more valuable when it is reported in U.S. dollars.

Aflac's strategy is to increase premium growth through new customers, as well as increase sales to existing customers. It is also investing to expand its distribution channels, including its digital footprint, in the U.S. and Japan.



Source: Investor Presentation, page 4

Aflac continues to perform well overall. The company announced solid quarterly results for the most recent quarter. Total revenue of $5.6 billion increased 1.8% from the same quarter last year. Revenue increased 2.6% in the U.S., partially offset by a 0.4% decline in Japan. Aflac's adjusted earnings-per-share of $1.03 increased 21% year-over-year. Earnings growth was attributable to the company's revenue growth, margin expansion, as well as a boost from tax reform.

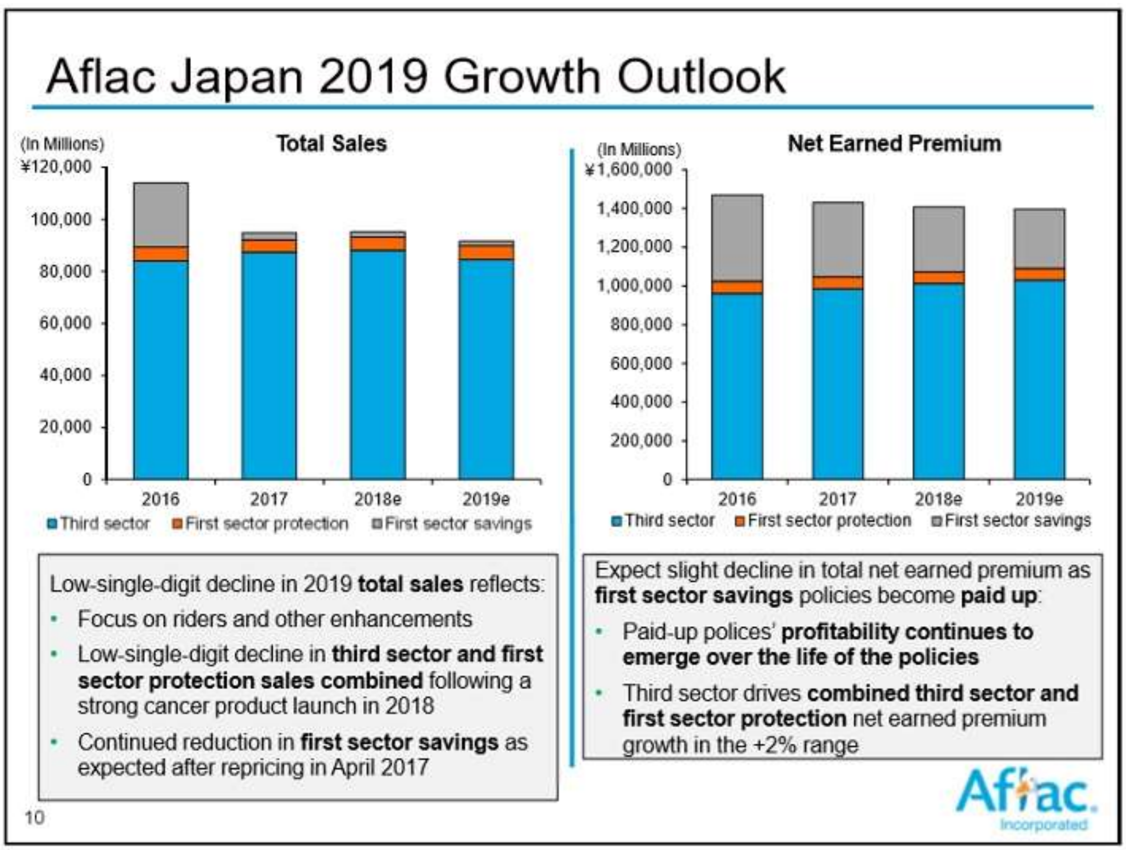
The company also posted strong results over the first three quarters of 2018, with 2.4% revenue growth and 21% earnings growth over the nine-month period.

Growth Prospects

Aflac has positive growth prospects moving forward, because it is developing new products to generate growth.

For example, in the U.S., Aflac is expanding its two-channel distribution model to bring in additional customers. Aflac expects to increase its U.S. sales by 3% to 5% in 2019.

In the company's core market, Japan, Aflac is expanding its offerings of "third-sector" products. These include non-traditional products such as cancer insurance, as well as medical and income support. Growth in these products is expected to continue, although Aflac expects overall sales in Japan to decline slightly in 2019.



Source: Investor Presentation, page 10

Aflac has enjoyed strong demand in Japan for third-sector products, due to the country's aging population, and declining birthrate. Moving forward, Aflac expects 4%-6% annual growth in third-sector product sales in Japan.

Another growth catalyst for Aflac is rising interest rates. As previously mentioned, Aflac makes money in part by investing its accumulated premiums. With interest rates on the rise over the course of 2018, Aflac's net investment income increased 8% in Japan and 3% in the U.S. in the third quarter. Aflac ended last quarter with $124 billion in cash and investments on the balance sheet. As a result, higher interest rates could be a significant tailwind for the company's profits.

Overall, investors can reasonably expect Aflac to grow earnings-per-share by 8% annually over the next five years.

Competitive Advantages & Recession Performance

Aflac has many competitive advantages. First, it dominates its niche. It operates in supplemental insurance products, and is the leading company in that category. The company also has a strong brand, its business model has low capital expenditure requirements, and it sells a product that enjoys steady demand.

Aflac's strong brand is a key competitive advantage. Competition is intense in the insurance industry. Insurance companies are constantly trying to lure each others' customers. To retain customers and attract new customers, Aflac invests heavily in advertising.

Aflac is also a recession-resistant company. It remained profitable even during the Great Recession:

- 2007 earnings-per-share of $3.27
- 2008 earnings-per-share of $2.62 (20% decline)
- 2009 earnings-per-share of $3.91 (49% increase)
- 2010 earnings-per-share of $5.13 (31% increase)

Aflac had a tough year in 2008, which is understandable given the deep recession at the time. However, its earnings-per-share came roaring back in 2009 and 2010.

Valuation & Expected Returns

Aflac shares appear to be undervalued today. Based on 2018 expected earnings-per-share of $4.05, the stock trades for a price-to-earnings ratio of 11.2. The current valuation is below our fair value estimate, which is a price-to-earnings ratio of 12.0.

The slight undervaluation of the stock is expected to be a modest boost to annual shareholder returns. If Aflac's price-to-earnings multiple expands to 12 over the next five years, shareholder returns would increase by 1.4% per year.

In addition, Aflac shareholders will generate returns from the company's earnings growth, which we expect to reach 8% annually. Lastly, Aflac's dividend will contribute to shareholder returns. The company has a current annual dividend payout of $1.04 per share, which represents a 2.3% dividend yield.

Overall, the combination of valuation changes, earnings growth, and dividends is expected to result in total returns of 11.7% per year for Aflac stock. This is an attractive rate of return, from a highly profitable Dividend Aristocrat.

Final Thoughts

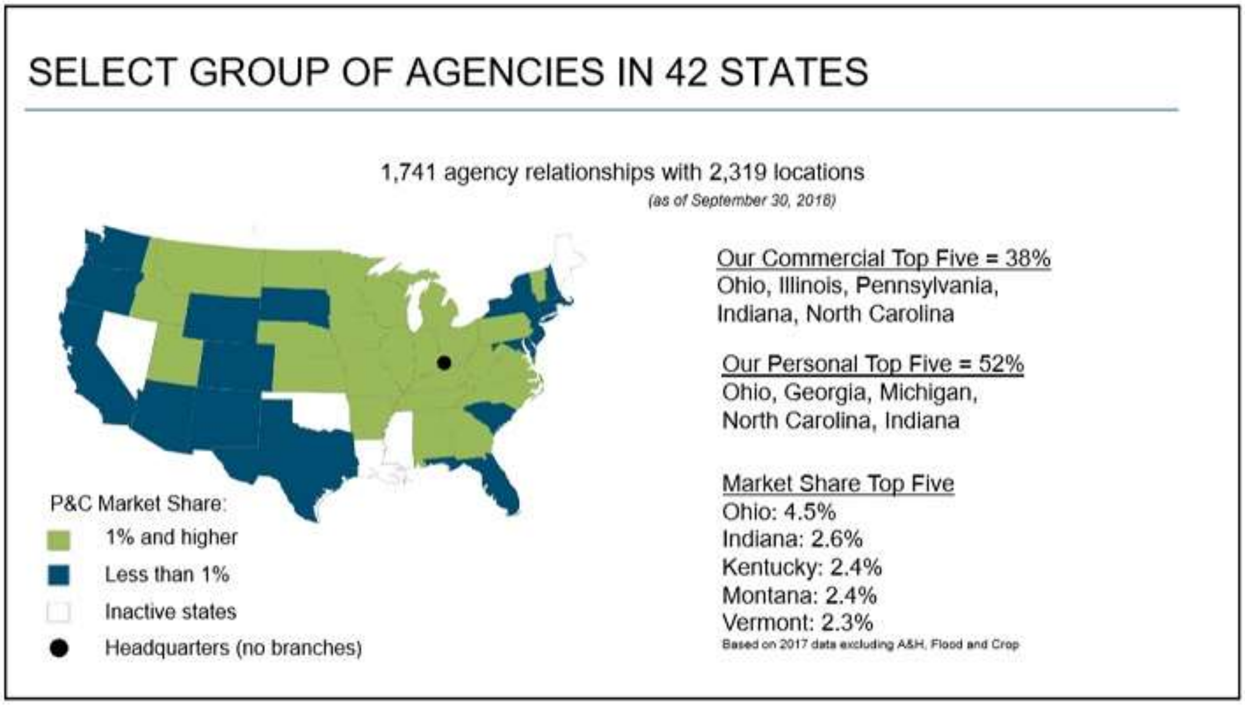
Aflac is a high-quality company, with a profitable business and durable competitive advantages. The company has increased its dividend for over 30 years in a row, and should continue to do so, thanks to a low payout ratio and earnings growth.

While Aflac does not have the highest yield around, it offers steady dividend increases and a reasonable valuation. As a result, it is still an attractive stock for dividend growth and value investors.

Cincinnati Financial (CINF)

Business Overview

Cincinnati Financial is an insurance company, founded in 1950. It offers business, home, and auto insurance, as well as financial products including life insurance, annuities, and property and casualty insurance. Revenue is derived from five sources, with agencies across 42 states.



Source: Investor Handout, page 4

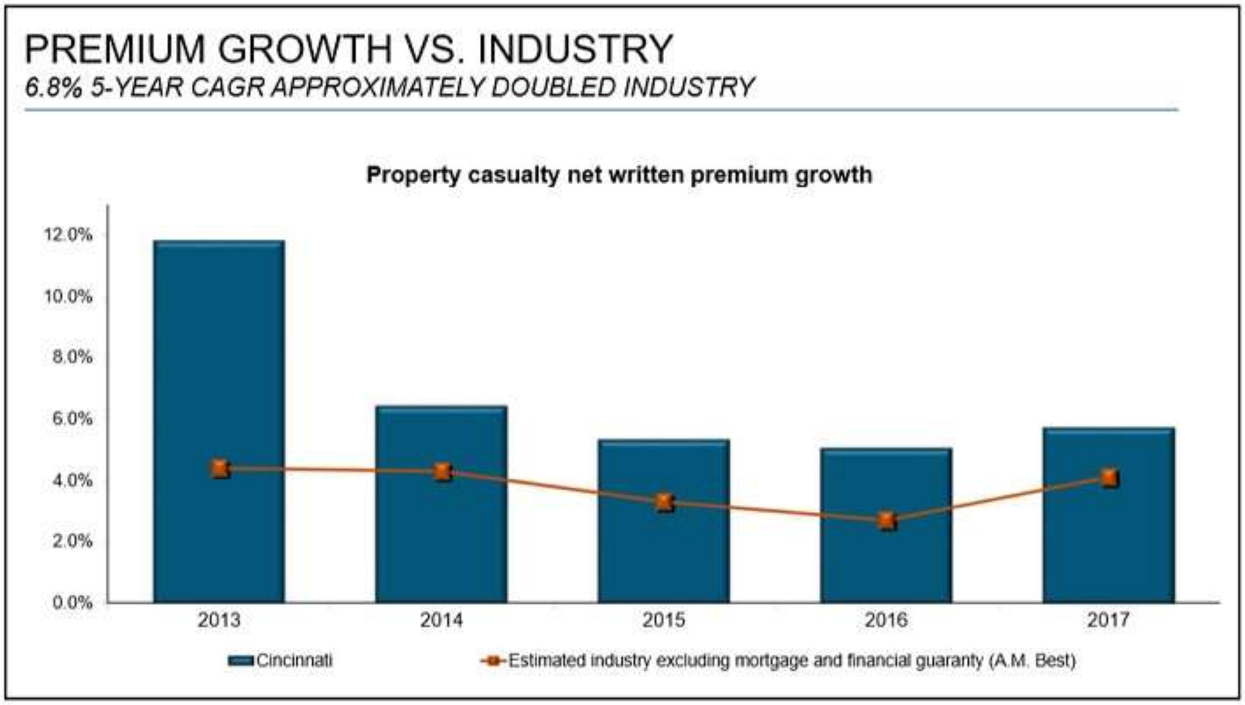
The company has a profitable business model. Instead of focusing solely on high-margin products, Cincinnati Financial is willing to write lower-margin policies. It earns a high level of profit by issuing high volumes and taking market share.

In addition, as an insurance company, Cincinnati Financial makes money in two ways. It earns income from premiums on policies written, and also by investing its float, the large sum of premium income not paid out in claims.

This has led to steady growth over many years, and there should be room for continued growth up ahead.

Growth Prospects

Cincinnati Financial has a positive growth outlook moving forward. Growth should continue to come from new policies written. The company has a successful history of growing profits through new policies written.



Source: [Investor Handout](), page 13

Price increases helped the company grow revenue from premiums over the past year. Rising interest rates will also give the company a boost. Interest rates have risen over the past year, which will help Cincinnati Financial earn higher income from its investment portfolio.

Cincinnati Financial's strong performance continued in 2018. The company released strong results for the third quarter. Total revenue increased 36% for the quarter, to $1.91 billion. Earned premiums increased 4% to $1.3 billion. Adjusted earnings-per-share of $0.84 beat by $0.11 per share, up 45% year-over-year. The high growth rate was due largely to a $355 million investment gain, as well as earned premiums growth. Book value per share increased 1.8% to a record high for the quarter.

The company also acquired MSP Underwriting Limited, a global specialty underwriter from Munich Re for approximately $131 million. The acquisition of MSP will boost its international growth.

Cincinnati Financial's earnings-per-share will grow considerably for 2018, but much of this growth will be due to non-recurring items, such as the 2017 damages from Hurricane Harvey and tax reform. Over the long-term, the company's growth prospects are more modest, due to the mature nature of the industry. We see a 5% annual earnings growth rate as a reasonable projection for the next five years.

Competitive Advantages & Recession Performance

There are not many identifiable competitive advantages in the insurance industry, other than brand recognition. There are not very high barriers to entry in insurance, which leads to fierce competition.

Fortunately, Cincinnati Financial has decades of experience, and has built a close relationship with its customers.

Insurance companies are not immune from economic downturns. Cincinnati Financial does not have a highly recession-resistant business model. Earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $3.54
- 2008 earnings-per-share of $2.10 (41% decline)
- 2009 earnings-per-share of $1.32 (37% decline)
- 2010 earnings-per-share of $1.68 (27% increase)

As you can see, earnings declined significantly from 2008-2010. Insurers like Cincinnati Financial typically sell fewer policies during recessions, along with poor performance of their investment portfolios when markets decline.

That said, the company did remain profitable during the recession, which allowed it to continue increasing dividends each year. And, the company enjoyed a strong recovery in 2010 and thereafter, once the recession ended.

Valuation & Expected Returns

Cincinnati Financial stock has outperformed the broader S&P 500 Index over the past 30 years. The share price has continued to rise in recent years. The combination of weak growth and a rising share price means the stock now trades for a relatively high valuation.

Based on 2018 earnings-per-share forecasts, Cincinnati Financial stock trades for a price-to-earnings ratio of approximately 23.1. In the past 10 years, Cincinnati Financial stock held an average price-to-earnings ratio of 20.5, although the valuation is skewed by an elevated price-to-earnings ratio in 2011.

Based on comparable valuations in the insurance industry, our fair value estimate is a price-to-earnings ratio of 14. Cincinnati Financial is a high-quality company with a long dividend history, but insurance companies typically do not hold price-to-earnings ratios in the high-teens. For example, insurance industry peer and fellow Dividend Aristocrat Aflac (AFL) has a fairly low price-to-earnings ratio of 11.2.

As a result, we view Cincinnati Financial stock as overvalued. If the shares revert to their fair value price-to-earnings ratio, future returns would be reduced by 9% per year.

Earnings growth and dividends will help offset the decline. However, the company has fairly modest growth expectations. We forecast 5% annual earnings growth for Cincinnati Financial. In addition, the stock has a current dividend yield of 2.7%. Cincinnati Financial's dividend is highly secure, and a projected payout ratio of 66% leaves room for future dividend increases.

Still, the stock is expected to produce negative total returns of 1.3% per year over the next five years.

Final Thoughts

Cincinnati Financial is a steady company with a consistent dividend payout, and the ability to raise the dividend modestly each year. The dividend payout is highly secure.

While the company has a strong business model and is solidly profitable, it does not seem to be a particularly attractive stock from a valuation standpoint. Overall, investors interested in buying this stock should wait for a lower valuation and higher dividend yield.

Franklin Resources (BEN)

Business Overview

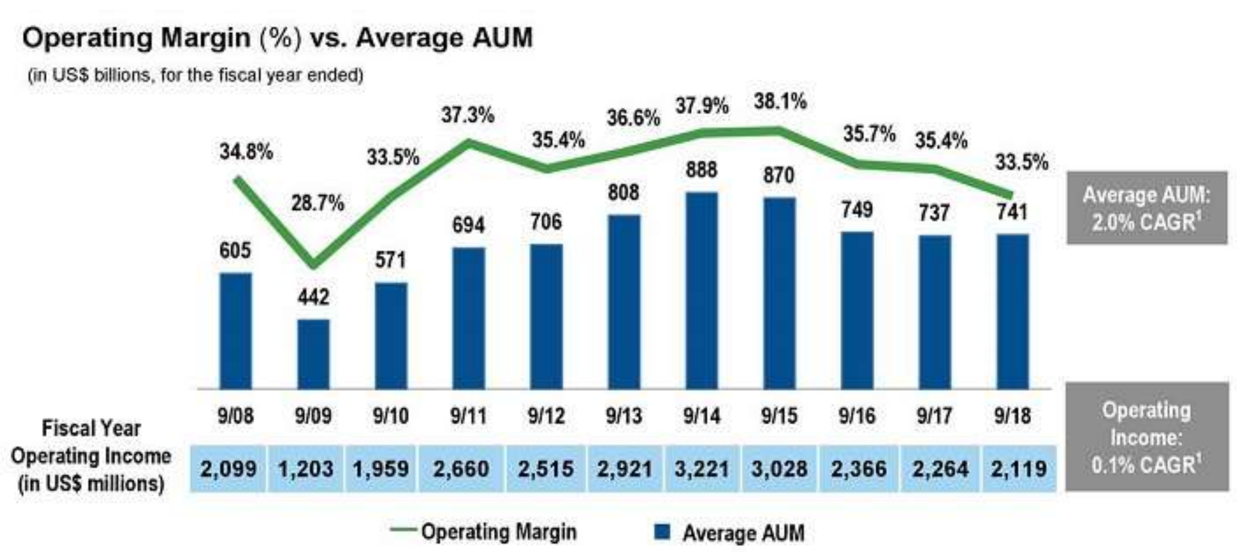
Franklin Resources is an investment management company. It was founded in 1947 in New York, by Rupert H. Johnson Sr., who had previously managed a Wall Street brokerage firm.

He named the company after Benjamin Franklin, the founding father who was viewed as a symbol for frugality, saving, and wise investments.

Today, Franklin Resources manages the Franklin and Templeton families of mutual funds. The past few years have been difficult for Franklin Resources. In 2015, revenue and earnings-per-share declined by 6% and 13%, respectively. Things only got worse the following year—in 2016, revenue fell 17%, while earnings-per-share declined 11%.

The declines were due to under-performance across several of the company's flagship funds. Weak performance is a big problem for an asset manager, because it typically results in lower assets under management.

When funds do poorly, investors take their money elsewhere. This has caused Franklin Resources' fundamental deterioration Assets under management is the key driver of revenue and earnings.



Source: Earnings Presentation, page 14

Conditions improved moderately in 2017, as Franklin Resources grew AUM by 3% to $753.2 billion. However, its fundamentals have worsened again in 2018. By September 2018, AUM had declined 5% to $717.1 billion. Franklin Resources finished the year with assets under management of $649.9 billion. Much of this decline was due to a sizable reduction in the company's international equity portfolio.

Franklin Resources’ assets under management exceeded $880 billion at the end of 2014. As a result, the company has a long way to go to regain the ground it has lost.

Growth Prospects

Despite the difficult operating environment, there are reasons to be optimistic about the company’s long-term growth. The U.S. is an aging population. There are thousands of Baby Boomers retiring every day. Combined with rising life expectancies, there is a great need for investment planning.

There should always be a need for the financial services provided by Franklin Resources. The company has seen assets under management increase again in recent periods.

In the short term, the company could see continued difficulty. Franklin Resources saw revenue decline 1% due to lower average assets and lower average fees in the company's fourth quarter. Earnings-per-share did rise 26% year-over-year, but this was due to lower taxes and a lower share count. For the year, earnings-per-share increased 12% from fiscal year 2017.

Source: Earnings Presentation, page 13

Franklin Resources is attempting to remedy its issues. The company announced that it agreed to acquire alternative credit manager Benefit Street for an undisclosed sum. Benefit Street has $26 billion in assets under management.

Franklin Resources reduced its diluted share count by 6% in fiscal 2018, which helps boost earnings-per-share. We expect the share count to decline another 2% in fiscal 2019.

Accretion to earnings is even stronger when the price of a stock declines. This is an advantage of consistent profitability—the company can use short-term dips in the share price as an opportunity to buy back its own stock.

Competitive Advantages & Recession Performance

Asset management is a highly competitive business, and there are not many competitive advantages in the financial services industry. The ability to retain clients depends largely on performance. If funds perform worse than their benchmarks, clients typically see a need to withdraw their funds.

However, Franklin Resources does have a few advantages going for it. The first, and perhaps most important, is brand recognition. Franklin Resources has been in operation for 70 years. That indicates a certain developed expertise and some innate investment abilities. Franklin Resources also still has huge assets under management, allowing the company to offer a wide range of investment opportunities to clients and generate some economies of scale.

Counterbalancing these advantages, Franklin Resources most recent recession performance was poor:

- 2007 earnings-per-share of $2.37
- 2008 earnings-per-share of $2.24 (5.5% decline)
- 2009 earnings-per-share of $1.30 (42% decline)
- 2010 earnings-per-share of $2.12 (63% increase)

As you can see, earnings-per-share fell steeply in 2009 during the worst part of the Great Recession. This should come as no surprise, since investing is hardly recession-resistant. During recessions, stock markets typically decline. For asset managers, this can lower assets under management and fees. That said, Franklin Resources recovered quickly, and saw earnings jump in 2010 and thereafter.

During recessions, stock markets typically decline. This prompts many investors to sell their stocks out of fear, which causes lower assets under management and fees. That said, Franklin Resources recovered quickly, and saw earnings jump in 2010 and thereafter.

Valuation & Expected Returns

While Franklin Resources' fundamentals have worsened in recent years The good news is potential investors in Franklin Resources are not paying a high price for the stock.

We expect that Franklin Resources will earn $3.50 per share in fiscal year 2019. Based off the current share price of $30, the stock has a price-to-earnings ratio of 8.6. This is well below the S&P 500, which has an average price-to-earnings ratio of 19.9.

If the company can grow its asset under management either through acquisition or improvement in its core business, the stock could see its price-to-earnings ratio rise to 12 by 2024.

If Franklin Resources can recover and return to earnings growth, the current price could prove to be a good value.

An expanding price-to-earnings ratio could generate significant returns.

Franklin Resources has an attractive dividend yield of 3.4%, and the dividend payout appears to be secure. In addition, we forecast 3.8% earnings growth for Franklin Resources through 2024, slightly below the long term average. A potential breakdown of returns is below:

- 3.8% earnings growth
- 3.4% dividend yield
- 6.8% valuation expansion

If Franklin Resources can return to growth investors buying the stock now could see annual returns of 14% over the next five years.

Final Thoughts

Franklin Resources' assets under management again declined in 2018. It will likely take some time to recover what it has lost, but the company is still growing earnings, thanks to share buybacks. The stock offers a 3.4% dividend yield and the potential for annual dividend increases.

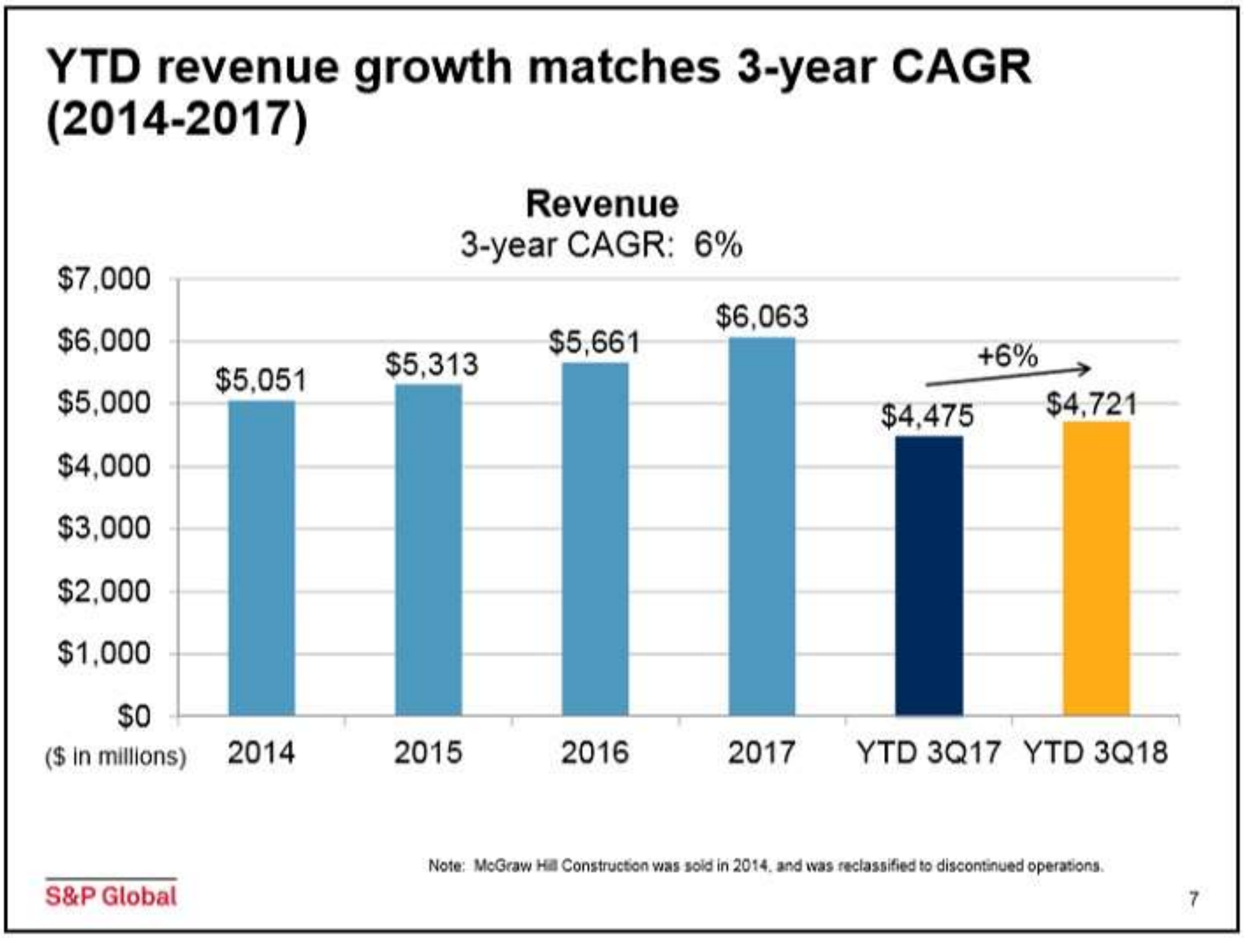
With a low valuation, solid yield and possibility of a higher valuation down the road, Franklin Resources could be a buying opportunity for value and dividend growth investors.

S&P Global (SPGI)

Business Overview

S&P Global traces its roots back to 1917, when McGraw Publishing Company and the Hill Publishing Company came together. The company was first named McGraw Hill Financial. In 1957, McGraw Hill introduced the S&P 500.

S&P Global has a very strong business model. The company has generated impressive growth rates over the past several years.



Source: Investor Presentation

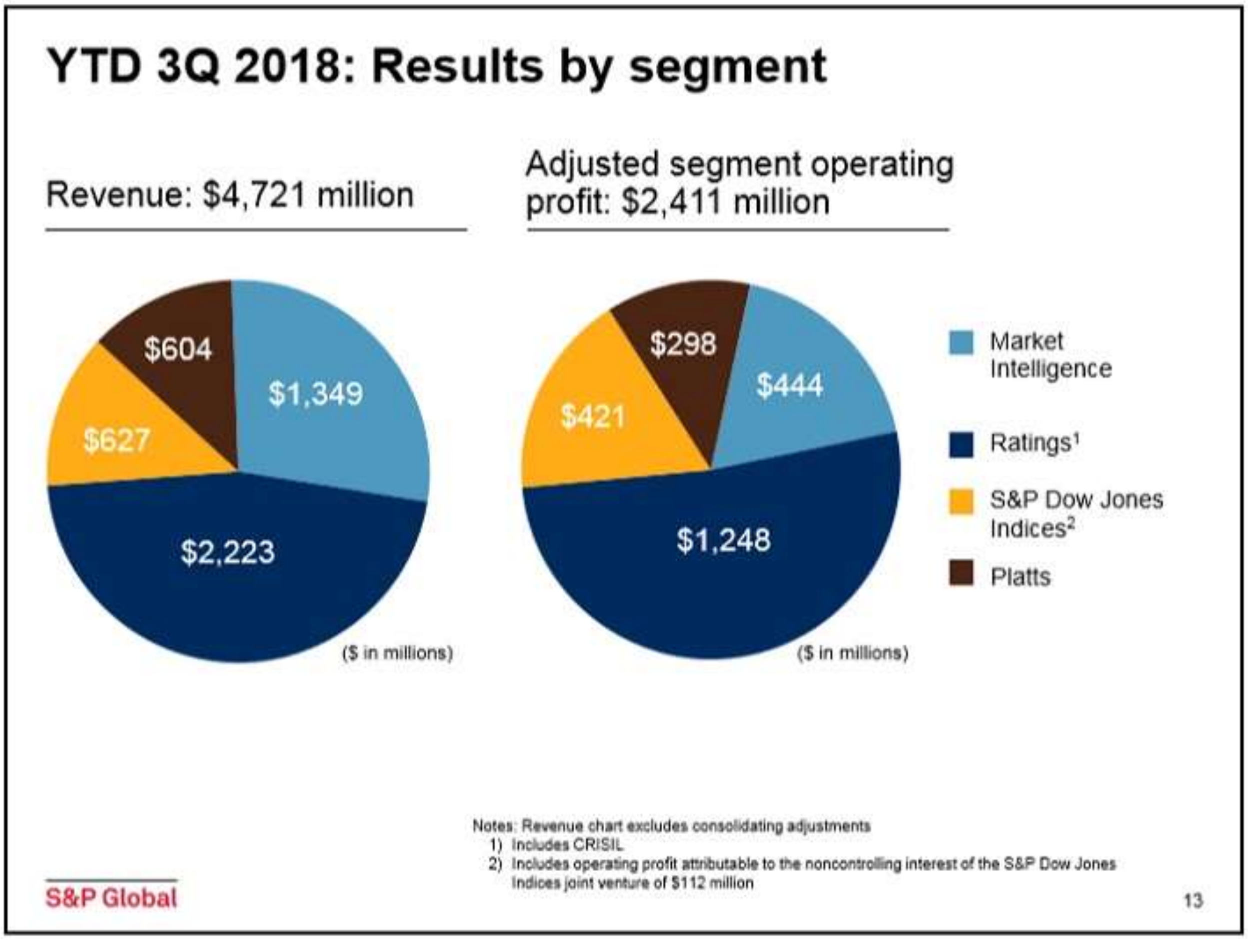
Today, the S&P 500 is arguably the most widely-known stock market index in the world. The company generates more than $6 billion in annual revenue, with 20,000 employees. The company's has a current market cap of $46 billion.

S&P Global's business performed very well during the third quarter (10/25/2018). The company had earnings-per-share of $2.11, which was a 23% improvement from the previous year. This result also beat estimates by $0.07. Revenue increased just 2% to $1.55 billion, missing estimates by $40 million.

While revenue growth was tepid, the S&P Global's margins did expand by 8% year-over-year.

S&P Global offers financial services, including credit ratings, benchmarks, analytics, and data, to the global capital and commodity markets.

It derives revenue from four operating segments: Ratings, Market Intelligence, Platts, and S&P Dow Jones Indices.



Source: [Investor Presentation]

S&P Global has a highly profitable business model. It is the industry leader in credit ratings and stock market indexes, which provide it with high profit margins and growth opportunities.

Growth Prospects

S&P Global has significant catalysts for future growth. The global economy continues to expand, which fuels greater demand for financial analysis and debt ratings, which is crucial information for investors.

Ratings revenue continues to rise at a steady pace, and took only a modest dip during the Great Recession.

Through the first three quarters of 2018, S&P Global's adjusted earnings-per-share has increased 24.4% from the previous year while revenues have improved 5.1%. These year-over-year results are in line with 2017's growth totals.

Share repurchases contributed 2% to adjusted earnings-per-share growth in the third quarter, but gains due to U.S. tax reform added 11%. Almost half of the company's adjusted earnings-per-share growth came from a lower tax rate.

Divestitures and acquisitions have helped fuel growth. The company has sold off low-growth businesses, and reinvested in new areas. Its many divestitures include J.D. Power, the SPSE/CMA pricing businesses, QuantHouse, and equity and fund research. S&P Global also acquired PIRA and RigData last year.

Ratings revenue declined 5% due to lower revenues from product transactions and a drop in bank loan rating activity.

Market Intelligence revenue improved by 10%, with gains in Risk Services and Data Management Solutions being the primary driver off growth.

Lastly, S&P Dow Jones Indices revenue increased 10% last quarter, due to a 11% increase in asset-linked fees. This primarily includes revenue from exchange-traded funds. Assets under management associated with S&P Global’s indexes climbed 23% for the quarter. Revenue associated with data and subscriptions was higher by 12%

For 2018, S&P Global expects adjusted earnings-per-share of $8.55. This would represent 24% growth from the previous year if achieved. We expect annual earnings-per-share growth of 10% through 2023.

Competitive Advantages & Recession Performance

S&P Global enjoys multiple competitive advantages. First, it operates in a highly concentrated industry. It is one of only three major credit ratings agencies in the U.S., along with Moody’s (MCO) and Fitch Ratings.

Put together, these three companies control over 90% of the global financial debt rating industry, with S&P Global on top. And, there are high barriers to entry. Specifically, becoming an accepted rating agency would require a great deal of trust from the financial industry and government that is hard to imagine being built quickly.

Clients pay S&P Global hefty sums for investment research, as S&P Global has built a strong reputation over its many decades of business.

These competitive advantages helped the company remain consistently profitable throughout the Great Recession:

- 2007 earnings-per-share of $2.94
- 2008 earnings-per-share of $2.51 (15% decline)
- 2009 earnings-per-share of $2.33 (7% decline)
- 2010 earnings-per-share of $2.65 (14% increase)

S&P Global's earnings declined in 2008 and 2009, as investors should expect the company to struggle during recessions. A global recession will naturally result in lower demand for financial services, as investors exit the markets.

That said, S&P Global quickly bounced back after the recession ended. By 2011, earnings-per-share had hit a new post-recession high.

Valuation & Expected Returns

S&P Global currently trades at $185 per share. Using the company's adjusted earnings-per-share guidance for the year of $8.55, the stock has a price-to earnings ratio of 21.6. This is higher than the stock's five-year average price-to-earnings ratio of 20.8. If shares were to retreat to this valuation by 2023, investors would see a reduction in annual returns of 0.8%.

A potential bull-case breakdown of future returns is as follows:

- 10% adjusted earnings-per-share growth
- 1.2% dividend yield
- 0.8% multiple reversion

We expect that S&P Global can offer a total return of 10.4% per year through 2023. The stock is down almost 15% from its 52-week high. While S&P Global's yield is almost half that of the S&P 500, the stock does offer the potential for annual double-digit returns going forward.

Final Thoughts

S&P Global is a strong business, with a long runway of growth up ahead. There will always be a need for financial ratings services. And, future growth potential is strong in new areas like data and financial technology. S&P Global's acquisitions will accelerate its growth in these segments.

The dividend yield of 1.2% might not be attractive to income investors, but dividend growth investors should view the stock favorably. The company has increased its dividend by 10% per year, over the past five years. S&P Global announced a 22% dividend increase last February. The expected payout ratio for 2018 is under 24%.

Investors looking for double digit annual returns and dividend growth are encouraged to consider buying shares of S&P Global, with the acknowledgement that shares are slightly overvalued at the present time.

T. Rowe Price Group (TROW)

Business Overview

T. Rowe Price was founded in 1937 by Thomas Rowe Price, Jr. In the eight decades since, T. Rowe Price has grown into one of the largest financial services providers in the United States. Today, the company has a market cap of $23 billion and manages over $1 trillion in assets.

The company provides mutual funds, advisory services, and separately managed accounts for individuals, institutional investors, retirement plans, and financial intermediaries.

T. Rowe Price has a diverse client base, in terms of assets and client type.

Source: [2018 Shareholders Meeting], page 3

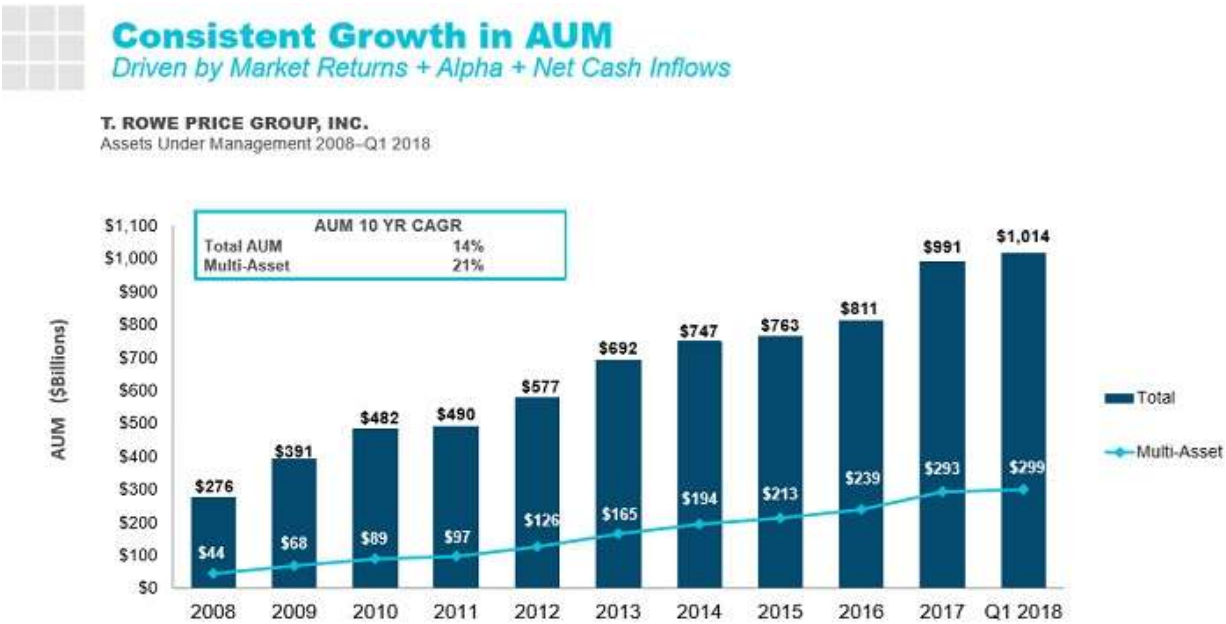
This is a difficult climate for asset managers. The onset of low-cost exchange traded funds, or ETFs, have successfully lured client assets away from traditional mutual funds that have higher fees. In addition, the poor performance of the S&P 500 Index last year is a negative catalyst for industry assets under management, or AUM.

However, T. Rowe Price continues to perform well, and the company has strong growth potential in the years ahead.

Growth Prospects

T. Rowe Price has a number of catalysts for future growth. The first catalyst is higher assets under management. The company has done very well this year, in attracting investor capital.

T. Rowe Price ended the third quarter (September 30th) with $1 trillion in assets under management. AUM increased 15.6% from the previous year. AUM improved 3.5% from the second quarter of 2018. The following image shows T. Rowe Price's successful long-term AUM growth.



Source: 2018 Shareholders Meeting, page 8

This is excellent growth, and will help drive higher revenue through investment fees. This has already started to occur. The company has seen net revenues increase 16% for the first three quarters of 2018. This is an acceleration from T. Rowe Price's net revenue growth of 13.6% in 2017.

Specifically, T. Rowe Price has benefited from the flow of investor capital away from actively-managed products, toward passive investments. Expense controls will also help boost earnings growth. Operating expenses increased at a lower rate than revenue to start 2017, which helps support margins.

Lastly, share repurchases are a part of the company's earnings growth plan. T. Rowe Price repurchased 1.1 million of its own shares in the third quarter for a total price of $124.5 million. The company saw its share count decline 1% year-over-year.

For the first three quarters of 2018, T. Rowe Price has repurchase 5.4 million shares worth $575 million. This has reduced the number of outstanding shares by 2.2% from the prior year. Overall, adjusted earnings-per-share increased 37% in the third quarter.

Competitive Advantages & Recession Performance

T. Rowe Price's competitive advantage comes from its brand recognition and expertise. The company enjoys a good reputation in the financial services industry. This helps generate fees, a major driver of revenue. It has built this reputation through strong mutual fund performance. Over the past 10 years, over half the company's mutual funds placed in the top quartile of performance among their peer group.

T. Rowe Price considers its employees to be its most valuable assets. There is good reason for this, since it is critical for an asset management company to have qualified experts and retain top talent.

Source: [2018 Shareholders Meeting](), page 6

This focus on building a strong brand gives the company competitive advantages, primarily the ability to keep existing clients, and bring in new ones.

T. Rowe Price did not perform well during the Great Recession:

- 2007 earnings-per-share of $2.40
- 2008 earnings-per-share of $1.82 (24% decline)
- 2009 earnings-per-share of $1.65 (9% decline)
- 2010 earnings-per-share of $2.53 (53% increase)

As could be expected, T. Rowe Price experienced a sharp decline in earnings-per-share in 2008 and 2009. When stock markets decline, equity investors typically withdraw funds to raise cash.

Fortunately, the company remained profitable throughout the recession, which allowed it to continue raising its dividend each year. And, T. Rowe Price quickly recovered in the aftermath of the Great Recession. Earnings increased significantly in 2010, and by 2011 had reached a new high.

Valuation & Expected Returns

We expect T. Rowe Price to produce adjusted earnings-per-share of $7.15 for 2018. Using the recent closing price of $93, the stock has a price-to-earnings ratio of 13. We have a 2023 target price-to-earnings ratio of 18, which indicates the stock is significantly undervalued at the present time. If the stock valuation expands to the fair value estimate, annual returns would be boosted by 6.7% just from valuation expansion.

For a company with a strong brand, consistent profitability, and earnings growth, T. Rowe Price stock seems to be undervalued. An expanding price-to-earnings ratio would fuel substantial returns, as will earnings growth and dividends.

We see earnings-per-share increasing 26.5% for 2018, but growing at a rate of 6.5% annually through 2023.

Over the long-term, earnings growth in the high-single digits seems realistic and attainable for T. Rowe Price. If that proves accurate, a potential breakdown of future returns is as follows:

- 6.5% earnings growth
- 3% dividend yield
- 6.7% multiple expansion

T. Rowe Price is a particularly attractive stock for dividends. The company has raised its dividend for over 30 years in a row, including a huge 32% increase last year. And, the dividend has an attractive yield of 3%.

From the combination of valuation changes, earnings growth, and dividends, T. Rowe Price could offer investors annual returns of 16.2% through 2023, a very attractive expected rate of return for a Dividend Aristocrat.

Final Thoughts

Investors scanning the financial sector for dividend stocks may naturally land on the big banks. But there are no bank stocks on the list of Dividend Aristocrats.

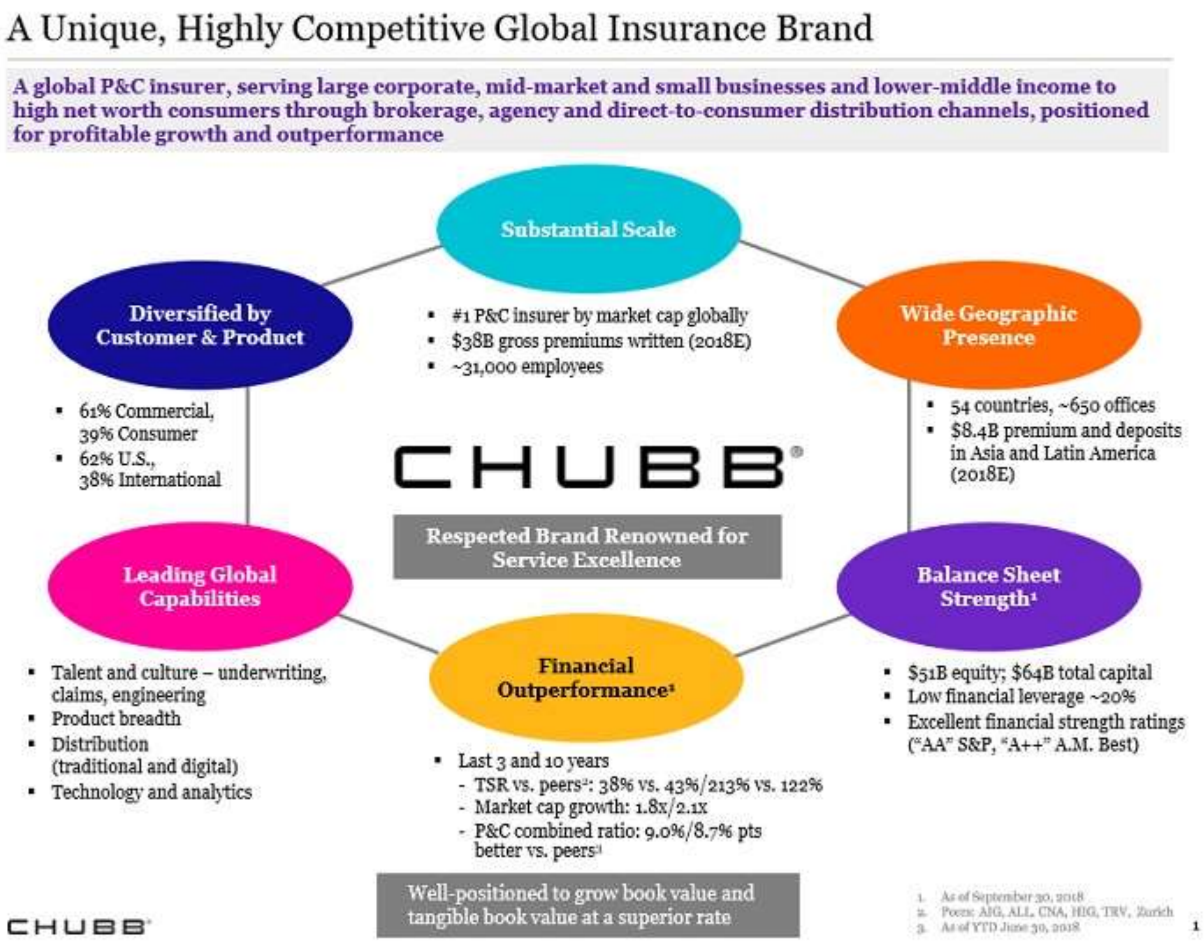
In fact, the only Dividend Aristocrats hailing from the financial sector, come from the insurance and investment management industry. This speaks volumes about the stability of their business models.

T. Rowe Price is an industry leader, and should continue to increase its dividend each year. With a high expected rate of return and a 3% yield, T. Rowe Price is a buy for dividend growth investors.

Chubb (CB)

Business Overview

The company has operations in 54 countries and territories. Chubb is based in Zurich, Switzerland and provides insurance services including property & casualty insurance, accident & health insurance, life insurance, and reinsurance.



Source: [Investor Presentation]()

The current version of Chubb was created in 2016, when Ace Limited acquired the 'old' Chubb and adopted its name. U.S. investors can initiate an ownership position in Chubb through shares listed on the New York Stock Exchange under the stock symbol CB.

Chubb reported (10/23/18) financial results for the third quarter of fiscal 2018 in late October. In the quarter, the company's most widely-cited profitability metric (core operating income excluding catastrophic losses) increased by 2.9% versus the same quarter a year ago. Chubb's book value per share grew 0.4% versus the second quarter of 2018. Importantly, Chubb's combined ratio in the quarter was 90.9%, showing very profitable underwriting activity.

Note: The combined ratio is calculated as the sum of incurred losses and expenses divided by earned premiums. A combined ratio under 100% shows the insurance company is operating profitably before investment income. A combined ratio in excess of 100% shows unprofitable underwriting.

Growth Prospects

Chubb's earnings-per-share have barely moved over the past ten years. The company earned $8.19 per share in 2017, which was only a modest improvement from 2008's $7.72 total.

That said, Chubb has created significant value for shareholders in terms of book value per share, an important metric for insurance companies. Over the last 10 years, the company's book value grew at a CAGR of 11%. We expect Chubb's book value per share to grow 4.2% to $115 for fiscal 2018.

Chubb compares favorably in terms of profitability to many of its peers. The company's combined ratio for the first half of 2018 was 89% with peers averaging 98%. In fact, Chubb has outperformed its peers on this metric over the past three, five and ten years. The company has beaten its peers by ~9% for each period of time.

We also expect Chubb to generate strong earnings growth over the next five years, due to multiple factors. Chubb will benefit from new policies, price increases, and rising interest rates.

Source: Investor Presentation

First, Chubb's net premiums written increased 4.6% over the first nine months of 2018, which indicates strong demand for policies. The company also has a leading industry position across its product categories, which gives it the ability to raise prices to boost revenue growth.

In addition, rising interest rates will also help boost profit by growing investment income. The Federal Reserve raised interest rates four times last year, and could hike rates again in 2019. This would be a growth tailwind for all insurance companies with large investment portfolios, including Chubb.

As an insurance company, Chubb has a large pool of accumulated premium income that has not been paid out in claims to customers. This is known as float. Insurers invest premiums as soon as they are collected, to earn interest or other income. Chubb had an investment portfolio of $101 billion at the end of the most recent quarter, invested primarily in investment-grade fixed income securities. Rising interest rates will boost fixed income yields, and will naturally help Chubb's earnings growth.

Chubb can also grow earnings-per-share through share buybacks. In November, Chubb authorized a new $1.5 billion share repurchase program. The authorization will be completed in the current year, and represents approximately 2.5% of the company's current market capitalization.

Overall, we expect Chubb to grow earnings-per-share by 8% per year over the next five years.

Competitive Advantages & Recession Performance

Chubb's competitive advantages are its leading industry position, as well as its financial strength. First, Chubb is the world’s largest publicly traded property and casualty insurance company, and the largest commercial insurer in the United States. It has a dominant position across its product categories, which helps it to retain customers.

It is also in strong financial position. Chubb is rated AA from Standard & Poor’s, AA from Fitch, and Aa3 from Moody’s, the three major U.S. credit ratings agencies. A healthy balance sheet and high credit rating provide the company with the financial security necessary to retain clients and invest for growth.

Chubb is also a fairly diversified company, with roughly two-thirds of net premiums written occurring in North America. The remainder of net premiums written are spread out across 51 other countries, making Chubb a global business. This competitive advantage provides Chubb with growth potential in the international markets.

The insurance industry can be incredibly cyclical. As the economy strengths, people tend to have more discretionary capital that can be used to add to their insurance policies. As the economy weakens, customers may pull back on their spending. This occurred during the last recession for Chubb.

- 2007 earnings-per-share of $8.07
- 2008 earnings-per-share of $7.72 (4.3% decline)
- 2009 earnings-per-share of $8.17 (5.8% increase)
- 2010 earnings-per-share of $7.79 (4.7% decrease)
- 2011 earnings-per-share of $6.96 (10.7% decrease)

Although Chubb didn't see quite as severe profit declines as many other financial firms, earnings-per-share did experience some variability. As noted above, earnings-per-share results for 2017 were not much higher than 2008's total. However, Chubb remained highly profitable during the Great Recession, which allowed it to continue raising its dividend even through the steep economic downturn.

While earnings-per-share haven't grown much in the last decade, the company's book value has increased every year since 2008. The only exception was 2015. We expect that book value will continue to grow in the coming years, but at the slightly slower than average rate of 8% per year.

Valuation & Expected Returns

Using Chubb's most recent closing price of $132 and expected earnings-per-share of $10.50 for 2018, the stock has a price-to-earnings ratio of 12.5. The average price-to-earnings ratio for the S&P 500 is 20.4, making Chubb undervalued against the market index. On the other hand, Chubb has a ten-year average price-to-earnings ratio of 10 so the current valuation is well above its historical average.

You can see a detailed view of Chubb's historical valuation multiples in the table below:

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	7.1	5.7	6.9	9.3	9.5	9.8	10.6	11.2	12.2	17.7	*12.6*	*10.0*
Avg. P/B	1.26	0.80	0.79	0.88	0.92	1.07	1.15	1.22	1.19	1.29	*1.10*	*1.06*
Avg. Yld.	2.0%	2.6%	2.4%	2.3%	2.6%	2.3%	2.5%	2.4%	2.2%	2.0%	*2.3%*	*2.7%*

We believe that valuing Chubb solely through the lens of earnings-per-share does not paint the full picture of the company's worth. In addition to earnings-per-share, investors should also consider book value per share when performing valuation on insurance companies.

When using expected book value of $115 for 2018, Chubb has price-to-book ratio of 1.15. The stock has an average price-to-book ratio of 1.06 over the last decade. If shares were to revert to this average value by 2023, investors would see total returns reduced by 1.6% per year.

Chubb can generate returns from book value growth and dividends as well. A breakdown of total returns is as follows:

- 8% book value growth
- -1.6% book value multiple reversion
- 1.4% yield

From these values, we forecast that investors can expect 7.8% annual returns over the next five years. This is a satisfactory rate of return for a high-quality company, although investors can find better buying opportunities among the Dividend Aristocrats.

Final Thoughts

While Chubb is a well managed, diversified insurance company with a long history of growing book value, we find the total projected return to be below other companies in the insurance industry. We would encourage investors looking to enter the insurance sector to either seek out other investment opportunities or wait for Chubb to pull back before purchasing shares.

People's United Financial (PBCT)

Business Overview

People's was founded in 1842 in Bridgeport, Connecticut. The bank began operations with just $97 in total deposits and had no paid employees for its first 10 years of operations. In the 177 years since that humble beginning, People's has grown into a regional bank with more than 5,000 employees and almost 400 retail locations in the Northeast United States.

Today, People's produces $1.8 billion in annual revenue from its $48 billion in total assets, and the stock has a market capitalization of $6.2 billion.

People's reported Q4 earnings on 1/17/19 and results were strong, producing another record in earnings-per-share. Adjusted earnings-per-share came in at $0.36, an increase of 16% year-over-year. Operating earnings actually grew 28% in dollar terms but the bank's higher share count – thanks to shares issued for acquisitions – was much higher and offset some of that growth.

Net interest income grew 14% thanks to 10bps growth in net interest margin to 3.17%, but also acquired and organic revenue growth; noninterest income rose less than 2% during the quarter. Importantly, adjusted noninterest expense rose only 7%, which was much slower than the pace of revenue growth.

Source: [Q4 earnings presentation, page 11]

As a result, the bank's efficiency ratio fell 100bps year-over-year, despite acquisition integration expenses, to 55.1%. That is a very respectable efficiency ratio and with People's focus on cost savings, we expect it will continue to drift lower over time.

Indeed, the above slide shows how People's efficiency ratio has improved rather drastically just in the past four quarters, declining from 59.4% to 55.1% during 2018. While gains like this aren't realistic for the long-term, we see People's ability to fairly rapidly improve its cost structure as a major benefit.

Total loans ended the year 8.5% higher than 2017 and deposits followed suit, gaining 9.4%. People's loan-to-deposit ratio is very high at 97.4%, but is actually slightly lower than it was at the end of 2017. Most banks tend to stay under 90% and while there isn't anything inherently wrong with a high loan-to-deposit ratio, it does open the bank up to more exposure to losses.

Essentially, the loan-to deposit ratio is a measure of leverage, and People's is very high. It also crimps future growth potential simply because there isn't much more the bank can do to boost it from very high levels, so this is not a lever the bank can pull to boost revenue growth going forward.

Asset quality, however, is outstanding and affords People's the ability to have nearly all of its deposits lent out. Net charge-offs were just 9bps of all loans in Q4, which is consistent with recent results. Its originated nonperforming loans did tick up to 55bps from 49bps in the year-ago period, but again, these are strong numbers and we aren't concerned about credit quality.

Return on average assets moved higher in Q4, gaining a whopping 15bps over last year's Q4 to 1.11%. That's an average ROA number so People's isn't near the top of profitability for banks, but it certainly isn't near the bottom either. Return on average tangible common equity gained as well, rising 110bps to 14.9% in Q4.

The balance sheet is in good shape, despite the high loan-to-deposit ratio, as People's tier 1 common equity ratio moved 60bps higher to 10.3% in Q4. Overall, we see People's as a strong operator with good metrics all around, which is relatively rare for a bank that likes to acquire its growth.

We like People's performance in 2018 and expect another year of strong growth for 2019. We're out with an initial estimate of $1.45 in earnings-per-share for this year, representing low double-digit growth over 2018 and another record.

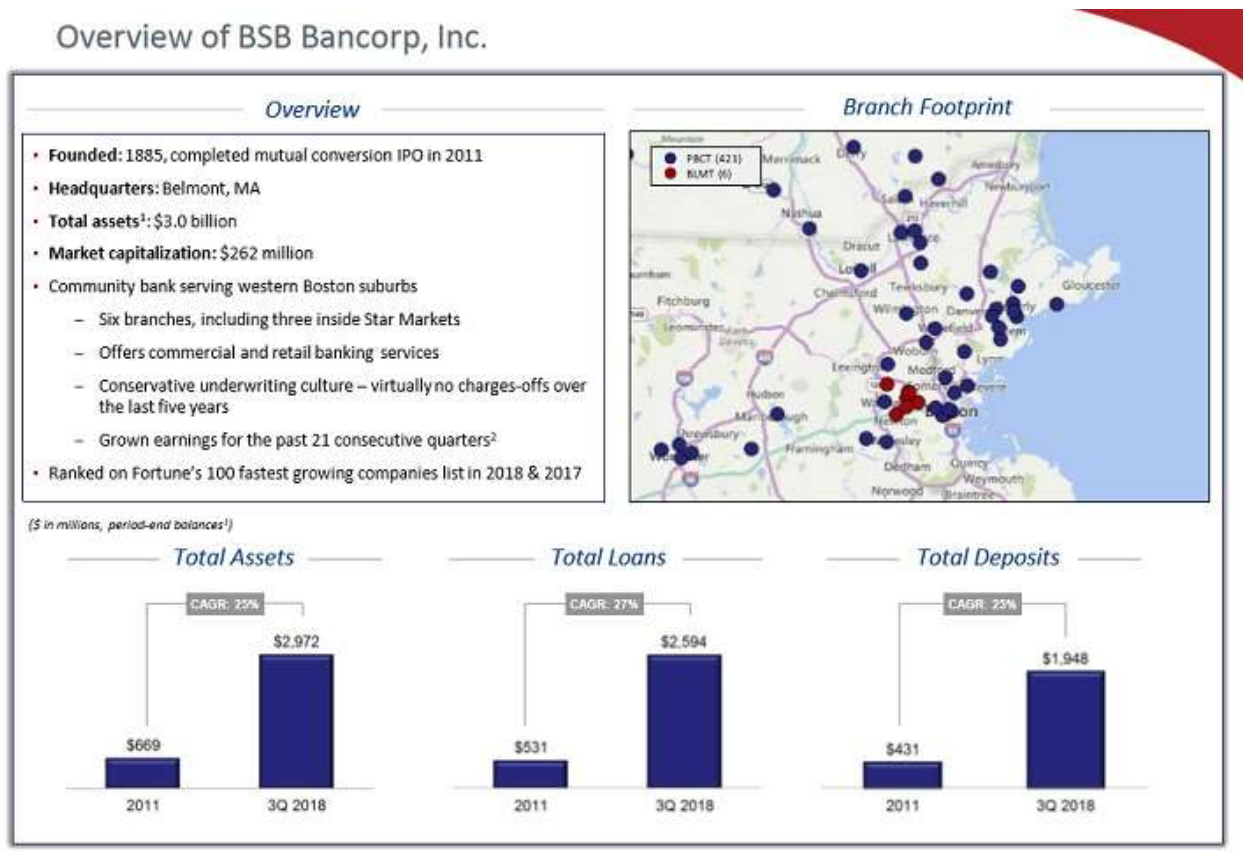
Growth Prospects

While People's produces a small amount of organic growth – as just about any other bank would – its strategy instead focuses on acquiring its growth. It has a diversified portfolio of financial services it can offer to customers, but its bread and butter is still core deposit-taking and lending activities.

The bank recently completed the acquisition of First Connecticut Bancorp, an all-stock transaction valued at $544 million. The purchase afforded People's more than $3 billion in assets, representing high single digit asset growth at the time of the transaction. The transaction has a projected tangible book value earn back period of 3.5 years, which is fairly low. The all-stock, immediately accretive model of acquisitions is one People's has used over and over again with good success. We have no reason to think the recently-completed First Connecticut purchase will work out any differently.

More recently, the bank announced on 1/17/19 the acquisition of VAR Financial, a Texas-based private leasing and finance company. VAR finances equipment sales for technology manufacturers, software companies and resellers. This non-core banking business will fold in with People's existing LEAF Commercial Capital subsidiary and help the bank diversify away from core lending activities a bit more.

Finally, People's announced during the fourth quarter it was acquiring BSB Bancorp in another all-stock transaction valued at $327 million.



Source: Company acquisition presentation, page 5

As seen in this slide, BSB has about $3 billion in total assets, so it is similarly sized to the First Connecticut purchase, but was substantially cheaper. BSB is a focused community bank with only six branches in the Boston area as People's continues to build market share in that very competitive market. BSB has done a nice job in recent years growing assets, loans and deposits and People's is certainly looking to take advantage of BSB's past success.

The BSB purchase has a tangible book value payback period of 3.1 years, so it is more favorably priced than First Connecticut, and should be immediately accretive to earnings-per-share upon consummation of the acquisition. The acquisition will take People's Boston market share from 13th today to 8th on a pro-forma basis, so the purchase is a meaningful step towards increased competitiveness in that critical market.

We see People's as being able to produce 5% earnings-per-share growth annually over full economic cycles given that its growth-by-acquisition strategy is lumpy and unpredictable, but also because People's is subject to the same risks as other banks.

In other words, with the yield curve flattening out significantly in recent quarters, we see organic growth in earnings as tough to come by for all banks, People's included. In addition, since it issues stock for acquisitions, its share count rises fairly rapidly over time, introducing a significant headwind for earnings-per-share even if dollar earnings grow nicely.

Still, we see the bank as a strong operator and one that focuses heavily on cost savings, so we think it has some meaningful growth in front of it.

Competitive Advantages & Recession Performance

Competitive advantages are difficult to come by for banks given that they largely offer the same products and services as their competitors. However, one way to offer an advantage is to grow scale in key markets, and that is exactly what People's is doing with Boston as an example.

Growing scale and name recognition in key markets like that can help drive efficiency and scale and that is part of the reason why People's has been able to boost margins in recent quarters, despite the flattening yield curve. This key strategic pillar is a differentiator and we think it will serve People's well in the coming years.

However, that certainly does not insulate People's from economic downturns. Its performance during the Great Recession wasn't great, but it did fare much better than many of its larger competitors.

People's earnings-per-share during the Great Recession are below:

- 2007 earnings-per-share of $0.52
- 2008 earnings-per-share of $0.42 (19% decline)
- 2009 earnings-per-share of $0.30 (29% decline)
- 2010 earnings-per-share of $0.24 (20% decline)

While People's remained profitable throughout, the damage was significant. Indeed, it was 2011 before People's earnings-per-share crested its pre-recession high, hitting $0.57 in that year to top

2007's level of $0.52. Growth has been robust since that time, however, and the company is expected to generate earnings-per-share of $1.45 this year.

Valuation & Expected Returns

People's has a current price-to-earnings ratio of 11.6 based on our estimate of $1.45 of earnings-per-share for this year. This is meaningfully lower than our fair value estimate of 13 times earnings, so we see People's as somewhat undervalued after recent weakness in the stock. The 10-year historical valuation multiples for People's stock can be seen in the following image:

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	N/A	N/A	22.3	17.0	19.0	17.5	18.2	17.3	19.0	13.8	***11.4***	***13.0***
Avg. Yld.	3.7%	4.3%	5.0%	5.2%	4.6%	4.5%	4.3%	4.3%	3.8%	3.9%	***4.3%***	***3.2%***

Thus, People's offers good value at current prices. Should the stock revert to our estimate of fair value, it would provide a 2% to 3% annual tailwind to total returns for shareholders.

In addition, we see earnings-per-share growth at 5% annually, combined with the current 4.2% yield. In total, annual returns are expected to reach approximately 12%, which is good enough to earn a buy recommendation, particularly for income investors interested in the high current yield.

The payout ratio is also right at half of earnings after years of slow payout growth. This was necessary as People's payout ratio used to exceed earnings, but it is in a much better spot now. Keep in mind that all-stock acquisitions make the dividend costlier even if it isn't raised on a per-share basis, so growth will likely be muted. We are forecasting low single digit growth in the payout in the coming years for this reason.

Final Thoughts

People's has an attractive dividend yield above 4%, and growth potential for the years ahead. The bank is not immune from economic downturns, and a flat yield curve is a risk. However, People's has proven adept over the years at finding and acquiring reasonably priced growth in its key markets, and we have no reason to believe that won't continue.

People's is an appealing stock for its relatively low valuation, strong competitive position in key markets in the Northeast, and its 4%+ yield. For these reasons, we rate People's a buy.

Materials Dividend Aristocrats

Air Products and Chemicals (APD)

Business Overview

Ecolab was created in 1923, when its founder Merritt J. Osborn invented a new cleaning product called "Absorbit". This product cleaned carpets without the need for businesses to shut down operations to conduct carpet cleaning. Osborn created a company revolving around the product, called Economics Laboratory, or Ecolab.

Today, Ecolab is the industry leader and generates annual sales in excess of $14 billion.

Ecolab operates three major business segments: Global Industrial, Global Institutional, and Global Energy, each of roughly equal size. The business is diversified in terms of operating segments, and also geography. Over 40% of the company's sales took place outside North America last year.

Source: [Investor Presentation](), page 4

The Global Industrial group provides water treatment, cleaning, and sanitation. Customers in this segment are primarily large firms in the food and beverage, manufacturing, chemical, and mining industries.

The Global Institutional business provides specialized cleaning and sanitation services, such as on-premise laundry, housekeeping, and food safety. Customers are primarily in the foodservice, hospitality, lodging, healthcare, and retail industries.

Lastly, the Global Energy segment includes the Nalco brand. Nalco provides chemical and water treatment services to the petroleum and petrochemical industries, specifically to oilfield services and refineries.

Growth Prospects

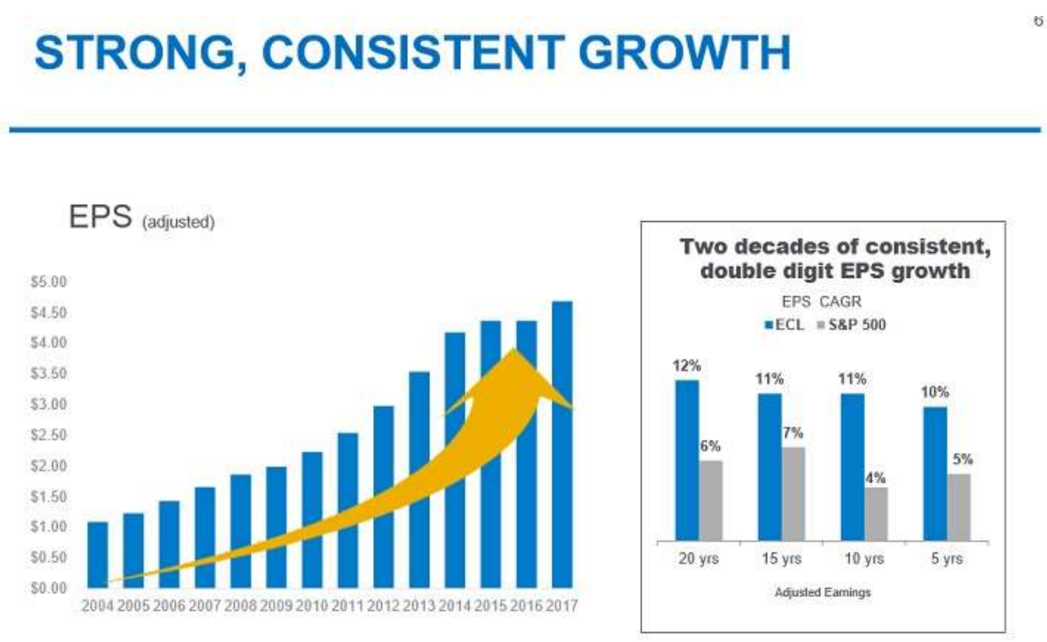
Ecolab has many positive growth catalysts. One of the company's most important growth catalysts is acquisitions.

In 2016, Ecolab acquired UltraClenz, a developer of electronic hand hygiene systems and dispensers. It also acquired Anios, a European healthcare and hygiene business. These deals helped Ecolab expand its scale, particularly in the international markets.

In 2017, Ecolab announced the acquisition of Georgia Pacific's paper chemicals business. The purchase will help boost Ecolab's growing paper business, which helps paper manufactures improve their efficiency, product quality, and profitability.

More recently, Ecolab announced that it would be purchasing U.K. based Holchem Group Limited for US$56 million. Holchem Group Limited is a supplier of hygiene and cleaning products and services for the foodservice and hospitality industries.

Acquisitions such as these, along with organic investment, have fueled steady earnings growth for decades.



Source: Investor Presentation, page 6

Ecolab generates steady growth. In 2017, earnings-per-share grew 8% to $4.69. Growth returned with improving volume growth, and higher pricing, across all business segments.

2018 was also a strong year for the company. Through the first three-quarters of 2018, Ecolab has seen revenues increase more than 7% to $10.9 billion. Earnings-per-share have increased 12.4% over this same time period.

Ecolab has been able to accomplish this growth even in the face of higher raw material and transportation costs through sizable product price hikes. A reduced tax rate has also contributed to the company's top and bottom line growth, although Ecolab's management reduced the midpoint for earnings-per-share for 2018 to $5.25 from $5.40.

Competitive Advantages & Recession Performance

Ecolab’s many competitive advantages include scale, a strong reputation among its customers, and innovation.

Ecolab serves more than 1 million customer locations, spread across more than 170 countries. The company is not afraid to spend significant resources on research and development of new products and services.

Management refers to R&D spending as its “innovation pipeline”. Ecolab often spends more than a $1 billion on the innovation pipeline. The company's number of patents in nearing 8,000.

Ecolab’s R&D investments and intellectual property help the company stay ahead of the competition.

Source: Investor Presentation, page 12

Ecolab's R&D investments have created an incredibly strong business, one that can hold up very well even during economic downturns. For clear evidence of Ecolab's competitive advantages, look no further than its performance during the Great Recession:

- 2006 earnings-per-share of $1.43
- 2007 earnings-per-share of $1.66 (16% increase)
- 2008 earnings-per-share of $1.86 (12% increase)
- 2009 earnings-per-share of $1.99 (7% increase)
- 2010 earnings-per-share of $2.23 (12% increase)

Ecolab's growth during the Great Recession was truly remarkable. Not only did the company generate positive earnings growth in each year of the recession, but in three of those years, it achieved double-digit earnings growth. This growth came during arguably the worst economic downturn in the U.S., since the Great Depression. Ecolab's recession performance makes abundantly clear that the company holds sustainable competitive advantages.

Valuation & Expected Returns

Based off of the current trading price of $149 and expected earnings-per-share of $5.25, Ecolab has a price-to-earnings ratio of 28.4. The company expects 8%-10% annual earnings growth in the coming years.

The stock has a five-year average price-to-earnings ratio of 26.2. We have a target price-to-earnings ratio of 20. If shares of Ecolab were to return to our target valuation by 2023, this would reduce total annual returns by 6.8%.

The stock is in danger of experiencing contraction of the valuation multiple, which would negatively impact total returns. A breakdown of potential returns is as follows:

- 9% earnings growth
- 1% dividend yield
- 6.8% valuation reversion

We expect that Ecolab will offer a total annual return of 3.3% through 2023. This is a fairly weak expected return, due to the high valuation. The stock's current valuation is well above our target, and a decline toward fair value would be a significant headwind for investors buying at the current price.

Ecolab’s dividend is not likely to represent a large portion of total returns. This is because the current dividend yield is just 1.1%. This is about half the average dividend yield of the S&P 500 Index.

Final Thoughts

Ecolab is a time-tested Dividend Aristocrat, with an excellent track record of profitability and growth. However, now is not the best time to buy the stock, due to its high valuation and low dividend yield.

Ecolab is not likely to be an attractive stock for investors interested solely in high levels of income. That said, it is a very strong stock for investors interested in a recession-resistant business, and dividend growth.

Ecolab (ECL)

Business Overview

Ecolab was created in 1923, when its founder Merritt J. Osborn invented a new cleaning product called "Absorbit". This product cleaned carpets without the need for businesses to shut down operations to conduct carpet cleaning. Osborn created a company revolving around the product, called Economics Laboratory, or Ecolab.

Today, Ecolab is the industry leader and generates annual sales in excess of $14 billion.

Ecolab operates three major business segments: Global Industrial, Global Institutional, and Global Energy, each of roughly equal size. The business is diversified in terms of operating segments, and also geography. Over 40% of the company's sales took place outside North America last year.

Source: [Investor Presentation](), page 4

The Global Industrial group provides water treatment, cleaning, and sanitation. Customers in this segment are primarily large firms in the food and beverage, manufacturing, chemical, and mining industries.

The Global Institutional business provides specialized cleaning and sanitation services, such as on-premise laundry, housekeeping, and food safety. Customers are primarily in the foodservice, hospitality, lodging, healthcare, and retail industries.

Lastly, the Global Energy segment includes the Nalco brand. Nalco provides chemical and water treatment services to the petroleum and petrochemical industries, specifically to oilfield services and refineries.

Growth Prospects

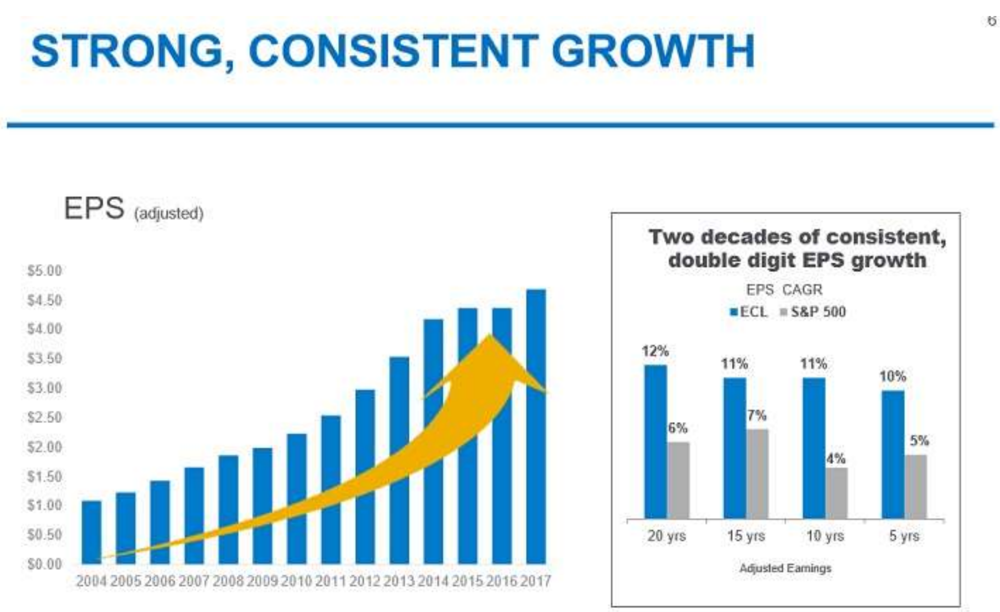
Ecolab has many positive growth catalysts. One of the company's most important growth catalysts is acquisitions.

In 2016, Ecolab acquired UltraClenz, a developer of electronic hand hygiene systems and dispensers. It also acquired Anios, a European healthcare and hygiene business. These deals helped Ecolab expand its scale, particularly in the international markets.

In 2017, Ecolab announced the acquisition of Georgia Pacific's paper chemicals business. The purchase will help boost Ecolab's growing paper business, which helps paper manufactures improve their efficiency, product quality, and profitability.

More recently, Ecolab announced that it would be purchasing U.K. based Holchem Group Limited for US$56 million. Holchem Group Limited is a supplier of hygiene and cleaning products and services for the foodservice and hospitality industries.

Acquisitions such as these, along with organic investment, have fueled steady earnings growth for decades.



Source: Investor Presentation, page 6

Ecolab generates steady growth. In 2017, earnings-per-share grew 8% to $4.69. Growth returned with improving volume growth, and higher pricing, across all business segments.

2018 was also a strong year for the company. Through the first three-quarters of 2018, Ecolab has seen revenues increase more than 7% to $10.9 billion. Earnings-per-share have increased 12.4% over this same time period.

Ecolab has been able to accomplish this growth even in the face of higher raw material and transportation costs through sizable product price hikes. A reduced tax rate has also contributed to the company's top and bottom line growth, although Ecolab's management reduced the midpoint for earnings-per-share for 2018 to $5.25 from $5.40.

Competitive Advantages & Recession Performance

Ecolab's many competitive advantages include scale, a strong reputation among its customers, and innovation.

Ecolab serves more than 1 million customer locations, spread across more than 170 countries. The company is not afraid to spend significant resources on research and development of new products and services.

Management refers to R&D spending as its "innovation pipeline". Ecolab often spends more than a $1 billion on the innovation pipeline. The company's number of patents in nearing 8,000.

Ecolab's R&D investments and intellectual property help the company stay ahead of the competition.

Source: Investor Presentation, page 12

Ecolab's R&D investments have created an incredibly strong business, one that can hold up very well even during economic downturns. For clear evidence of Ecolab’s competitive advantages, look no further than its performance during the Great Recession:

- 2006 earnings-per-share of $1.43
- 2007 earnings-per-share of $1.66 (16% increase)
- 2008 earnings-per-share of $1.86 (12% increase)
- 2009 earnings-per-share of $1.99 (7% increase)
- 2010 earnings-per-share of $2.23 (12% increase)

Ecolab’s growth during the Great Recession was truly remarkable. Not only did the company generate positive earnings growth in each year of the recession, but in three of those years, it achieved double-digit earnings growth. This growth came during arguably the worst economic downturn in the U.S., since the Great Depression. Ecolab’s recession performance makes abundantly clear that the company holds sustainable competitive advantages.

Valuation & Expected Returns

Based off of the current trading price of $149 and expected earnings-per-share of $5.25, Ecolab has a price-to-earnings ratio of 28.4. The company expects 8%-10% annual earnings growth in the coming years.

The stock has a five-year average price-to-earnings ratio of 26.2. We have a target price-to-earnings ratio of 20. If shares of Ecolab were to return to our target valuation by 2023, this would reduce total annual returns by 6.8%.

The stock is in danger of experiencing contraction of the valuation multiple, which would negatively impact total returns. A breakdown of potential returns is as follows:

- 9% earnings growth
- 1% dividend yield
- 6.8% valuation reversion

We expect that Ecolab will offer a total annual return of 3.3% through 2023. This is a fairly weak expected return, due to the high valuation. The stock's current valuation is well above our target, and a decline toward fair value would be a significant headwind for investors buying at the current price.

Ecolab’s dividend is not likely to represent a large portion of total returns. This is because the current dividend yield is just 1.1%. This is about half the average dividend yield of the S&P 500 Index.

Final Thoughts

Ecolab is a time-tested Dividend Aristocrat, with an excellent track record of profitability and growth. However, now is not the best time to buy the stock, due to its high valuation and low dividend yield.

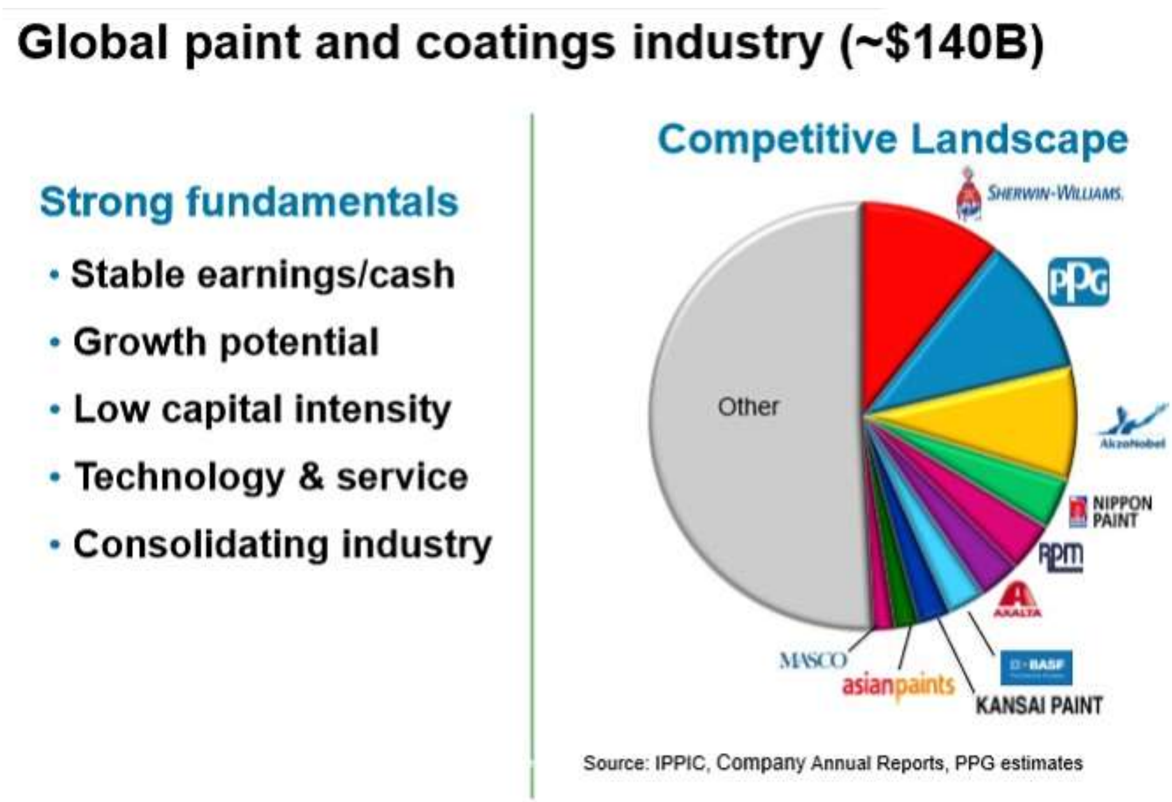
Ecolab is not likely to be an attractive stock for investors interested solely in high levels of income. That said, it is a very strong stock for investors interested in a recession-resistant business, and dividend growth.

PPG Industries (PPG)

Business Overview

PPG Industries was originally founded in 1883 as a manufacturer and distributor of glass. The 'PPG' in PPG Industries stands for Pittsburgh Plate Glass, which is a reference to the company's original operations. Over time, PPG has made remarkable strides in becoming an industry leader in the paints and coatings industry.

With a market capitalization of $25 billion and annual revenues in excess of $15 billion, PPG's only competitors of similar size are fellow Dividend Aristocrat Sherwin-Williams (SHW), as well as Dutch paint company Akzo Nobel. PPGs' strong market share can be seen in the following chart.



Source: Investor Presentation

PPG Industries has grown to such an impressive size thanks to its worldwide operating presence and focus on technology and innovation. The company has approximately 47,000 employees located in more than 70 countries at 150 unique locations. Its research and development focus is a key differentiator between PPG and other paint & coatings companies. PPG has grown to be a market leader today.

Growth Prospects

By and large, a company's ability to increase revenues and profits is a function of their capital allocation. In fiscal 2018, PPG spent about $2.9 billion in cash, nearly 60% of which was devoted to its ample share repurchase program. This is more than what PPG is typically used to, with buybacks generally around one-quarter of cash usage, but acquisition spending was down on a relative basis in 2018.

With this in mind, it is likely that mergers and acquisitions will be a focus for PPG moving forward as the company moves back towards its core competency of portfolio optimization. Acquisitions have been a key growth driver for PPG for many years.

Source: Investor Presentation

The evidence supports this thesis. In late 2018, the company announced acquisitions including SEM, Whitford and Hemmelrath. This is consistent with PPG's history of acquiring growth - and sometimes divesting non-core activities - and we have no reason to think that strategy won't continue to be employed.

PPG is now virtually exclusively a coatings business. The transformation in recent years away from legacy businesses like glass and chemicals has left the company with an impressive portfolio of coatings products that collectively generate more than $15 billion in annual revenue. PPG recognized years ago that the future was in coatings and has positioned itself as such.

PPG's track record suggests that the stock's underlying business is likely to continue growing at a satisfactory rate for the foreseeable future. The company's adjusted earnings-per-share over the trailing 15-year period can be seen below.

PPG Industries managed to compound its adjusted earnings-per-share at high single digit rates in recent years, although that growth has been nonlinear.

Earnings rebounded significantly in 2017 after a pension plan charge depressed profitability in 2017, but 2018 earnings were roughly flat year-over-year. We don't think flat earnings are going to be the norm going forward, however, as PPG has impressive fundamentals that should fuel additional growth.

We believe that PPG is likely to grow more slowly than this rate moving forward. Investors can reasonably expect ~7% adjusted earnings-per-share growth from PPG Industries through full economic cycles.

PPG's performance is likely to suffer during periods of economic recession, an observation that is discussed in the next section of this analysis.

Competitive Advantages & Recession Performance

PPG operates in the paints & coatings industry, which is economically attractive for a number of reasons. First, these products have high profit margins for manufacturers. They also have low capital investment, which results in significant cash flow.

Given all this, it begins to make more sense that there are *two* paint companies (Sherwin-Williams and PPG Industries) in the Dividend Aristocrats list.

With that said, the paint and coatings industry is not very recession-resistant because it depends on a healthy housing and construction market. This impact can be seen in PPG's performance during the 2007-2009 financial crisis:

- 2007 adjusted earnings-per-share: $2.52
- 2008 adjusted earnings-per-share: $1.63 (35% decline)
- 2009 adjusted earnings-per-share: $1.02 (37% decline)
- 2010 adjusted earnings-per-share: $2.32 (127% increase)

PPG's adjusted earnings-per-share fell by more than 50% during the last major recession, and took two years to recover. While the long-term prospects of this Dividend Aristocrat remain bright, investors that own PPG should be willing to double-down and purchase more shares of this stock if a recession hits and its stock price falls precipitously.

Valuation & Expected Total Returns

PPG reported $5.92 in earnings-per-share for fiscal 2018, putting the current price-to-earnings multiple at 17.8. Earnings are expected to rise at a high single digit rate in 2019, so the forward price-to-earnings multiple would be more like 16.5. Either way, PPG trades below our fair value estimate of 19 times earnings, so the stock certainly appears to be undervalued.

Shares have traded sideways for years now as PPG's earnings have moved around somewhat erratically. However, during this time, the company has continued its portfolio transformation, reduced the float via buybacks, and grown earnings. While growth has been lumpy, we think PPG looks attractive today given the lower-than-normal valuation.

We see PPG producing low double digit total returns in the years to come, consisting of the current 1.9% dividend yield, ~7% earnings growth and a ~3% tailwind from a rising valuation. This is good enough to earn a buy recommendation with the caveat that PPG is not a recession-resistant stock.

Final Thoughts

PPG Industries has many of the characteristics of a very high-quality business. It has a proven business model, and has generated strong growth over the past several years. It has a significant international presence, and multiple catalysts for future growth. Lastly, it has increased its dividend for nearly 50 years.

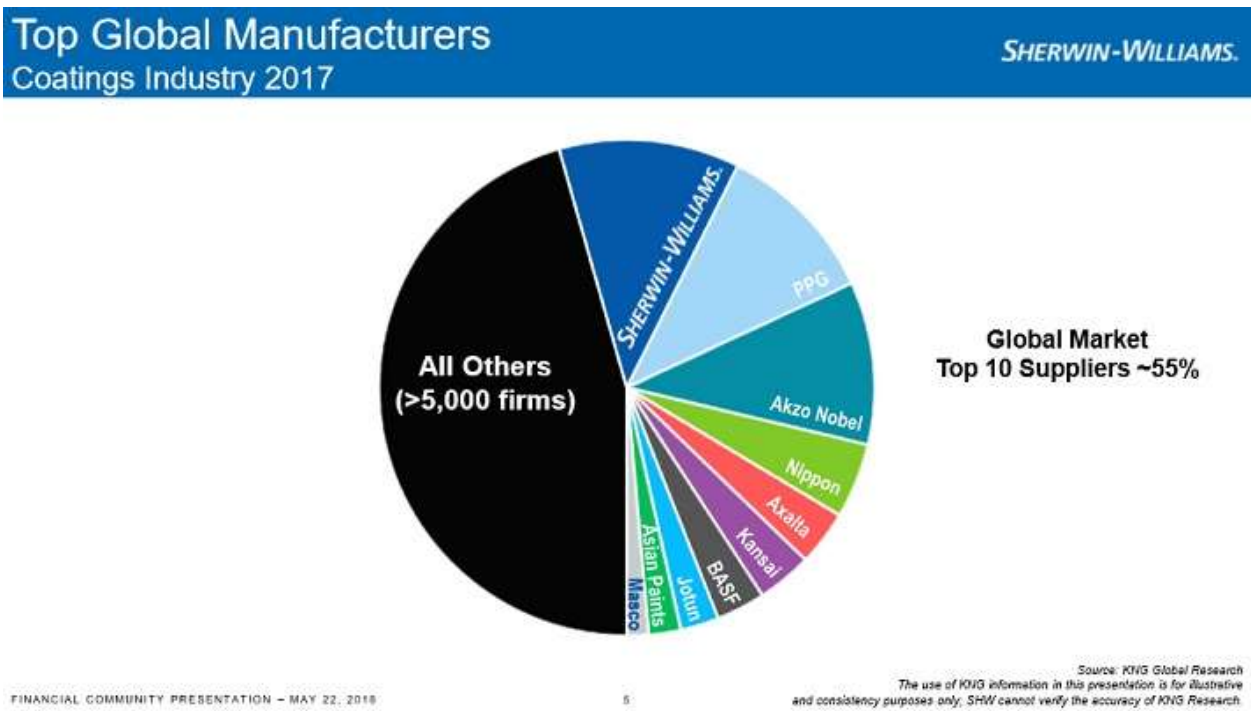
However, the company's weakness during recessions means that even though its valuation looks appealing on paper, better buying opportunities are likely to occur in the future. PPG is attractive for its growth outlook and relatively cheap valuation, but note that investors could see lower prices if a recession occurs.

Sherwin-Williams (SHW)

Business Overview

Sherwin-Williams is the world's second-largest manufacturer of paints and coatings. The company distributes its products through wholesalers as well as retail stores. Sherwin-Williams was founded in 1866, and has grown to a market capitalization of $37 billion and annual sales of $15 billion.

The company distributes its products through wholesalers as well as retail stores that bear the Sherwin-Williams name. Its only competitor of comparable size is fellow Dividend Aristocrat PPG Industries (PPG).



Source: Investor Presentation, page 3

Sherwin-Williams is certainly a market leader. The company has become significantly larger since its relatively recent acquisition of Valspar.

The Valspar merger was transformative for Sherwin-Williams. Post-merger, Sherwin-Williams is now divided into three segments: Americas, Consumer Brands, and Performance Coatings.

Sherwin-Williams is a much more diversified company than it was prior to the Valspar purchase. Management believes it can deliver strong earnings-per-share growth, with less volatility and variability in earnings.

In late October, Sherwin-Williams reported (10/25/18) financial results for the third quarter of fiscal 2018. In the quarter, consolidated net sales increased by 5.0% to $4.73 billion while same store sales for locations in the United States and Canada increased by 5.2%. Sherwin-Williams generated diluted earnings-per-share of $3.72, which represents an 11.7% increase over the same period a year ago.

Excluding nonrecurring accounting charges, Sherwin-Williams generated adjusted earnings-per-share of $5.68, a 19.6% increase year-on-year. Sherwin-Williams also updated its 2018 financial guidance with the publication of its third quarter earnings release. The company now expects to generate adjusted earnings-per-share between $19.05 and $19.20.

Growth Prospects

Sherwin-Williams has grown at strong rates over the past couple of years. Fiscal 2017 saw sales growth of 26% while fiscal 2018 is on pace for a high-teens gain on top of that. This has led to some robust earnings-per-share growth, as our estimate of 2018 earnings-per-share of $19.13 is nearly *60%* higher than two years prior. Strong sales growth has helped but margins have been buoyant and a lower tax rate has aided the effort as well.

Looking ahead, Sherwin-Williams stands to benefit from broad-based demand for its products internationally. Demand for Sherwin-Williams' products is expected to grow most rapidly in the Asia-Pacific region. In addition, the company has scale unlike any of its competitors in Latin America and North America. There is still plenty of growth potential in its more mature markets, but the Valspar acquisition helped to expedite expansion into Asia-Pacific, where the company is relatively small.

These factors should combine to accelerate the company's revenue growth in the near-term. Sherwin-Williams expects sales growth of 4%-6% per year through the end of fiscal 2020.

Source: Investor Presentation, page 5

Revenues are just one component of Sherwin-Williams future growth in profitability. The Valspar acquisition has presented some meaningful opportunities to reduce expenses by eliminating duplicate roles, integrating supply chains, and combining SG&A workforces.

All said, Sherwin-Williams is expecting between $400 million and $415 million in annual cost synergies by 2020.

Sherwin-Williams has plenty of opportunities to grow its sales and earnings for the foreseeable future. The company also has a very strong track record of earnings growth:

Sherwin-Williams is accustomed to growing earnings at double digit rates, and management has guided for that to continue in the coming years. This company has a broad and deep portfolio of popular brands with good margins and a bright sales outlook. In addition, meaningful merger synergies have yet to accrue, so margins should improve further in the next couple of years. In short, even though Sherwin-Williams is the dominant player in its sector, it is far from done when it comes to growth.

Competitive Advantages & Recession Performance

Sherwin-Williams is not the most recession-resistant Dividend Aristocrat. The company's performance depends on a healthy U.S. and international housing market, which is the underlying driver of paint and coatings sales.

This impact can be seen by looking at the company's performance during the 2007-2009 financial crisis:

- 2007 adjusted earnings-per-share: $4.70
- 2008 adjusted earnings-per-share: $4.00 (15% decline)
- 2009 adjusted earnings-per-share: $3.78 (5.5% decline)
- 2010 adjusted earnings-per-share: $4.21 (11% increase)

It took Sherwin-Williams' earnings three full years to recover from its Great Recession lows; however, the company remained profitable and continued to raise its dividend (which is why it remains a Dividend Aristocrat today).

Another factor that investors should consider is the company's increased debt load after the closure of the Valspar acquisition. Sherwin-Williams acquired debt to fund the Valspar acquisition, which resulted in a debt to EBITDA ratio of 4.5x when the deal closed. The company has worked to pay off debt since. It lowered its debt to EBITDA ratio to 3.0x at the end of 2018, and the company maintains a long-term target of 2.0x to 2.5x.

Sherwin-Williams elevated debt load combined with our current position in the business cycle may lead some investors to consider investments in more conservative securities. Earnings are likely to fall if the economy begins to contract and the housing market slows. We don't believe it would result in negative earnings by any means, but certainly, the share price would suffer under such a scenario.

Valuation & Expected Total Returns

Sherwin-Williams has many of the characteristics of a high-quality business, and it is valued as such. The stock trades with a price-to-earnings multiple of 20.9 on its 2018 earnings-per-share estimate of $19.13, which compares to our estimate of fair value of 20.5. That implies a fractional headwind to total returns in the coming years as the stock is essentially fairly valued today.

However, this is not a stock that is likely to sink to a low price-to-earnings ratio, given its enormously successful history of growing earnings. Investors are willing to pay more for premium growth and Sherwin-Williams fits that description.

In addition, we expect 9% long-term annual earnings growth for Sherwin-Williams. The stock also has a secure dividend, which yields 0.9% right now. This results in annual expected returns of nearly 10% over the next five years.

The stock's fair price and high earnings growth mean that we recommend Sherwin-Williams as a buy. The dividend yield is still quite low, so it isn't worthwhile as a pure income stock. However, the high rate of dividend increases makes the stock attractive for long-term dividend growth investors.

Final Thoughts

Sherwin-Williams' acquisition of Valspar has created some compelling growth opportunities for this high-quality dividend stock.

This is a typical example of a great business trading at a not-so-great price. We'll let Warren Buffett take this one from here:

"For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments." - *Warren Buffett*

While the stock may not look cheap in a traditional sense, it is fairly valued for the first time in a while. We think there is a lot of growth ahead along with strong payout expansion, and think the stock is worth a look for investors with long time horizons.

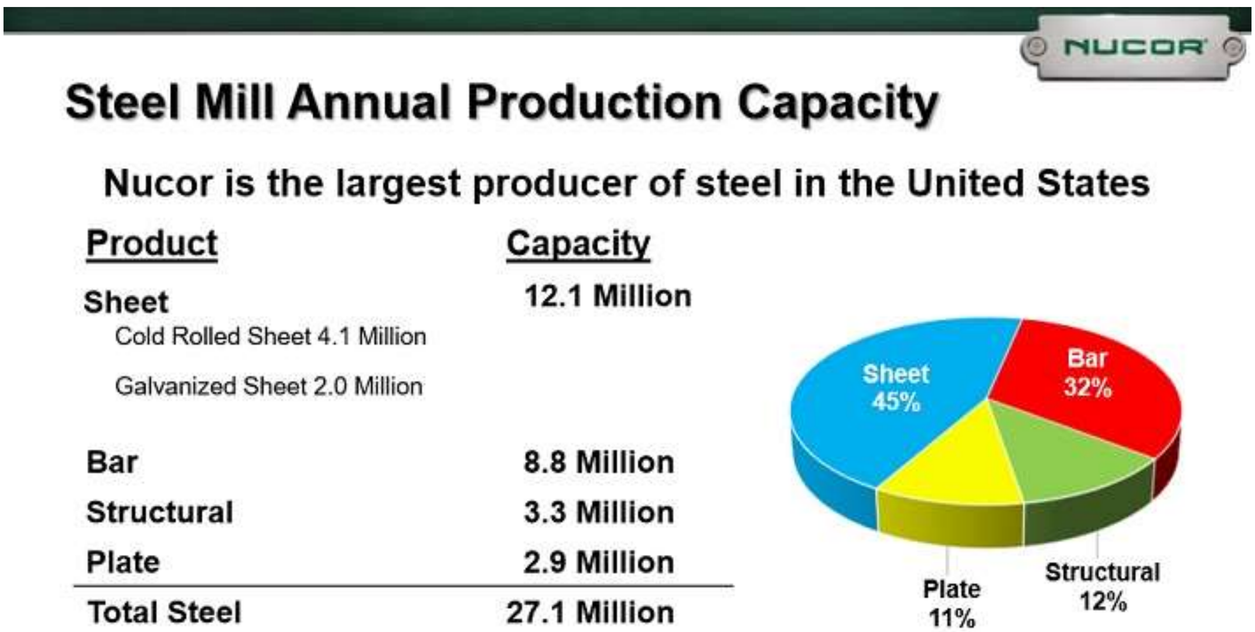
Nucor (NUE)

Business Overview

Nucor is the largest steel producer in the United States. The company is headquartered in Charlotte, North Carolina and has a market capitalization of $18 billion.

Nucor was not always a leader in the steel manufacturing industry. The company has a long and convoluted corporate history that can be traced back to the company's founder, Ransom E. Olds (the creator of the Oldsmobile automobile). Olds left his own automotive company over a disagreement with shareholders to form the REO Motor Company, which eventually transformed into the Nuclear Corporation of America - Nucor's first predecessor.

The company currently operates in three segments: Steel Mills (the largest segment by revenue), Steel Products, and Raw Materials.



Source: [Investor Presentation]

Nucor manufactures a wide variety of material types, including sheet steel, steel bars, structural formations, steel plates, downstream products, and raw materials. The majority of the company's production comes from a combination of sheet and bar steel, as has been the case for many years.

The past several years have been tough on Nucor thanks to a significant global supply glut in the steel market. In addition, state-subsidized steel production in China continues to support high levels of supply and low pricing. However, there are several factors that suggest the company's performance should improve over the next several years; these factors are discussed below.

Growth Prospects

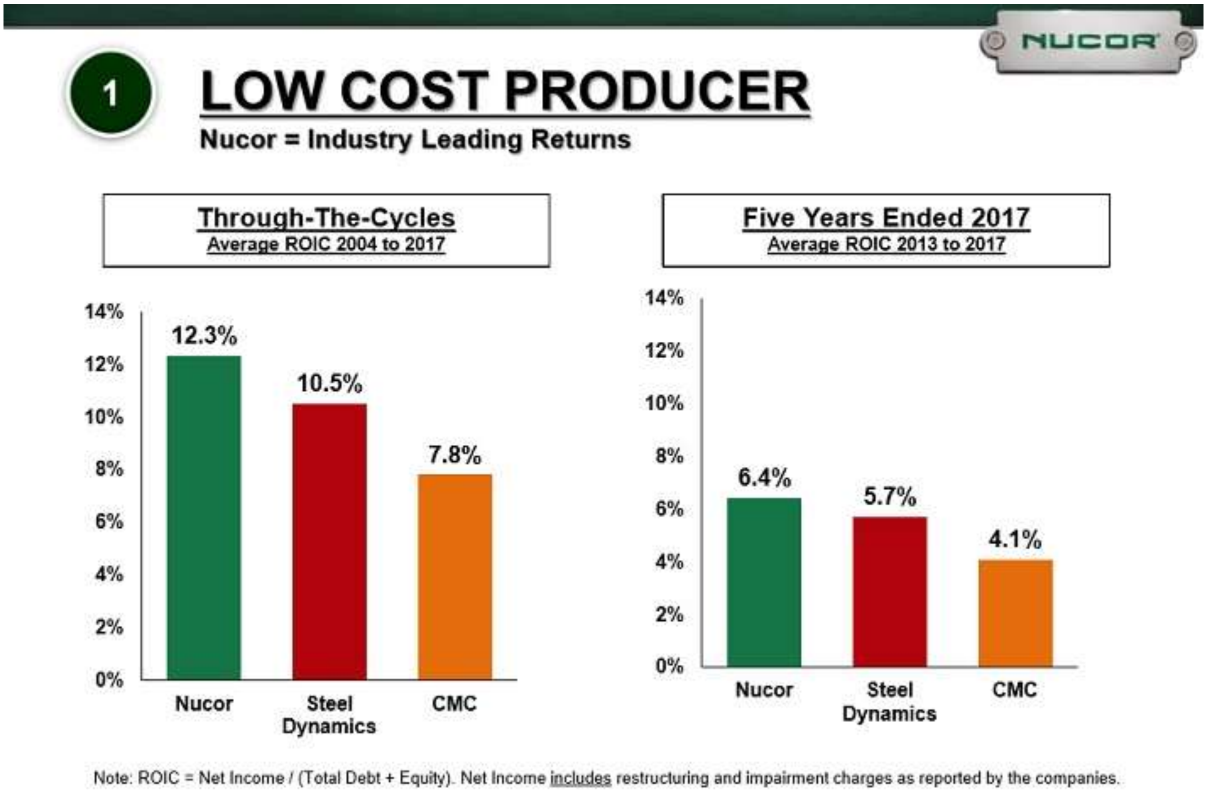
The past several years have been a rollercoaster for Nucor. Steels prices have been highly volatile, driven primarily by a supply glut coming out of international markets specifically, China.

This has resulted in decreased production, harming Nucor's profitability, although 2017 was certainly a strong rebound from the bottom, and 2018 was another strong year. In the 2018 third quarter, revenue increased 30% to $6.74 billion. Earnings-per-share more than doubled for the quarter. Sales volumes rose 7%, while higher prices and tax reform also contributed to earnings growth.

Tariffs on steel went into place in 2018 and have helped stabilize Nucor's results. Whether these tariffs remain in the current form, some other form, or are eventually abolished completely remains to be seen. However, they are a net positive for Nucor at the moment.

Nucor is also likely to drive growth through acquisitions moving forward. The company has historically executed strategic bolt-on acquisitions when appropriate and has stated its goal is to continue to do so, adding mills and capacity in the process.

Nucor's unique ability to grow dividends for over 40 years, even as a commodity producer, is due largely to its status as a low-cost producer.



Source: Investor Presentation

This has helped Nucor remain profitable and grow dividends through all economic cycles, while so many higher-cost commodity producers cannot stand the test of time.

Investors can get a sense of how quickly Nucor is likely to grow moving forward by looking at the company's historical growth rates. Between 2001 and 2016, Nucor compounded its adjusted earnings-per-share at a rate of ~13% even though 2016 was still a year of depressed earnings for this steelmaker.

We believe that Nucor is likely to deliver just 2.5% adjusted earnings-per-share growth from this point forward, although bottom line growth will be lumpy thanks to Nucor's presence in the cyclical materials sector. The enormous rebound in earnings seen in 2017 and 2018 has created what we believe may be close to a top in near-term earnings potential for Nucor.

Competitive Advantage & Recession Performance

Nucor is a manufacturer and distributor of a raw material: steel. Accordingly, the company is a 'commodity business' - one in which the single largest differentiator between competitors is price.

Warren Buffett has the following to say about commodity businesses:

"Stocks of companies selling commodity-like products should come with a warning label: 'Competition may prove hazardous to human wealth.'" - Warren Buffett

Certainly, commodity businesses are not the most defensive businesses thanks to their cyclicality. This can be seen by looking at Nucor's performance during the 2007-2009 financial crisis:

- 2007 adjusted earnings-per-share: $4.98
- 2008 adjusted earnings-per-share: $6.01
- 2009 adjusted earnings-per-share: net loss of $0.94
- 2010 adjusted earnings-per-share: $0.42
- 2011 adjusted earnings-per-share: $2.45

Nucor's earnings-per-share were decimated by the financial crisis. The company is one of few Dividend Aristocrats whose earnings actually turned negative during this tumultuous time period. Earnings have only recently caught up to their pre-recession levels, although Nucor has continued to steadily increase its dividend payments.

With all this in mind, Nucor should not be viewed as a defensive investment. Investors should expect the company to suffer during economic downturns. In addition, with steel being used as a political bargaining chip internationally, investors should be aware that the company's fortunes aren't tied only to its own actions, but potentially also to those of external forces.

Valuation & Expected Returns

Nucor is expected to report adjusted earnings-per-share of about $7.20 in fiscal 2018. This would represent another huge leap in year-over-year earnings as 2017 earnings-per-share were just $3.59. That puts the company's price-to-earnings ratio at just 8.2, which is obviously quite low compared to the broader market. It's also important to compare Nucor's current valuation to its long-term historical average, which is done below.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	9.4	----	----	16.7	25.5	31.2	23.2	40.1	19.7	16.3	***8.2***	***25.0***
Avg. Yld.	3.4%	3.3%	3.4%	3.6%	3.6%	3.1%	2.9%	3.3%	3.1%	2.6%	***2.6%***	***3.2%***

Based on this diagram, Nucor is currently trading at a discount to its long-term average and at a discount to the average valuation in the S&P 500.

However, the cyclicality of Nucor's business model means that changing which year's earnings that you use has a significant impact on the company's valuation. Indeed, 2018's earnings-per-share estimate likely represents the top of this cycle and thus, the stock should appear cheap, as declines in earnings are a much higher risk today than they were in past years.

Given this, using dividend yield as a valuation metric can help to inform investors' understanding of the valuation. The current yield is 2.8%, which is roughly in-line with its historical dividend yields, although as one can see, that metric is quite volatile as well.

The share price is trading at levels it did five years ago, indicating that investors don't find the current valuation to be all that attractive. Again, we believe it is because earnings are inflated in 2018 and are much more likely to decline in the coming years than to grow meaningfully. Accordingly, right now is probably not the best time to buy Nucor (although long-term investors should still fare reasonably well thanks to high-single-digit earnings growth and the company's healthy ~2.8% dividend yield).

We see total annual returns of close to zero in the coming years as earnings and valuation movements are likely to offset each other, as they have in the past. Thus, the yield of 2.8% is probably the most appealing aspect for investors. Nucor would be highly vulnerable to an economic downturn, meaning investors should consider the impact of a recession before buying shares.

Final Thoughts

Nucor's status as a Dividend Aristocrat helps it to stand out among the highly volatile materials sector. There are *very few* raw materials businesses that have multi-decade track records of compounding their adjusted earnings-per-share.

Nucor has a higher dividend yield than the S&P 500 Index, and the company has a long history of annual dividend increases. Nucor has a strong industry position and a healthy balance sheet.

However, the current stock valuation does not merit a buy recommendation. And, the company would be significantly affected by a recession.

For investors that are looking for raw materials exposure, we recommend waiting for a better opportunity to acquire shares of Nucor.

Linde plc (LIN)

Business Overview

Linde plc, which was created through the merger of Linde AG and Praxair, is the world's largest industrial gas corporation. Linde AG is headquartered in Munich, Germany. The company produces, sells, and distributes atmospheric, process, and specialty gases, along with high-performance surface coatings.

Linde products and services can be found in nearly every industry, in more than 100 countries around the world. Last year, Linde generated sales of approximately $19 billion.

The company operates in two core divisions: Industrial Gases & Healthcare; and Engineering.

Linde gases are used in a variety of industries, including energy, steel production, chemical processing, environmental protection, food processing, electronics, and more. The company also has a healthcare business consisting of medical gases and services.

Linde's Engineering division focuses on market segments such as olefin, natural gas, air separation, hydrogen and synthesis gas plants. It is involved in the planning, project development, and construction of industrial plants.

Linde has performed well in recent periods.

Source: Investor Presentation

Through the first three quarters of 2018, Linde's total revenue increased 4.8% from the same period the previous year. Operating profit increased 9% in the nine-month period, thanks to revenue growth as well as 140-basis point operating margin expansion.

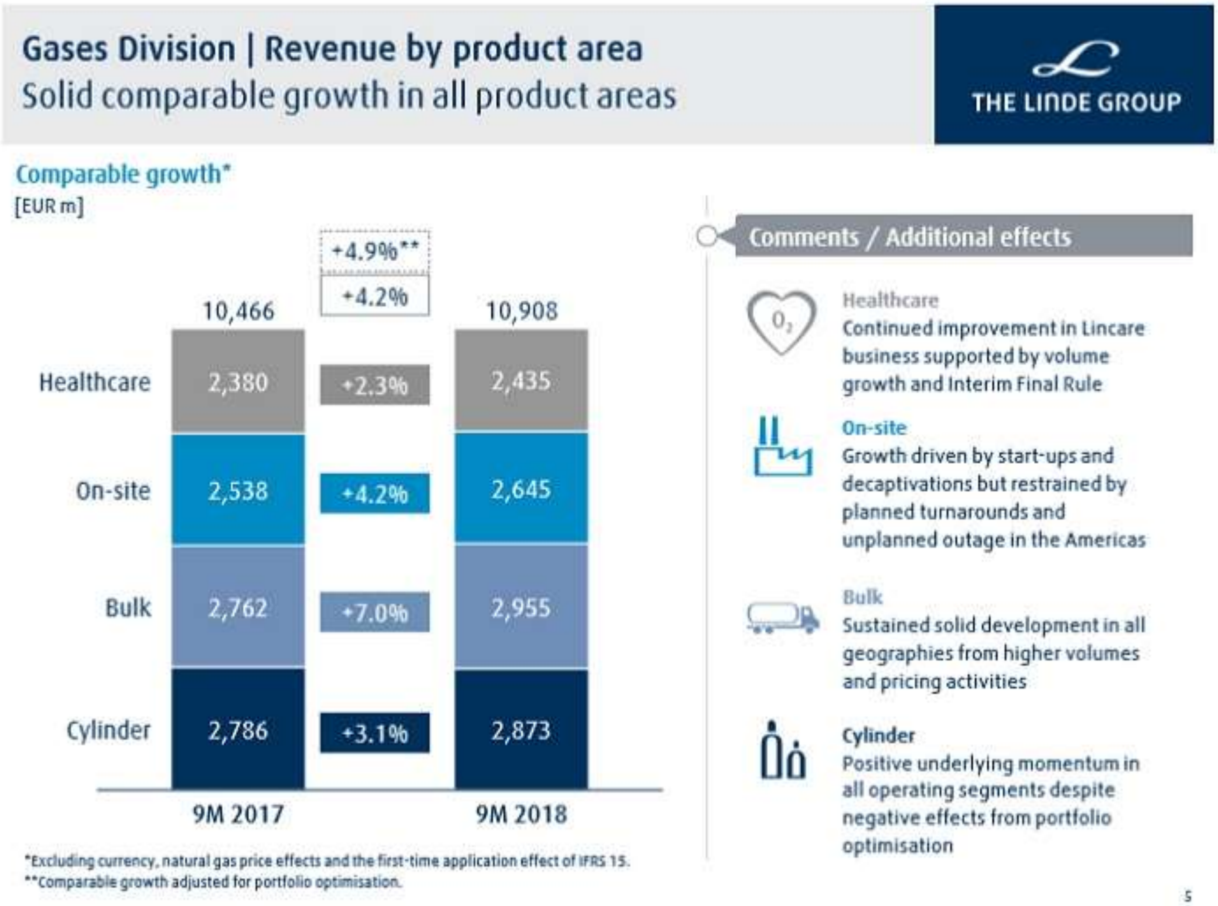
Currency-neutral revenue increased 4.5% in the Gases division, thanks to 5.1% growth in the Asia-Pacific region. Meanwhile, Engineering revenue increased 10% over the first three quarters of 2018.

During the last year the major development for the company was the merger with Praxair. In late October the two companies received approval for the merger-of-equals by U.S. regulators, with some conditions such as divestment of certain assets.

Growth Prospects

The merger of Praxair with Linde will be the primary growth catalyst moving forward. The deal creates an industrial gas giant. Combined, the two companies will generate approximately $29 billion in annual revenue.

Bringing Praxair on board will add to Linde's existing gases business, which was already performing well with strong growth and margin expansion.



Source: Investor Presentation

Praxair will contribute positively to Linde. Praxair reported its standalone third quarter earnings results last November (11/9/18). Revenue of $3.0 billion increased 3% year over year.

Adjusted for foreign exchange fluctuations, revenue increased 7% for the quarter. Operating earnings of $700 million increased 8% from the same quarter a year ago.

Earnings-per-share of $1.69 rose 13% compared to the year-ago quarter. Due to winning four new on-site projects, Praxair was able to grow its backlog by 29% compared to the prior year's quarter. The growth in the company's backlog (now at $2.2 billion) bodes well for Linde's revenue growth outlook.

Linde will also be able to generate substantial cost-savings through synergies between the two companies. Linde management expects deal synergies of $1.1 to $1.2 billion annually, achievable within three years after closing.

Share repurchases will also be a major catalyst for Linde's future earnings growth. Linde has an existing share repurchase program for up to $1 billion in buybacks.

On top of this, the company recently announced an additional $6 billion share repurchase program, for up to 15% of its outstanding shares through February 1st 2021.

We expect Linde to grow its earnings-per-share by 6% per year over the next five years.

Competitive Advantages & Recession Performance

Linde enjoys multiple competitive advantages. As the leader in industrial gases, the company enjoys economic scale and greater operational efficiency than its smaller competitors.

In addition, Linde's financial resources allow the company to invest heavily in research and development. Linde utilized $127 million on R&D expense in 2017, and $138 million in 2016, to build and maintain its competitive advantages.

For example, Linde filed 232 new patents in 2017 to protect its innovation from competitive threats. Linde has over 3,700 issued patents across its technologies.

Another competitive advantage is Linde's strong financial position. The company has a healthy balance sheet, with high credit ratings of 'A2' from Moody's and 'A' from Standard & Poor's.

Maintaining investment-grade credit ratings helps the company access capital markets at an attractive cost.

Linde is not a recession-resistant business. As a global industrial manufacturer, its business model is sensitive to fluctuations in the global economy. An economic downturn typically sees lower demand from industrial customers.

Linde's earnings-per-share during the Great Recession are as follows:

- 2008 earnings-per-share of $4.19
- 2009 earnings-per-share of $4.01 (4.3% decline)
- 2010 earnings-per-share of $3.84 (4.2% decline)
- 2011 earnings-per-share of $5.45 (42% increase)

The company did see a modest decline in earnings-per-share during the recession, but fortunately saw its earnings improve alongside the broader global economic recovery. By 2011, Linde's earnings had surpassed 2008 levels.

Valuation & Expected Returns

Linde is expected to generate earnings-per-share of $6.10 for 2018. Based on this, shares currently trade for a price-to-earnings ratio of 27.9. This is a fairly high valuation for the stock, even though the company is highly profitable and growing earnings at a satisfactory rate.

Over the past 10 years, shares of Linde traded for an average price-to-earnings ratio near 21. As a result, our fair value estimate for the stock is a price-to-earnings ratio of 20. This is a reasonable fair value target for a strong company with durable competitive advantages.

Linde appears to be significantly overvalued. If shares were to experience a falling valuation to reach our fair value estimate, it would reduce annual returns by 6.4% per year. This could be a stiff headwind for investors buying at the current price level.

Future returns will be boosted by earnings growth and dividends. In addition to Linde's expected earnings growth of 6% per year over the next five years, the stock has a current quarterly dividend of $0.875 per share.

Linde is a dividend growth stock. The most recently quarterly dividend payout was increased 6% from the previous dividend. On an annualized basis, Linde's dividend of $3.50 per share represents a dividend yield of 2.1%.

The combination of valuation changes, earnings growth, and dividends results in total expected returns of 1.7% per year through 2024. This is a low expected rate of return, which makes the stock unattractive in our view.

Linde is a profitable company with a positive earnings growth outlook and a solid dividend, but the impact of overvaluation is enough to warrant a sell recommendation at the current price.

Final Thoughts

Linde stock has performed well since the merger with Praxair. Expectations are high for the potential of the combined company, but at this time we feel Linde's stock is overvalued.

Linde will be an industry leader with clear and durable competitive advantages. The company should grow revenue and earnings at a steady rate going forward, assuming the global economy stays out of recession.

However, while Linde is a strong business, the stock is too richly valued to buy today.

Energy Dividend Aristocrats

Chevron (CVX)

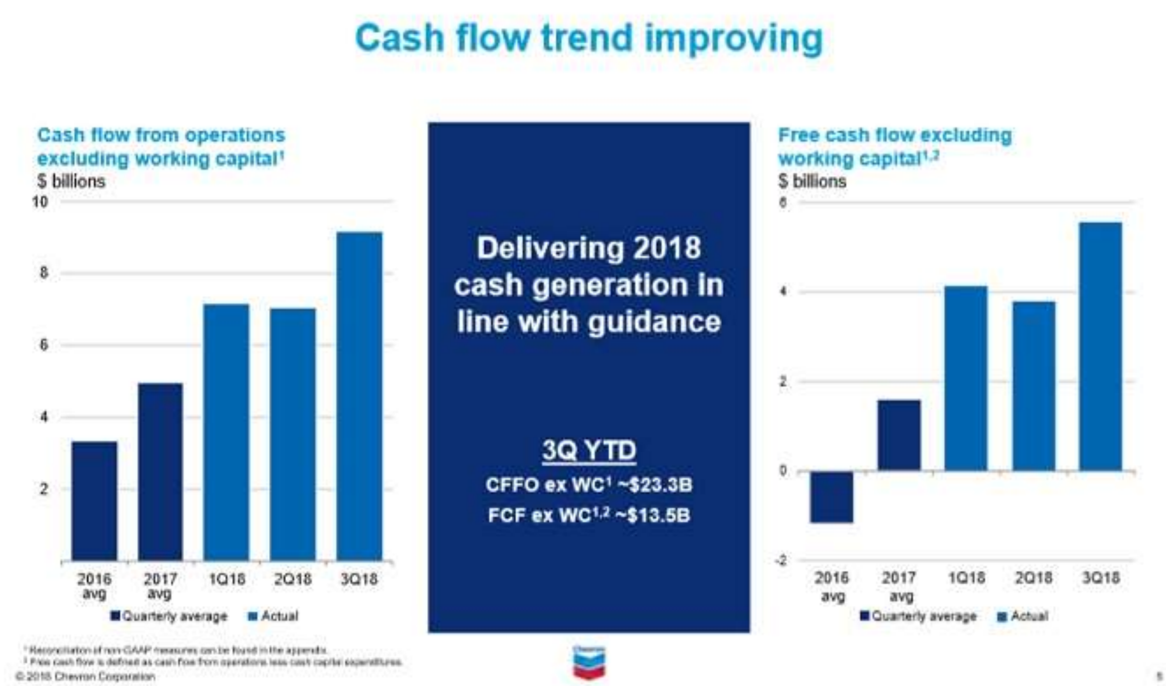
Business Overview

Chevron is one of six oil and gas supermajors, along with:

- BP (BP)
- Eni SpA (E)
- Total SA (TOT)
- Chevron (CVX)
- Exxon Mobil (XOM)
- Royal Dutch Shell (RDS-B)

Chevron is one of only two of the top six oil and gas supermajors to be headquartered in the United States, along with fellow Dividend Aristocrat Exxon Mobil. Like the other integrated supermajors, Chevron engages in upstream oil and gas production, as well as downstream refining businesses.

After a difficult period for the oil and gas supermajors from 2014-2016, when oil prices sank from over $100 per barrel to under $30 per barrel, the industry enjoyed a recovery last year. Trends meaningfully improved throughout the year.

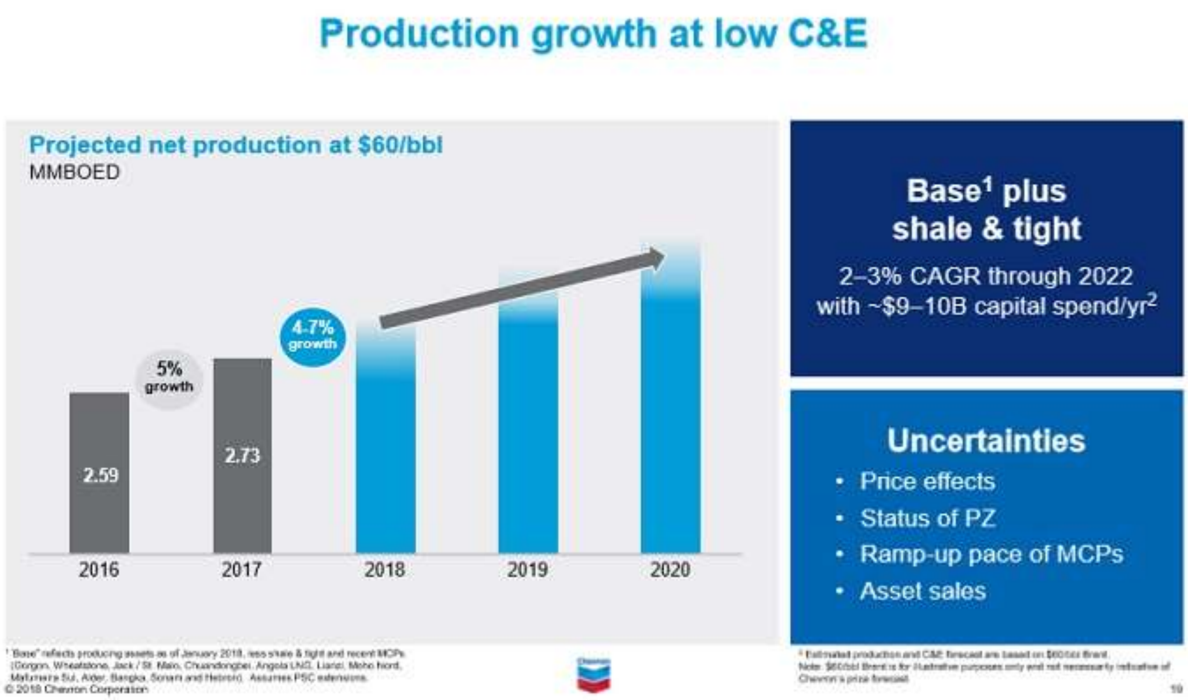


Source: Investor Presentation

In early November (11/2/18) Chevron reported strong third-quarter earnings. Revenue of $44 billion increased 22% from the same quarter a year ago. Revenue growth was due to higher oil and gas prices, as well as a huge boost in production. Chevron had record quarterly oil-equivalent production of 2.96 million barrels per day, 9% higher than a year ago. Not surprisingly, the upstream segment benefited the most from rising commodity prices. Earnings in the upstream segment soared from $489 million to $3.4 billion in the quarter.

Growth Prospects

Chevron is one of the largest publicly-traded energy corporations in the world and stands to benefit tremendously from the continued rebound in oil prices. In addition, the company has invested heavily in new projects, many of which are set to ramp up over the next year. Chevron is expecting 7% production growth for 2018 before the impact of asset sales, with continued growth in 2019 and beyond. The company's projected net production over the next several years can be seen below.



Source: Investor Presentation

The rebound in oil prices from the 2016 lows has fueled significantly higher cash flow for Chevron. According to the company's third-quarter conference call, cash flow from operations for the quarter was $9.6 billion, or $9.2 billion excluding working capital effects. Cash flow from operations totaled $21.5 billion through the first three quarters, an increase of approximately 48% from the same nine-month period the previous year. In the third quarter, operating cash flow grew to its highest level in nearly five years.

Indeed, we believe that Chevron is well-positioned to continue paying steadily rising dividends for years to come. The dividend is one of its major financial priorities. Chevron maintained a debt ratio of 19% in the most recent quarter, with a long-term target of 20%-25% moving forward. A low level of debt will help improve the sustainability of the dividend payout.

Chevron's growth will come primarily from rising oil prices. In addition, new projects will fuel growth. Third quarter 2018 production was 2.96 million barrels per day, an increase of 239,000 barrels from the same quarter last year. Approximately 237,000 barrels of this production growth came from major capital projects, specifically the Wheatstone and Gorgon liquified natural gas project in Australia.

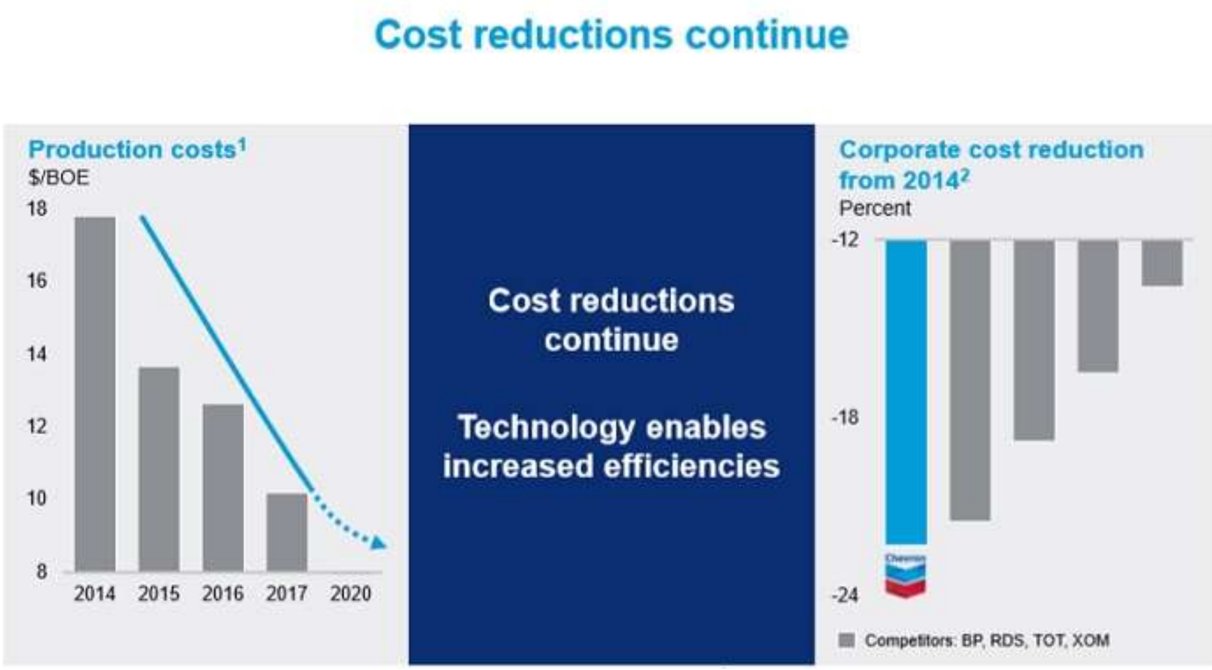
Shale production increased 155,000 barrels per day, primarily due to growth in the Midland and Delaware Basins, up 80% from the previous year.

Over the long run, we believe that growth of at least 5%-6% per year is likely for this high-quality company.

Competitive Advantages & Recession Performance

Chevron's competitive advantage in the highly-cyclical energy sector comes primarily from its size and financial strength . The company's operational expertise allowed it to successfully navigate during 2014-2016, one of the worst oil bear markets on record.

Chevron's aggressive cost-cutting efforts helped it maintain consistent profitability. Chevron reduced its capital expenditures and exploratory budget from ~$10 billion to ~$5 billion between fiscal 2014 and fiscal 2015. The company has continued to reduce drilling costs, making it more profitable even if oil prices do not get back to $100 per barrel.



Source: Investor Presentation

Chevron stacks up well among its peer in the energy sector. However, the company is certainly not the most recession-resistant Dividend Aristocrat, as evidenced by its performance during the 2007-2009 financial crisis:

- 2007 adjusted earnings-per-share: $8.77
- 2008 adjusted earnings-per-share: $11.67 (33% increase)
- 2009 adjusted earnings-per-share: $5.24 (55% decline)
- 2010 adjusted earnings-per-share: $9.48 (81% increase)

Chevron's adjusted earnings-per-share declined by more than 50% during the 2007-2009 financial crisis, but the company did manage to remain profitable during a bear market that drove many of its competitors out of business. This allowed Chevron to continue raising its dividend payment each year of the Great Recession.

Valuation & Expected Total Returns

Chevron's expected total returns are more difficult to assess than many of the companies we cover at Sure Dividend. This is primarily due to the fact that the company's current earnings situation seems lower than under a more normal oil price environment.

The company's long-term valuation history can be seen below:

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	7.3	13.4	8.2	7.5	8.1	10.9	11.9	39.4	---	29.4	***14.7***	***15.1***
Avg. Yld.	3.0%	3.8%	3.6%	3.1%	3.3%	3.2%	3.5%	4.4%	4.3%	3.9%	***3.8%***	***3.3%***

Note: The price-to-earnings ratio has come down to ~14 from 14.7.

Chevron is now trading at a price-to-earnings ratio of 14 using expected 2018 EPS of $8.09, which is slightly lower than its 10-year average of 15.1. As a result, shares of Chevron appear to be slightly undervalued right now. We believe the stock is likely to incur a modest 0.5% annualized boost due to valuation expansion over the next five years.

In addition, shareholder returns will be fueled by expected earnings growth of 5%-6% per year, along with the current dividend yield of 4.0%. In all, total expected returns are 10% per year for Chevron over the next five years. This is a strong expected rate of return for a high-quality Dividend Aristocrat.

Final Thoughts

Chevron is one of the rare oil and gas companies that was able to navigate through both the Great Recession of 2007-2009 and the oil downturn of 2014-2016, without cutting its dividend. It has even managed to grow its dividend, including a 4% increase in 2018.

Oil prices have reversed course in recent months, and have declined back toward $50 per barrel in the United States. Fortunately, Chevron has continued to lower its cost structure to handle lower commodity prices. New projects in the U.S. and international markets will also help the company continue to grow cash flow.

Chevron stock appears to be slightly undervalued, with a positive outlook that calls for total returns of approximately 10% per year. This makes Chevron stock a buy for long-term dividend growth investors.

Exxon Mobil (XOM)

Business Overview

In its early days, Standard Oil came to dominate the U.S. oil and gas industry. It did this with a laser-like focus on drilling innovation, production growth, and limiting costs.

Standard Oil was almost too successful—it grew at such a rapid pace that in 1911, it was dissolved by the U.S. Supreme Court on antitrust grounds. Standard Oil was broken up into 33 smaller companies, many of which became giants on their own, such as Chevron (CVX).

Many of the same business practices used by Standard Oil, are still used today by Exxon Mobil. Specifically, the company focuses on high-return projects that allow for profitable growth.

The company generates a high return on invested capital, a key measure of a management team's ability to effectively deploy capital. Exxon Mobil has consistently generated industry-leading returns on capital employed.

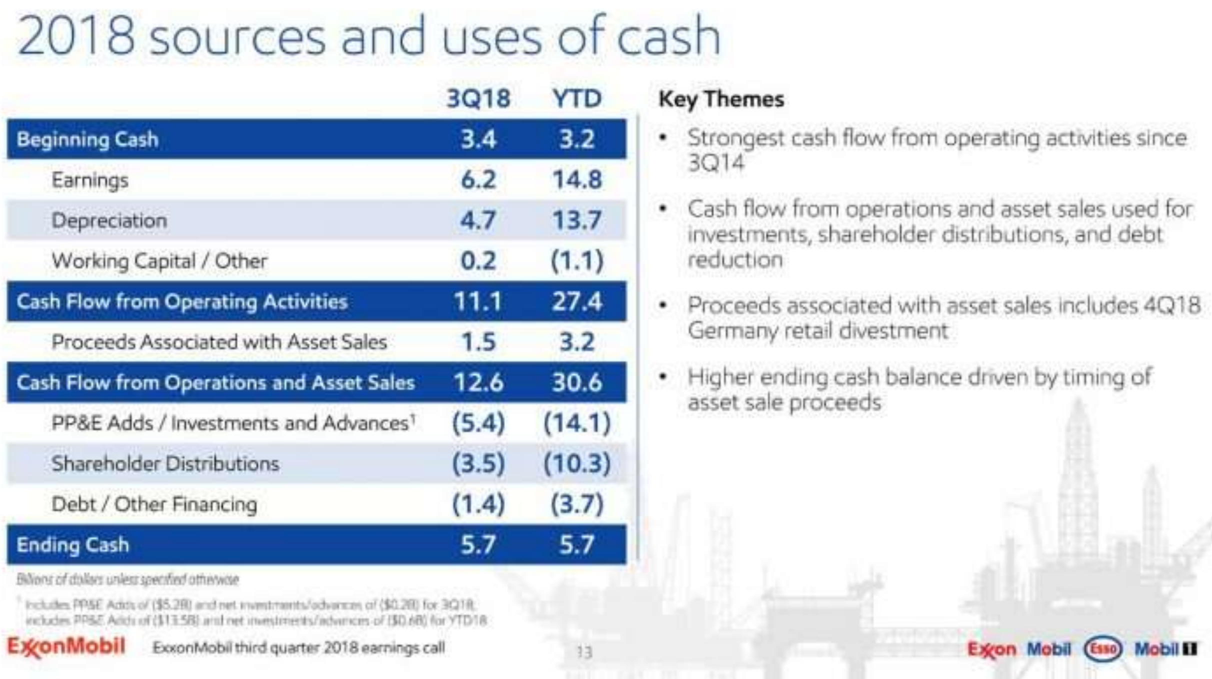
The company operates three large business segments. The Upstream segment includes oil and gas exploration and production. Downstream activities include refining and marketing. Manufactured chemicals include olefins, aromatics, polyethylene, and polypropylene plastics.

Growth Prospects

The climate for oil and gas majors remains challenged because oil prices are still down by roughly half from the peak levels of 2014.

Fortunately, Exxon Mobil is an integrated company. Its upstream and downstream businesses complement each other well and help insulate it from swings in the prices of commodities. Indeed, when oil and gas prices decline, upstream profits fall. But, downstream tends to benefit from sharp fluctuations in oil prices.

This helps Exxon Mobil's profits hold up relatively well compared with other oil and gas majors. Earnings-per-share have risen by 30% in the first three quarters of 2018 now that oil prices have stabilized in the area of $50.



Source: Earnings Presentation, page 13

The fact that ExxonMobil can operate so profitably in an environment of $40 to $50 speaks to how efficient it is.

Exxon Mobil has also boosted cash flow, thanks to its focus on cost discipline. After years of cutting capital expenditures when oil prices were the lowest, ExxonMobil has begun the process of rebuilding its spending. Capital expenditures are up 28% in the first three quarters of the year but are still quite low by historical standards. Capital spending during the peak oil days was still another ~50% higher than today's levels, so ExxonMobil hasn't lost its sense of discipline by any means.

Despite unfavorable oil pricing, ExxonMobil generated $12.6 billion in free cash flow in the first three quarters of the year. Keep in mind this is despite a nearly 30% increase in capital spending, which reduces free cash flow. This terrific result highlights how strong ExxonMobil's operating model is, even when oil prices don't necessarily cooperate.

This is more than enough to continue paying the dividend, which has cost about $10 billion over the first three quarters of the year.

Going forward, future earnings growth would be accelerated with higher oil and gas prices. But growth will also come organically from the company's long list of new projects. The Permian Basin is one of the strongest oil fields in the U.S., and is an area of high investment for Exxon Mobil.

Source: Earnings Presentation, page 18

Exxon Mobil has a massive project pipeline, consisting of more than 100 new projects. In addition to the Permian Basin, Exxon Mobil has significant international projects located in offshore Guyana, and Angola.

Production increases have been somewhat spotty in recent quarters as Exxon Mobil is now feeling the impact of lower capital expenditures in past years. However, production is set to rise in the coming years as its legacy projects contribute more and as some of its larger growth projects come online. Thanks to these factors, we expect a low single digit tailwind to production volumes in the coming years.

Competitive Advantages & Recession Performance

Exxon Mobil enjoys several competitive advantages, primarily its tremendous scale, which provides the ability to cut costs when times are tough.

It also has the financial strength to invest heavily in new growth opportunities. The company has allocated tens of billions of dollars in the past few years to capital expenditures to support future growth:

- 2014 capital expenditures of $33.0 billion
- 2015 capital expenditures of $26.5 billion
- 2016 capital expenditures of $16.2 billion
- 2017 capital expenditures of $15.4 billion

Another competitive advantage is Exxon Mobil’s industry-leading balance sheet. It has a credit rating of AA+, which helps it keep a low cost of capital.

Exxon Mobil’s integrated business model allows the company to remain profitable, even during recessions and periods of low commodity prices. The company saw volatility during the Great Recession, but still remained profitable:

- 2007 earnings-per-share of $7.26
- 2008 earnings-per-share of $8.66 (19% increase)
- 2009 earnings-per-share of $3.98 (54% decline)
- 2010 earnings-per-share of $6.22 (56% increase)

Continuing to generate steady profits allowed Exxon Mobil to keep raising its dividend each year.

Valuation & Expected Returns

Exxon Mobil appears to be somewhat overvalued today. We estimate earnings-per-share of $4.50 for 2018, implying a current price-to-earnings multiple of 16. That compares somewhat unfavorably to our fair value estimate of 13 times earnings. However, keep in mind that the company's earnings haven't yet recovered from the decline that began in 2015 as oil prices remain low by historical standards.

Thus, even modest increases in the prices of natural gas and oil could see Exxon Mobil produce sizable earnings growth. Indeed, we expect the company to produce nearly $8 per share in earnings by 2023, so the opportunity for growth is sizable. Given this, the somewhat high valuation probably makes sense.

Much of this depends on the direction of oil and gas prices, which are difficult to predict. To account for this uncertainty, investors may want to err on the side of caution when forecasting future earnings growth.

With that in mind, a potential breakdown of long-term returns is as follows:

- 11% annual earnings growth
- 4.6% dividend yield
- -4% valuation change

Exxon Mobil's operating earnings could reasonably increase by at least 8% each year. Adding in share repurchases could elevate total earnings growth to 11%. In this scenario, total returns would reach approximately 12% annually after accounting for the high current valuation, which we expect will moderate over time.

Of course, earnings growth is not likely to be this smooth, and is subject to change depending on oil and gas prices. Still, it appears that Exxon Mobil stock is poised to deliver strong returns to shareholders in the coming years.

Final Thoughts

Exxon Mobil has had a difficult past few years demonstrating that it is susceptible to falling oil and gas prices. However, it has performed better than most other energy stocks in this time frame.

And, Exxon Mobil has a bright future. The company has many promising new projects nearing completion, and it generates more than enough cash to continue raising the dividend.

As a result, Exxon Mobil stock appears attractive based on earnings growth and dividend growth potential.

Information Technology Dividend Aristocrats

Automatic Data Processing (ADP)

Business Overview

ADP is a business outsourcing services company. It was founded in 1949, and began with a single client. In the 70 years since, ADP has grown into the leading payroll and human resource outsourcing company. It has approximately 700,000 clients, in more than 110 countries worldwide.

ADP provides services including payroll, benefits administration, and human resources management, to companies of all sizes. ADP enjoys high demand for these services, as companies would prefer to outsource these functions in order to better focus on their core business activities.

Source: [Investor Day Presentation](), page 9

ADP has a leading position across its strategic pillars, as well as a highly diversified client list; no single customer represents more than 2% of annual revenue.

The company has undergone a significant restructuring in recent years. In 2014, ADP spun off its human capital management business, which now trades as CDK Global (CDK).

Its reshaped business model will place greater emphasis on helping clients streamline their business functions, by investing in cloud-based software as a growth initiative.

Growth Prospects

ADP has produced strong growth in recent years and we expect that will continue. The company recently reported fiscal 2019 Q1 earnings, which was another terrific quarter. Total revenue increased 8%, to $3.3 billion. Excluding the impact of currency exchange, organic revenue increased 7% for the first quarter.

Strength was seen in both of its business segments as Employer Services saw bookings rise 8%, while PEO (Professional Employer Organization) produced 9% growth in employees during the quarter. ADP also raised its revenue growth forecast for the fiscal year to 6% to 7% from the prior range of 5% to 7%.

Revenue growth, margin growth, a lower tax rate, and share repurchases combined to drive a staggering 28% gain in earnings-per-share in Q1.

Source: Earnings Slides, page 4

Both core segments performed well once again in Q1. Revenue increased 7% for Employer Services while PEO saw a 10% increase in the top line. In addition, margins rose significantly for both segments, increasing 260bps and 110bps, respectively, during what was an extremely productive first quarter.

For fiscal 2019, ADP is a bit more cautious as it has guided for 6% to 7% revenue growth. Employer Services is expected to contribute 4% to 6% and PEO was guided for 8% to 9% on a reported basis, while excluding zero-margin benefits pass-through revenue will bring segment growth down to 6% to 7%. Still, adjusted EBIT margin should rise 100bps to 125bps in fiscal 2019, helping to lead to 15% to 17% adjusted earnings-per-share growth during the year.

Two key growth catalysts for ADP are continued increases in payrolls, and regulation. First, as the economy continues to grow at a modest rate, businesses are adding employees. The number of employees on ADP clients' payrolls is forecast to increase by 2.5% in fiscal 2019, continuing years of steady growth.

Next, the increasingly complex regulatory environment creates significant compliance costs for businesses; this also helps provide ADP with steady growth. The company expects new business bookings to increase 6%-8% in the current fiscal year, in addition to a slightly higher customer retention rate.

Competitive Advantages & Recession Performance

ADP's growth is fueled by its competitive advantages, of which it has many. ADP has a deep connection with its customers, and enjoys a strong reputation for customer service, which helps keep customer retention very high.

ADP enjoys tremendous scale that its competitors cannot match. As a global company, ADP is uniquely positioned to help companies that have employees on multiple continents.

In addition, ADP benefits from a recession-resistant business model. ADP's earnings-per-share during the Great Recession are shown below:

- 2007 earnings-per-share of $1.83
- 2008 earnings-per-share of $2.20 (20% increase)
- 2009 earnings-per-share of $2.39 (8.6% increase)
- 2010 earnings-per-share of $2.39 (flat)

ADP increased earnings-per-share in 2008 and 2009, which is a rare accomplishment. The reason for ADP's continued growth during the Great Recession is that businesses still need payroll and human resource services. This helps insulates ADP from the effects of a recession.

Valuation & Expected Returns

ADP forecast adjusted earnings-per-share of approximately $5.26 for fiscal 2019. Based on the current share price, the stock has a price-to-earnings ratio of 25. This is a fairly rich valuation by most standards, and it is high by ADP's own historical norms as well. We see fair value for ADP at 20 times earnings, which is a meaningful discount to the current valuation. Indeed, should the stock return to its historical norm in terms of valuation, it would be a mid-single digit (-4.4%) headwind to total returns annually.

As a result, investors cannot rely on an expanding price-to-earnings ratio to fuel shareholder returns. Instead, future returns will be generated from earnings growth and dividends. The good news is that the company is growing at a high enough rate that it could help justify its current valuation.

We expect ADP to grow earnings-per-share by 8% annually over the next five years. In addition, the stock has a current dividend yield of 2.4%. The combination of a contracting P/E multiple, earnings growth, and dividends yields a total expected return of 6% per year through 2024.

ADP will almost certainly continue to increase its dividend for many years to come given that its fundamentals are so strong. ADP maintains a target payout ratio of 55%-60% of annual earnings, so the payout is always very safe with room to grow. The payout for fiscal 2019 is $3.16 per share. Based upon the forecast for earnings-per-share management provided, the payout ratio for this year should be right at 60%.

Final Thoughts

ADP is a strong business. The company maintains a large list of customers, and holds a top position in the industry. This gives it a wide economic "moat", a term popularized by investing legend Warren Buffett. Indeed, ADP's moat keeps competitors at bay, and leads to high profitability.

There should be plenty of growth going forward, both in terms of earnings and dividends. Regulations continue to increase and become more complex. And, as the economy expands, companies are adding employees and increasingly use ADP's services.

If a recession occurs, ADP should continue to increase its dividend, as customers will still need its services. Although ADP is a highly consistent dividend growth stock, its mid-single-digit expected total returns make the stock a hold.

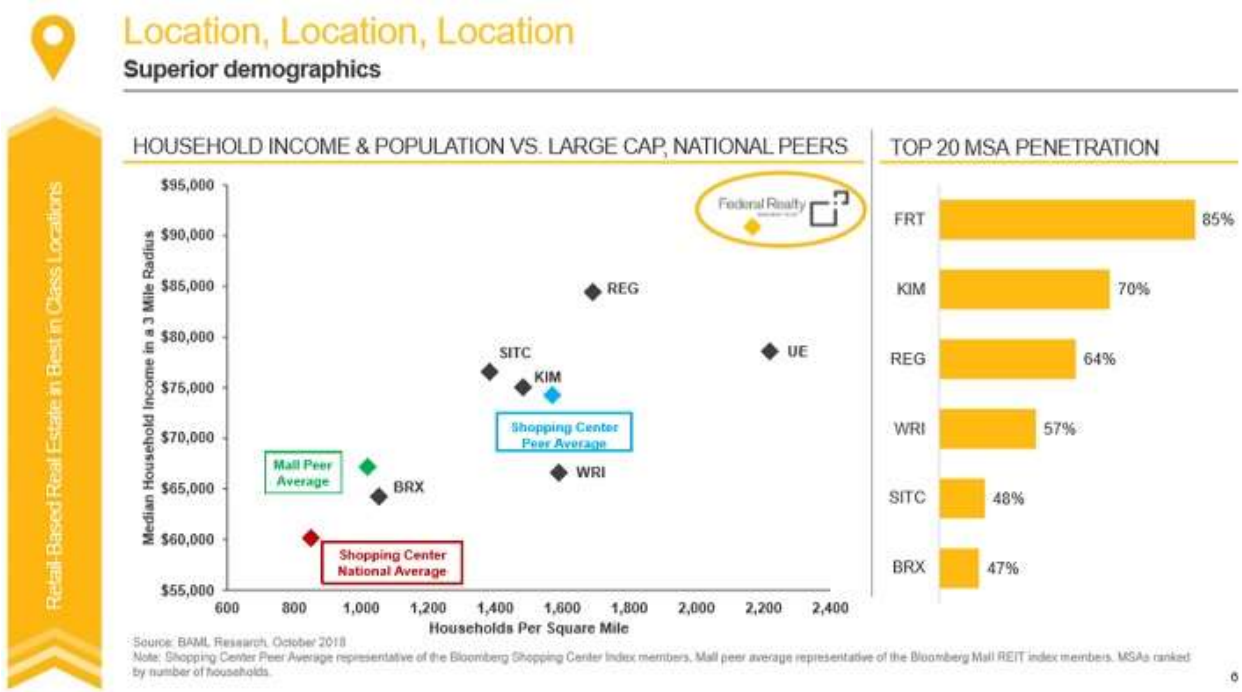
Real Estate Dividend Aristocrats

Federal Realty Investment Trust (FRT)

Business Overview

Federal Realty was founded in 1962. As a REIT, Federal Realty's business model is to own and rent out real estate properties. It uses a significant portion of its rental income, as well as external financing, to acquire new properties. This helps create a "snow-ball" effect of rising income over time.

Federal Realty primarily owns shopping centers. However, it also operates in redevelopment of multi-purpose properties including retail, apartments, and condominiums. The portfolio is highly diversified in terms of tenant base. No individual industry represents more than 9% of the portfolio, and no single tenant accounts for more than 3%. Federal Realty has a high-quality tenant portfolio.



Source: Investor Presentation, page 6

Federal Realty's retail portfolio is second to none in the industry in terms of average base rent, and consists of 105 properties. Approximately 95% of Federal Realty's properties were leased, as of the third quarter, which is consistent with recent results.

Its properties are geographically focused on the East and West coasts, and the trust now has properties in Miami and Chicago. Its major markets are Washington, D.C., New York, Philadelphia, Boston, San Francisco, and Los Angeles.

The trust's investment strategy is to pursue densely-populated, affluent communities, with high demand for commercial and residential real estate.

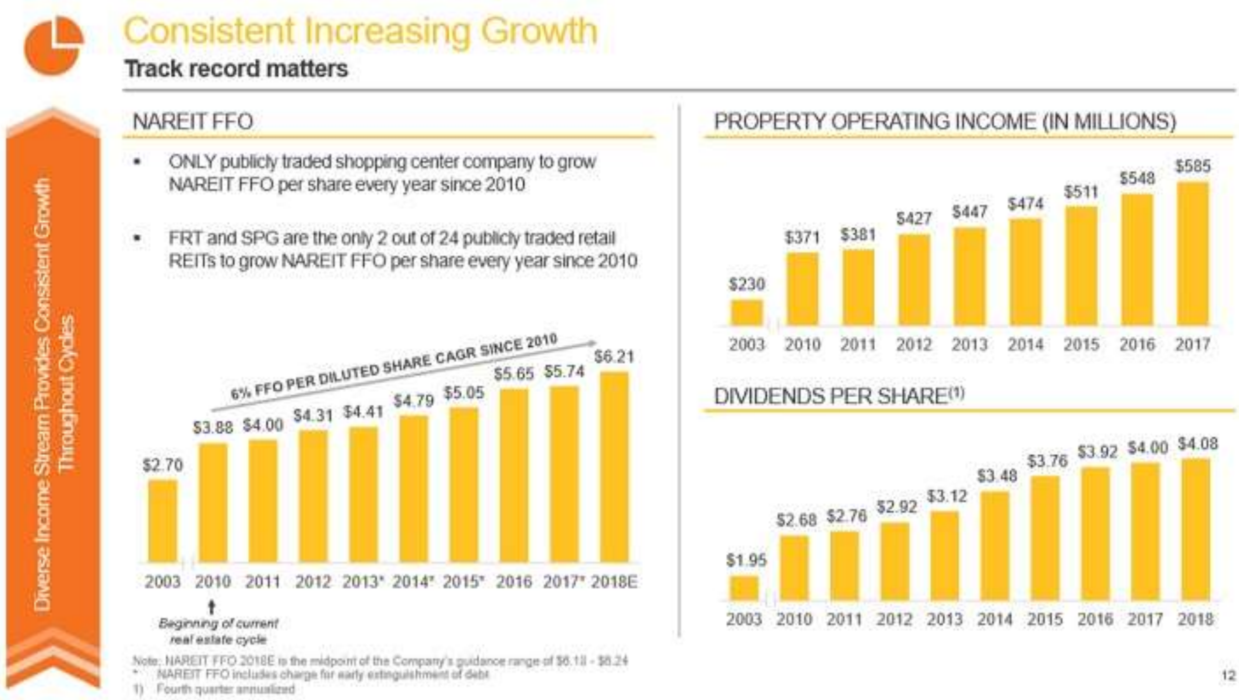
This strategy has fueled strong growth over the past several years.

Growth Prospects

Federal Realty's growth comes from new properties, and rental increases.

In 2017, Federal Realty grew funds from operation (otherwise known as FFO) by just 2%, to $5.74 per share, which was a record for the trust at the time. FFO is a non-GAAP financial metric that analyzes cash flow available for distributions.

However, since 2010, Federal Realty increased FFO by 6% per year, on average, which is more in line with our expected growth rate for the trust.



Source: [Investor Presentation](), page 12

Importantly, growth is back on track for 2018 with FFO expected to come in at $6.21 per share, or 8% higher than 2017.

Recent leasing activity is being completed at higher average rents than properties in the existing portfolio, which is a good sign that future rental income will grow.

2018's growth is being fueled by the familiar tailwinds of high occupancy and the trust rolling over leases at higher rates than before. This is leading to significant comparable property income growth, which is fueling higher FFO.

Last quarter, Federal Realty signed 101 leases, encompassing over 469,000 square feet of retail space. Not only is the trust keeping its occupancy rates high by reassigning its vacant properties, but it is doing so at ever-higher rates. Q3's leases were made at an average rate of $38.31 per square foot, compared with $36.22 last year. That represents cash basis rollover growth on comparable properties of 6%, but in the past 12 months, that number is even better at 12%.

New properties, therefore, should keep the “snowball effect” intact.

The trust expects FFO-per-share in a range of $6.18 to $6.24 for 2018. This would represent growth of 7.7%-8.7%, compared with 2017.

Competitive Advantages & Recession Performance

One way in which REITs establish a competitive advantage is through investing in the highest-quality portfolios. Federal Realty has done this by focusing on affluent areas of the country, where demand exceeds supply. This is also how it can continue to boost its cash basis rollover growth over time; it owns properties in the most desirable areas and tenants are willing to pay more.

Federal Realty benefits from a favorable economic backdrop, with high occupancy rates, and the ability to raise rents over time.

Another competitive advantage for Federal Realty is a strong balance sheet. The trust's senior unsecured debt holds a credit rating of A- from Standard & Poor’s, which is solidly investment-grade, and is a high rating for a REIT. Indeed, there are only five REITs with a "A" rating, with Federal Realty being one of them.

A strong balance sheet helps keep borrowing costs low, which is critical for the REIT business model.

These competitive strengths allowed Federal Realty to perform well during the last recession. Federal Realty’s FFO during the Great Recession is shown below:

- 2007 FFO-per-share of $3.63
- 2008 FFO-per-share of $3.87 (6.6% increase)
- 2009 FFO-per-share of $3.87 (flat)
- 2010 FFO-per-share of $3.88 (0.3% increase)
- 2011 FFO-per-share of $4.00 (3% increase)

FFO either held steady, or increased, during each year of the recession. This was a remarkable achievement, and speaks to the strength of the business.

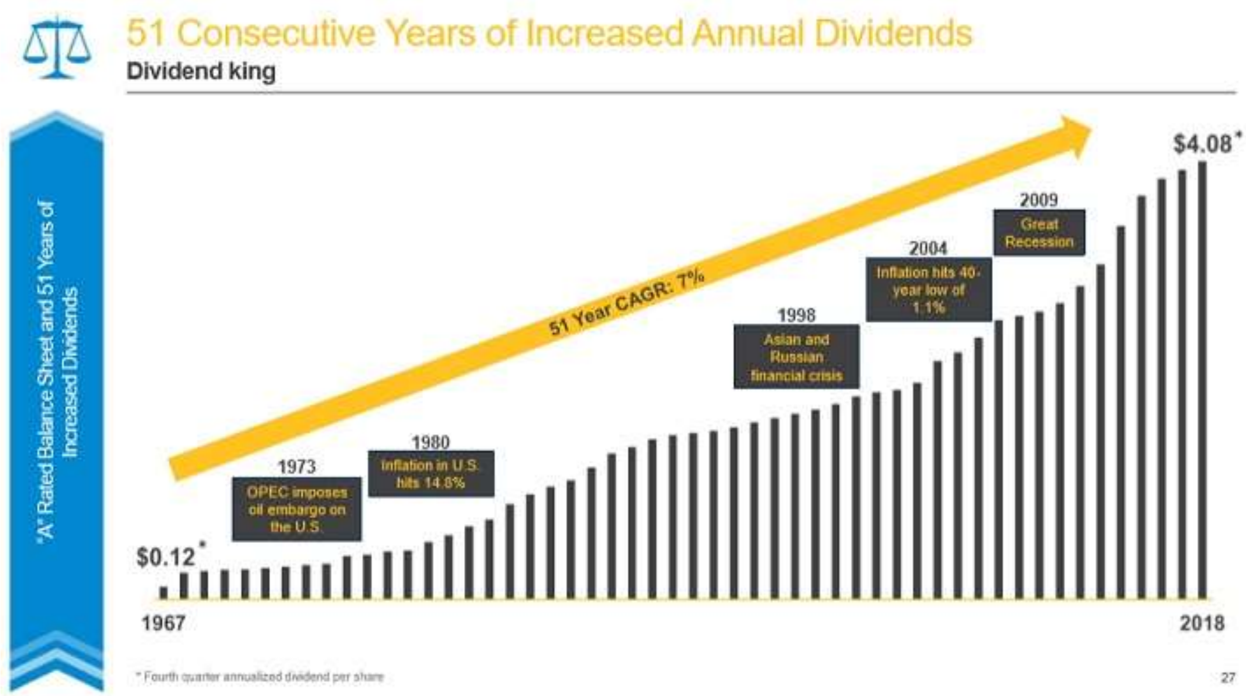
Valuation & Expected Returns

Based on 2018 FFO-per-share of $6.21, Federal Realty stock trades for a price-to-FFO ratio of 19.6. Investors can think of this as similar to a price-to-earnings ratio.

On a valuation basis, Federal Realty appears slightly undervalued. The trust has generally traded with a price-to-FFO ratio in the low 20s, and we expect it will again. Should the stock return to our forecast fair value of 22.6 times FFO, it would provide a ~3% tailwind to total annual returns.

Therefore, future returns will be comprised of a roughly congruent mix of FFO growth, valuation expansion, and dividends. In this scenario, total returns would reach approximately 11%-12% annually as the trust would see growth in its business while also enjoying a steady tailwind from a higher valuation.

The current dividend yield of 3.4% is a fairly low yield for a REIT. However, Federal Realty helps make up for this with strong dividend growth and its impeccable track record.



Source: Investor Presentation, page 27

It has increased its dividend for 51 years in a row, including a 3% raise for 2018.

And, the trust has increased its dividend at a consistently high rate. According to Federal Realty, it has maintained a 7% compound annual dividend growth rate, over the course of its 51-year streak.

The dividend appears quite secure. Federal Realty has a payout ratio of about 65% of FFO, and a manageable debt-to-EBITDA ratio of 5.4, which is a slight improvement upon 2017.

Final Thoughts

Investors flock to REITs for dividends, and with high yields across the asset class, it is easy to see why they are so popular for income investors.

We have compiled a list of 150+ REITs, that are worthy of further consideration, based on their dividend yields and dividend growth potential. You can see all 150+ REITs here.

Federal Realty does not have a high dividend yield, particularly for a REIT. This is because the stock consistently trades for a relatively high valuation. However, high-quality businesses tend to sport above-average valuations. Investors interested solely in receiving high income right now may not be impressed by Federal Realty. That said, it is a strong choice for dividend growth investors.

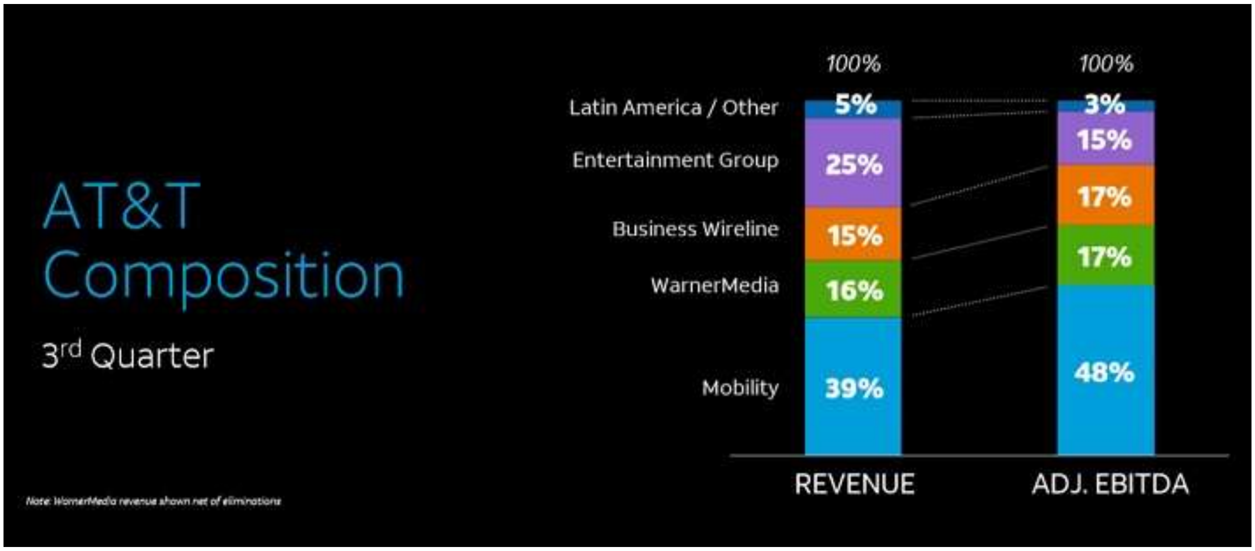
Telecommunication Services

AT&T Inc. (T)

Business Overview

AT&T is one of the largest providers of cable and satellite TV, wireless, and broadband service in the U.S. The company has provided telecom services for over 140 years. Today, it covers 99% of the U.S., and generates over $170 billion in annual revenue. AT&T stock has a market capitalization of $215 billion.

AT&T has a diversified business model across multiple telecom services, including both consumer and business customers.



Source: Analyst Meeting, page 5

Telecoms are an attractive industry for investors, because the biggest operators like AT&T are highly profitable, with huge levels of cash flow. And since consumers are so reluctant to give up their television, Internet, and wireless service, AT&T is highly profitable and possesses the ability to raise prices.

AT&T generated $19.5 billion of free cash flow in the past four reported quarters. In turn, such huge free cash flow fuels the high dividend payments that make telecommunications stocks such attractive selections for income investors.

Growth Prospects

The telecom industry is rapidly changing, and AT&T is changing along with it. Major telecommunications companies are making a big push into media, to have the ability to own content and distribution. Major deals that have come to pass include Comcast (CMCSA) acquiring the remaining 49% of NBCUniversal it didn't already own for $16.7 billion. Comcast also acquired Dreamworks for $3.8 billion, in 2016.

AT&T is following suit. Last year it acquired content giant Time Warner (TWX) in a massive $85 billion deal. The acquisition instantly made AT&T one of the major players in content. Time Warner has a number of valuable media properties including TNT, TBS, CNN, HBO, and Cinemax. It also owns the Warner Bros. movie studio.

Source: Time Warner Acquisition Presentation, page 6

By owning content and the technology on which it is delivered, AT&T can leverage its competitive advantages. It diversifies AT&T's revenue mix, and accelerates growth. In addition, as a provider and a buyer of content, adding Time Warner is a hedge against rising costs for content.

The acquisition has already boosted AT&T's growth. Total company revenue increased 15% for the period, while adjusted earnings-per-share increased 22% from the same quarter a year ago. The growth was fueled by the WarnerMedia segment, which grew revenue and operating income by 6.5% and 8.3%, respectively.

AT&T placed additional investments to maximize the monetization potential of its huge content library, specifically in advertising. AT&T recently acquired AppNexus for $1.6 billion and Otter Media, which will add to AT&T's online video services.

The company's dividend is well covered by both cash flows and earnings, which makes future dividend growth very likely.

Competitive Advantages & Recession Performance

One of the most important competitive advantages for AT&T is its network. It has invested billions to develop its network, which helps differentiate it from the competition. AT&T spent more than $140 billion on its network from 2002 to 2016, including spectrum acquisitions.

Because of these investments, AT&T is at the top of the U.S. telecom industry, along with Verizon, which is arguably the only other telecom that can compete on the same scale as AT&T. The concentration of the telecom industry helps drive AT&T's high profitability.

This provides AT&T with a wide economic "moat", a term popularized by legendary investor Warren Buffett. A wide economic moat indicates a company's durable competitive advantages.

Such a strong competitive position allowed AT&T to remain profitable, even during the Great Recession. AT&T's earnings-per-share during the Great Recession are as follows:

- 2007 earnings-per-share of $2.76
- 2008 earnings-per-share of $2.16 (22% decline)
- 2009 earnings-per-share of $2.12 (1.8% decline)
- 2010 earnings-per-share of $2.29 (8% increase)

AT&T's earnings-per-share declined during the Great Recession, which should be expected. Discretionary expenses like cable TV are one of the things consumers might cut out of their budgets when the economy enters a recession.

That said, AT&T remained highly profitable during the recession, and returned to growth in 2010. This allowed it to continue raising its dividend each year.

Valuation & Expected Returns

Based on 2018 expected adjusted earnings-per-share of $3.50, AT&T stock trades for a price-to-earnings ratio of just 8.7. This is a fairly low price-to-earnings ratio, considering the S&P 500 Index currently sports an average price-to-earnings ratio above 19. As a result, AT&T stock appears to be significantly undervalued. If AT&T's price-to-earnings ratio reverts to the fair value estimate of 13.4, shares would return approximately 9.0% per year just from expansion of the valuation multiple.

In addition, total returns will be supplemented by earnings growth and dividends. AT&T can reasonably be expected to grow earnings by 6% per year over the next five years. Plus, the stock has a current dividend yield of 6.7%. As a result, total returns are expected to reach 21.7% per year over the next five years.

Final Thoughts

AT&T has made a number of strategic decisions to position itself for future growth. In addition to its various acquisitions over the past year in media content and advertising, the company is investing heavily in 5G network technology. It seems apparent that AT&T has plenty of avenues for future growth in the years ahead.

In the meantime, AT&T stock has a very low valuation, along with a high dividend yield. AT&T's dividend yield exceeds 6% and the dividend is highly secure thanks to the company's strong profits and cash flow. This creates a favorable buying opportunity for value and income investors.

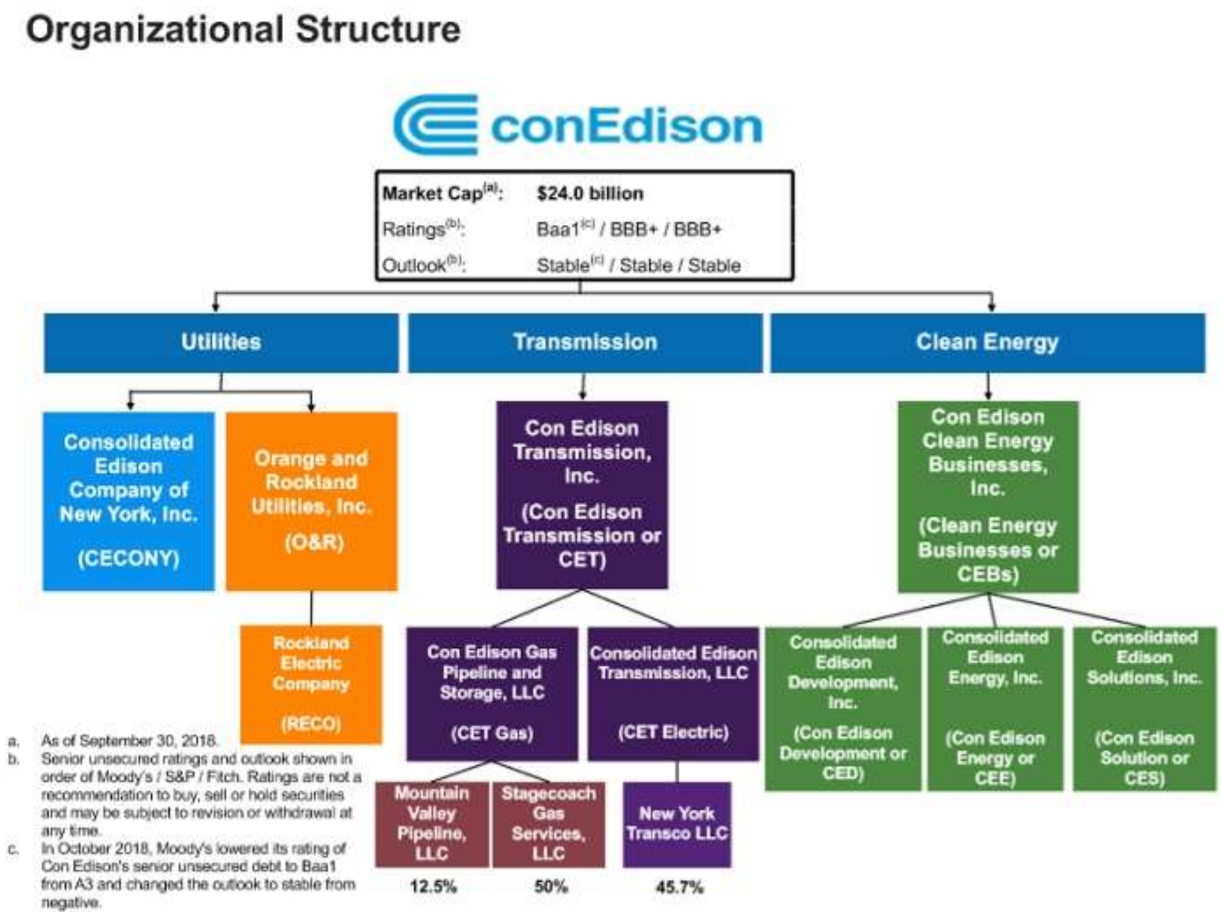
Utilities Dividend Aristocrats

Consolidated Edison (ED)

Business Overview

Consolidated Edison is a large-cap utility. The company generates approximately $12 billion in annual revenue, and has $50 billion in assets.

The company serves over 3 million electric customers, and another 1 million gas customers, in New York. It operates electric, gas, steam transmission, and green energy businesses.



Source: Earnings Presentation, page 5

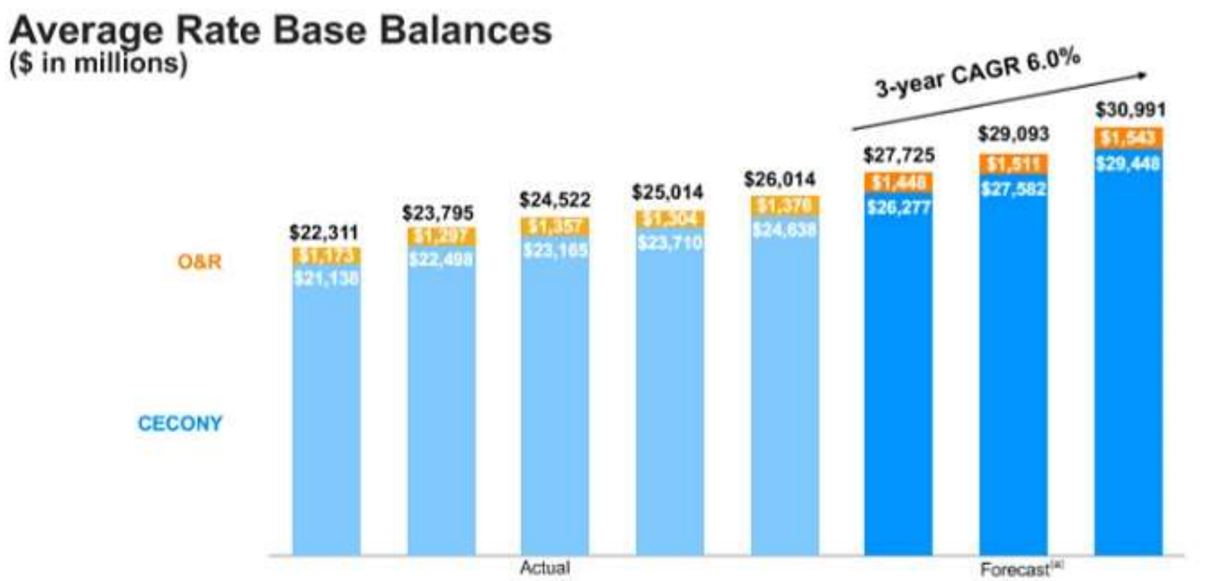
It should come as no surprise that Consolidated Edison generated steady growth over the course of 2018. Adjusted earnings-per-share increased 7% in both the 2018 third quarter, and over the first three quarters of the year combined.

Consolidated Edison should continue to generate modest earnings growth each year, through a combination of new customer acquisitions and rate increases.

Growth Prospects

Earnings growth across the utility industry typically mimics GDP growth. Over the next five years, we expect Consolidated Edison to increase earnings-per-share by 3.5% per year.

The growth drivers for Consolidated Edison are new customers and rate increases. One benefit of operating in a regulated industry is that utilities are permitted to raise rates on a regular basis, which virtually assures a steady level of growth.



		2013	2014	2015	2016	2017	2018E	2019E	2020E
CECONY	Electric	$ 16,235	$ 17,403	$ 17,599	$ 17,971	$ 18,513	$ 19,530	$ 20,277	$ 21,569
	Gas	3,395	3,593	4,023	4,267	4,723	5,395	6,005	6,629
	Steam	1,508	1,502	1,543	1,472	1,402	1,352	1,300	1,250
O&R	Electric	633	726	769	731	759	792	814	821
	Gas	345	372	386	362	392	422	444	454
RECO	Electric	195	199	202	211	225	234	253	268

Source: Earnings Presentation, page 23

In 2017, the company received approval for rate base plans over the next three years, in both the electric and gas delivery segments. Consolidated Edison expects to increase its rate base by 6% each year, through 2020.

One potential threat to future growth is rising interest rates, which could increase the cost of capital for companies that utilize debt, such as utilities. Fortunately, Consolidated Edison is in strong financial condition. It has an investment-grade credit rating of BBB+, and a modest capital structure with balanced debt maturities over the next several years.

A healthy balance sheet and strong business model help provide security to Consolidated Edison's dividends.

Competitive Advantages & Recession Performance

Consolidated Edison's main competitive advantage is the high regulatory hurdles of the utility industry. Electricity and gas service are necessary and vital to society. As a result, the industry is highly regulated, making it virtually impossible for a new competitor to enter the market. This provides a great deal of certainty to Consolidated Edison.

In addition, the utility business model is highly recession-resistant. While many companies experienced large earnings declines in 2008 and 2009, Consolidated Edison held up relatively well. Earnings-per-share during the Great Recession are shown below:

- 2007 earnings-per-share of $3.48
- 2008 earnings-per-share of $3.36 (3% decline)
- 2009 earnings-per-share of $3.14 (7% decline)
- 2010 earnings-per-share of $3.47 (11% increase)

Consolidated Edison’s earnings fell in 2008 and 2009, but recovered in 2010. The company still generated healthy profits, even during the worst of the economic downturn. This resilience allowed Consolidated Edison to continue increasing its dividend each year.

Valuation & Expected Returns

Consolidated Edison is expected to generate adjusted earnings-per-share of $4.25 in 2018. Based on this, the stock trades for a price-to-earnings ratio of 17.8, which is above our fair value estimate of 15.4. The fair value estimate is equal to the 10-year average price-to-earnings ratio for the stock.

As a result, Consolidated Edison shares appear to be overvalued. If the stock valuation retraces to the fair value estimate, the corresponding multiple contraction would reduce annual returns by 2.9%. This could be a significant headwind for future returns.

Fortunately, the stock could still provide positive returns to shareholders, through earnings growth and dividends. We expect the company to grow earnings by 3.5% per year over the next five years. In addition, the stock has a current dividend yield of 3.8%.

Putting it all together, Consolidated Edison's total expected returns are 4.4% per year over the next five years. This is a decent expected rate of return for a utility, which are typically bought primarily for their dividends.

Income investors will not be disappointed with Consolidated Edison. It has an attractive 3.8% yield and a highly secure payout. The company has a projected 2018 payout ratio below 70%, which indicates a sustainable dividend.

However, growth investors or those looking for a higher rate of return are likely not attracted to Consolidated Edison stock.

Final Thoughts

Consolidated Edison stock is slightly overvalued currently, making it relatively unattractive for value investors today.

That said, Consolidated Edison can still serve a valuable purpose in an income investor's portfolio. The stock offers secure dividend income, and its 3.8% dividend yield exceeds the 2% average dividend yield of the S&P 500 Index. Consolidated Edison is also a Dividend Aristocrat, and should raise its dividend each year.

As a result, Consolidated Edison stock is still worth considering for retirees.