Market Commentary Monday, February 10, 2020

February 10, 2020

EXECUTIVE SUMMARY

Errata – Microsoft Yield is 1.1%
Newsletter Buys – 3 Stocks Purchased on Thursday
Week in Review – Great Five Days of Trading
Coronavirus – More Perspective; Fed Comments
Econ News – Very Good Numbers
Reasons for Optimism, – Interest Rates, Dividends, Earnings
Trump Impeachment & Stocks – 12% Gain in the S&P since 09.24.19
Stock News – Updates on GOOG, ZBH, ETN, MCK, RCL, STX, DIS, PRU, SIEGY, BIIB, MRK, GM, SNY, TPR, CAH, TSN, BHE, NOV, NLOK

Market Review

A little housekeeping is in order before this week's missive. One of our intrepid readers pointed out just minutes after your Editor hit send on the email of Friday's *Sales Aler*t that there was a big typo in the metrics detailed for **Microsoft** (MSFT – $183.89). Alas, the software giant is NOT yielding a spectacular 112%…the correct yield is 1.1%. Apologies for the error…can only chalk it up to the difficulties of parting with a portion of one of our long-time core holdings.

We trust that readers have had a chance to peruse the February edition of *The Prudent Speculator*. As discussed therein, we picked up three stocks for our newsletter portfolios on Thursday, buying 68 shares of **Juniper Networks** (JNPR – $23.76) at $23.2343 for Buckingham Portfolio; 872 **New York Community Bancorp** (NYCB – $11.13) at $11.46 for Millennium Portfolio and 1009 **Kimco Realty** (KIM – $19.62) at $19.82 for PruFolio.

It was a crummy Friday (the Dow Jones Industrial Average tumbled 277 points, or 0.94%) that capped an otherwise terrific week in which the widely watched benchmark enjoyed an impressive +2.99% price return over the full five days of trading. Incredibly, the big rally came on the heels of a coronavirus-fear-induced sizable 2.53% setback the week prior, even as the headlines associated with the contagious disease have not exactly shown much in the way of improvement.

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Big Weekly Dow Moves

Illustrating again that volatility is not unusual, the DJIA jumped 2.99% in price over the week ended 2.7.20 after skidding 2.53% the week prior. The former has happened 370 times previously and the latter 473 times.

Up 2.99%

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	2000's	2010's	2020's	Totals
Years Ending in 0		8	5	2	2	6	6	4	7	3	1	44
Years Ending in 1		12	2	2	1	2	3	6	8	8		44
Years Ending in 2		18	3	0	2	1	7	3	6	2		42
Years Ending in 3		18	1	0	1	6	4	1	3	2		36
Years Ending in 4		6	1	3	0	8	3	2	1	2		26
Years Ending in 5		4	1	1	0	10	2	1	1	3		23
Years Ending in 6		4	3	1	2	2	5	5	1	3		26
Years Ending in 7		6	1	0	2	2	7	5	2	0		25
Years Ending in 8	11	14	1	1	2	5	4	6	9	3		56
Years Ending in 9	13	5	0	0	3	2	4	8	11	3		49
Totals	24	95	18	10	15	44	45	41	49	29	1	371

From 12.31.27 though 02.07.20. Weeks of index price return gains of more than 2.99%. SOURCE: Kovitz Investment Group using data from Bloomberg

Down 2.53%

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	2000's	2010's	2020's	Totals
Years Ending in 0		15	7	3	6	4	6	10	10	6	1	68
Years Ending in 1		27	9	2	0	4	5	2	8	7		64
Years Ending in 2		22	2	0	5	1	5	0	9	2		46
Years Ending in 3		11	3	1	2	12	2	0	3	0		34
Years Ending in 4		11	0	1	0	16	8	6	2	4		48
Years Ending in 5		3	0	3	1	4	0	0	3	6		20
Years Ending in 6		4	7	4	6	2	5	1	3	1		33
Years Ending in 7		11	2	5	2	3	8	5	4	0		40
Years Ending in 8	5	11	4	0	2	6	7	7	15	9		66
Years Ending in 9	16	8	1	0	6	3	4	6	9	2		55
Totals	21	123	35	19	30	55	50	37	66	37	1	474

From 12.31.27 though 02.07.20. Weeks of index price return drops of more than 2.53%. SOURCE: Kovitz Investment Group using data from Bloomberg

Indeed, late on Friday, *CNN.com* was reporting, "Mainland China had its deadliest day in the coronavirus outbreak Friday, with authorities reporting 86 fatalities from the pneumonia-like illness that is paralyzing much of the country…A total of 722 people had died from the virus and 34,546 were infected in mainland China by the end of Friday, China's National Health Commission said. The majority of new cases were recorded in Hubei province and its capital, Wuhan, the epicenter of the outbreak."

Not trying to minimize the severity of the coronavirus concern, especially given the terrifying quarantines ongoing in Wuhan and other parts of China, not to mention the cruise ship that has turned into a "floating prison," but it was interesting that the same *CNN.com* website offered a Trending tab on its home page titled "Flu Season." Clicking on that tab sent the user to a "Flu is Widespread Across the U.S." story, which offered some perspective-inducing data: "The CDC estimates that this flu season, which started on September 29, there have been at least 22 million cases of the illness in the US, 210,000 hospitalizations and 12,000 deaths."

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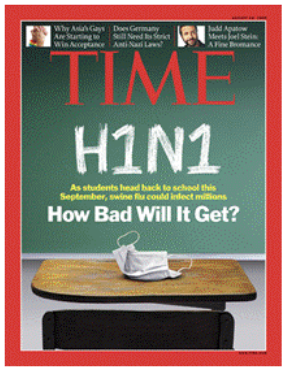
THE PRUDENT SPECULATOR
Viruses Have Yet to Kill the Stock Market

September 29, 2014

February 17, 2020



August 24, 2009

September 26, 2005

May 5, 2003

July 4, 1983

Though there undoubtedly will be more scary coronavirus headlines, we continue to believe that the danger will eventually pass, even as we concede that the virtual shutdown of a large part of China will have an impact on the global economy. The Federal Reserve acknowledged as much in its *Monetary Policy Report submitted to the Congress on February 7, 2020, pursuant to section 2B of the Federal Reserve Act*.

The section of the report on *Economic Growth* stated: "Real gross domestic product (GDP) is reported to have increased at a moderate rate in the second half of 2019, although growth was somewhat slower than in the first half of the year and in 2018. Consumer spending rose at a moderate pace, on average, and residential investment turned up after having declined in 2018 and the first half of 2019. In contrast, business fixed investment declined in the second half of last year, reflecting a number of factors that likely include trade policy uncertainty and weak global growth. Downside risks to the U.S. outlook seem to have receded in the latter part of the year, as the conflicts over trade policy diminished somewhat, economic growth abroad showed signs of stabilizing, and financial conditions eased. More recently, possible spillovers from the effects of the coronavirus in China have presented a new risk to the outlook."

The future is obviously uncertain, but the U.S. economic data out last week was very good, especially relative to expectations. The weak factory sector received some much-needed good

news, thanks to a surprising improvement in the Institute for Supply Management's (ISM) Manufacturing Index,…

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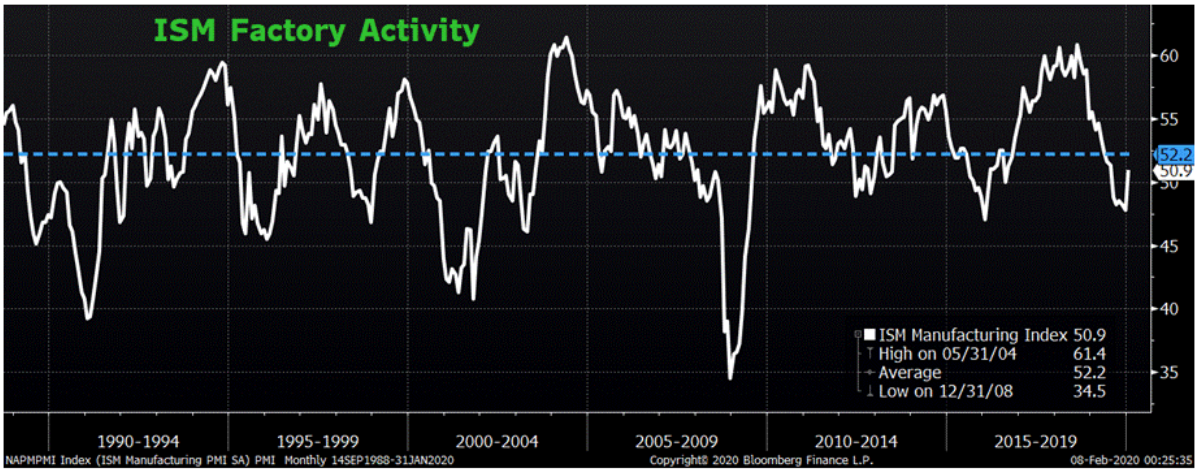
ISM Manufacturing = 2.4% GDP Growth

The latest read on the health of the manufacturing sector jumped to 50.9 in January. The measure was much better than expected and indicated a return to growth in the factory sector, while the Institute for Supply Management stated, "The past relationship between the PMI and the overall economy…corresponds to a 2.4% increase in real gross domestic product (GDP) on an annualized basis."



…while the ISM Non-Manufacturing Index gave a relatively healthy reading for the much-larger services sector.

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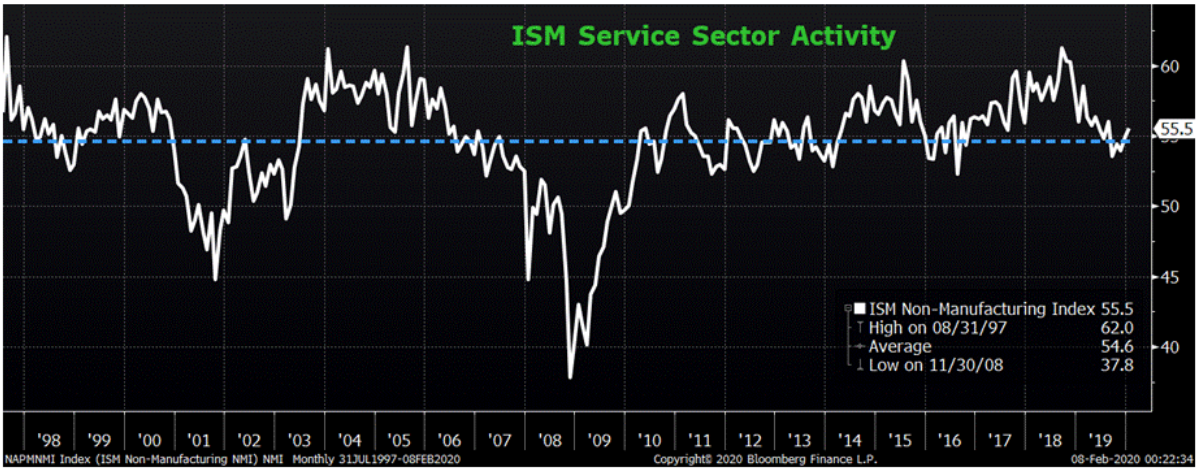
THE PRUDENT SPECULATOR
ISM Non-Manufacturing Climbs Again

The January reading on the health of the service sector (NMI) came in better than expected at 55.5, above the historical norm, and a signal of growth in the non-manufacturing economy, with the Institute for Supply Management stating, "The past relationship between the NMI and the overall economy…corresponds to a 2.4% increase in real gross domestic product (GDP) on an annualized basis."



And, the all-important monthly Employment Situation Report showed a robust numbers of new jobs created,…

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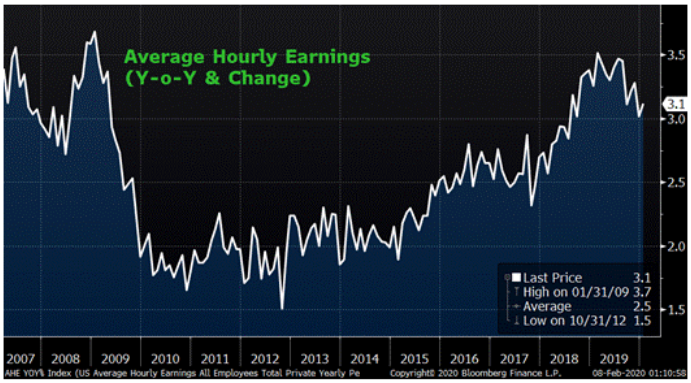
Very Good Employment Report



The number of new jobs created during January soared past estimates and nearly doubled the historical average, coming in at 225,000. The December tally was revised lower by 13,000, but the report was surprisingly strong and the annual gain in average hourly earnings inched up to 3.1%, slightly higher than projected, though continuing to suggest that inflation in the labor market remains in check.

…while the number of first-time filings for jobless benefits sank in the latest week to the lowest month-end figure in more than five decades.

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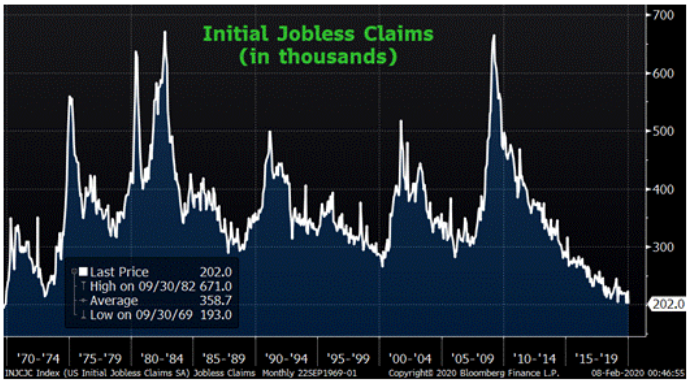
THE PRUDENT SPECULATOR
Near Historic Lows in Jobless Numbers



The jobs number in January came in well above forecasts, but the unemployment rate ticked up to 3.6%, still near a 50-year low, as more people were looking for work and the labor participation rate rose to 63.4%. And, the latest figures on initial claims for unemployment benefits saw just 202,000 new filings, still near lows last seen back in December 1969, when the workforce was significantly smaller than it is today.

Clearly, the bond market is of the mind that economic growth will remain subdued, given that interest rates have tumbled thus far in 2020, but we will continue to argue that income offered on fixed income investments is of little competition to yields on stocks,…

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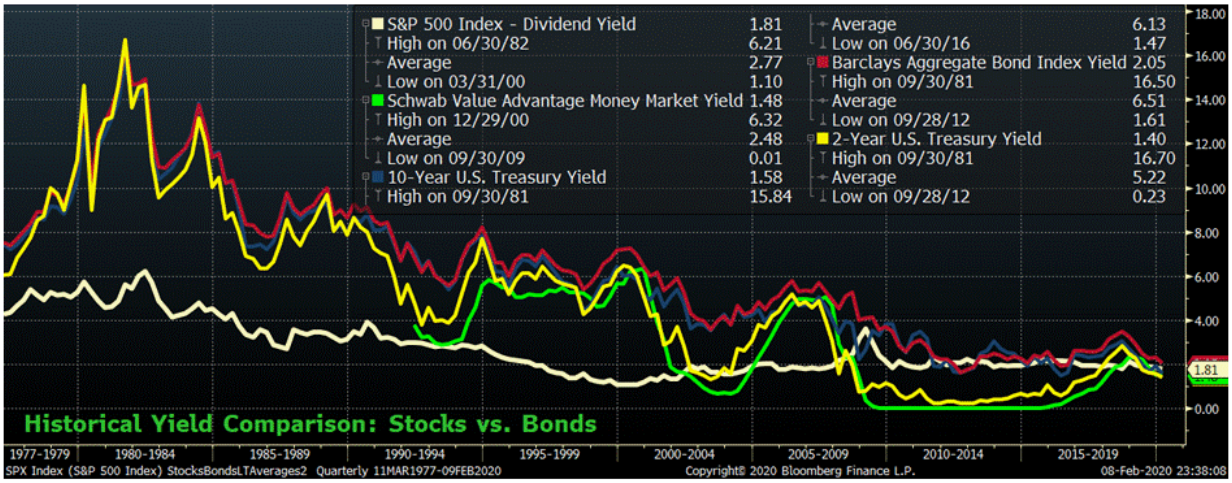
Equity vs. Fixed Income Yields

Though stocks are not necessarily a substitute for bonds, U.S. Treasuries and money market funds, the current payout on the S&P 500 (1.81%) is still very generous versus the income provided by fixed income, especially given the recent plunge in rates. And, the comparisons to the average yields for all of the securities below very much favors equities.



…especially when dividend payments, unlike most bond coupons, have been growing and are likely to continue to grow,…

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THE PRUDENT SPECULATOR
Dividends Provide Handsome Income

While dividends are never guaranteed, the historical evidence suggests that Corporate America has a long history of raising quarterly payouts, whereas the coupons on most debt instruments are fixed.

COUNT OF S&P 500 DIVIDEND ACTIONS	INCREASES	INITIATIONS	DECREASES	CESSATIONS
2019	355	6	7	0
2018	374	6	3	0
2017	351	5	9	2
2016	344	7	19	2
2015	344	7	16	3
2014	375	8	8	0
2013	366	15	12	0
2012	333	15	11	1
2011	320	22	5	0
2010	243	13	4	1
2009	151	6	68	10
2008	236	5	40	22
2007	287	11	8	4
2006	299	6	7	3

Source: Standard & Poor's.

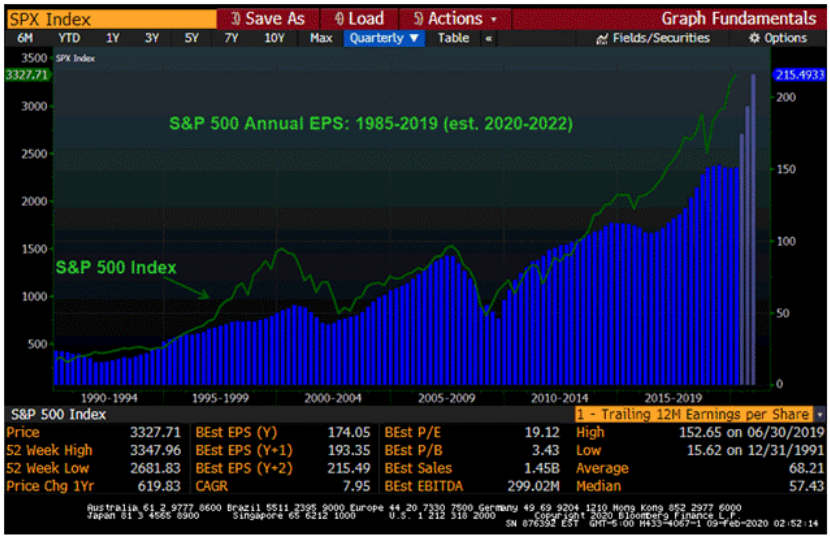
S&P 500 DIVIDENDS PER SHARE	
2021 (Est.)	$66.14
2020 (Est.)	$62.94
2019	$58.69
2018	$53.86
2017	$50.47
2016	$46.73
2015	$43.49
2014	$39.44
2013	$34.99
2012	$31.25
2011	$26.43
2010	$22.73
2009	$22.41
2008	$28.39
2007	$27.73

Source: Bloomberg. As of 2.7.20

…given that corporate profits are expected to continue to head in a northerly direction.

Growing Black Ink for Corporate America

Certainly, we understand that analysts are often overly optimistic in their projections, but solid year-over-year earnings expansion is expected in '20, with further growth likely in '21 and '22.



S&P 500 Earnings Per Share

Quanter Ended	Bottom Up Operating EPS 3 Month	Bottom Up Operating EPS 12 Month
ESTIMATES		
12/31/2021	$50.95	$194.23
9/30/2021	$50.35	$189.34
6/30/2021	$48.15	$184.56
3/31/2021	$44.78	$179.55
12/31/2020	$46.06	$174.59
9/30/2020	$45.57	$167.71
6/30/2020	$43.14	$161.95
3/31/2020	$39.82	$158.95
12/31/2019	$39.18	$157.12
ACTUAL		
9/30/2019	$39.81	$152.97
6/30/2019	$40.14	$154.54
3/31/2019	$37.99	$153.05
12/31/2018	$35.03	$151.60
9/30/2018	$41.38	$150.42
6/30/2018	$38.65	$140.37
3/31/2018	$36.54	$132.23
12/31/2017	$33.85	$124.51
9/30/2017	$31.33	$118.56
6/30/2017	$30.51	$115.92
3/31/2017	$28.82	$111.11
12/31/2016	$27.90	$106.26

Source: Standard & Poor's. As of 1.31.20

To be sure, with plenty of U.S. companies either selling into the Chinese market or manufacturing their products in the Middle Kingdom, the near-term earnings outlook is questionable. Of course, the coronavirus headwind is being offset to some degree by the ratcheting back of tariffs on both sides of the skirmish. Last week, Beijing confirmed that it would cut in half tariffs on $75 billion of U.S. imports starting on Valentine's Day. The U.S. will do the same, lowering tariffs on $120 billion in Chinese goods.

So, with the reminder that there will always be issues about which to be concerned,…

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Trump Impeachment Equity Rally

With the Senate voting on February 5, 2020, to acquit President Trump on both articles of impeachment, the inquiry that was announced by House Speaker Nancy Pelosi on Sept. 24, 2019, came to an end. No doubt, impeachment is a serious matter, even as few thought conviction would be the outcome, but the equity markets advanced more than 12% during the four-and-one-half-months of Washington drama.

…we remain optimistic about the long-term prospects of the stocks that we believe to be undervalued in our broadly diversified portfolios.

Stock Updates

Jason Clark, Chris Quigley and Zack Tart take a look at 19 of our companies that were out with news last week of sufficient importance to trigger a review of their review of their respective Target Prices. Note that all stocks are rated as a "Buy" until such time as they are a "Sell," while a listing of all current recommendations is available for download via the following link: https://theprudentspeculator.com/dashboard/.

Search engine and internet technology leader **Alphabet** (GOOG – $1,479.23) earned $14.89 per share in fiscal Q4 2019 (vs. $12.50 est.). GOOG had revenue of $37.6 billion, versus the $38.4 billion estimate. Shares tumbled 2.5% following the announcement but gained 3.2% for the week as a part of the wider market rally.

CEO Sundar Pichai explained, "Overall, in 2020, our teams at Google are focusing on 4 key things. First, creating the most helpful products for everyone. We are really focused on ensuring that our products like Search, Maps and Assistant are helping people in their daily lives. Second, providing the most trusted experiences for our users. We are doing lots of work to keep

improving users' privacy and security while also keeping harmful content off our systems. Third, executing at scale. This will show up as more seamless products across various surfaces and platforms like the Google Assistant, deeper partnerships and better use of our shared infrastructure. For example, Activision Blizzard recently chose Google as a strategic partner, using Google Cloud's computing infrastructure, YouTube for live streaming and our AI tools. Putting together these multiproduct partnerships helps us unlock great opportunities for our partners. And fourth, creating sustainable value. This means optimizing our usage of computing resources and also growing business opportunities in areas like YouTube, Cloud, Play, Hardware and beyond."

CFO Ruth Porat added, "In the fourth quarter, we repurchased $6.1 billion of shares, which was more than double the amount of repurchase in the fourth quarter of 2018. As of year-end, we had $21 billion remaining in the program and are focused on executing on the remaining authorization at a pace that is at least consistent with what you saw in the fourth quarter. We remain very confident about the opportunities across Alphabet and in our ability to continue to deliver at the steady pace."

While total cost of revenue and traffic acquisition costs (TAC) have crept up, with the former rising to $21 billion, an increase of 17% year-over-year, we think GOOG has reasonable valuation metrics compared to its peer group (including a forward P/E of 23.5, with adjusted EPS expected to grow from $43.00 in 2017 to $72.22 in 2021) and a terrific balance sheet ($105 billion in net cash or $150 per share). While Alphabet still doesn't pay a dividend, we see the big share buyback as a near-equal. Our Target Price now stands at $1,679.

Medical equipment and device maker **Zimmer Biomet Holdings** (ZBH – $156.39) reported solid Q4 results, capping off a much-improved 2019, and the stock ended last week up more than 5%. Zimmer posted adjusted EPS of $2.30 on revenue of $2.13 billion, versus consensus analyst estimates of $2.27 and $2.11 billion, respectively. Key drivers in the quarter included solid performance in the Americas and Asia, with continued momentum in the company's global Knee and Hip businesses. We were pleased to see that ZBH's underlying organic revenue growth (adjusting for selling days and comps) improved in every quarter during 2019. Further, we liked that the company generated $1.06 billion in free cash flow last year.

"In 2019 we continued to successfully execute our plan to reposition the company for success, driven by our global team's focus on our One ZB mission and culture," said CEO Bryan Hanson. "We continued to invest for growth and drove improved performance in 2019, especially in the second half of the year. We are operating from a position of strength for 2020 and beyond. I am proud of the entire ZB team and their unyielding commitment to the ZB mission and bettering the lives of patients around the world."

Management said that it believes the company will be able to achieve constant currency revenue growth of 2.5% to 3.5% and adjusted EPS of $8.15 to $8.45 in 2020.

Even with the solid performance over the last year for the stock, we still like ZBH, as it is the king of hip and knee implants, with the largest share of surgeons trained on its instrumentation where switching costs are high. Additionally, we believe favorable demographics, which include

aging Baby Boomers and (unfortunately) high obesity rates, will drive solid demand for large-joint replacement over the coming years. While ZBH shares currently trade at 18.8 times NTM adjusted EPS expectations, the multiple is still materially lower than the average of its key competitors of 27.8. Our Target Price has been lifted to $179.

Power management firm **Eaton Corp** (ETN- $101.96) released Q4 results last week that sent the shares rallying over 6% through Friday. Earnings per share in the quarter of $1.46 topped analyst estimates of $1.41 on revenue of $5.24 billion. Full-year earnings grew over 6% while revenue declined modestly year-over-year. Margins were above the high end of management's guidance range and 40 basis points above the prior year.

Management has been busy transforming the company's portfolio of late, closing the acquisition of Souriau-Sunbank and the sale Automotive Fluid Conveyance business in the past year. The company also expects to close the sale of the Lighting business in Q1, and an acquisition of Power Distribution, Inc. in 2020.

CEO Craig Arnold commented, "2019 as a year of significant progress on our journey to transform Eaton into a company with higher growth, higher margins and more earnings consistency. We closed 3 deals for $1.2 billion: Ulusoy, Innovative Switchgear in Electrical and Souriau-Sunbank in Aerospace. We announced 2 divestitures, with Automotive Fluid Conveyance closed in 2019 and Lighting scheduled to close in Q1. And our robust cash flow allowed us to return $2.2 billion to shareholders, including $1.2 billion of dividends and $1 billion in share repurchases."

Sharing guidance for the current quarter, he continued, "We expect EPS to be between $1.16 and $1.26. We expect organic revenues to be down 3%, 2% from acquisitions and 3% from divestitures. Segment margins are expected to be between 15.8% and 16.2%, and our tax rate should be between 15% and 16%."

Shares have been on a tear since bottoming near $76 last October, so Eaton is a name on which we might soon consider a trim as we balance our now-elevated-weight position versus other potential Industrials and other Sector names into which we might diversify. That said, we are fans of ETN's strong cash flow, capital returns and overall business prospects, and we have raised our Target Price for the time being to $108. Shares yield 2.8% and trade at 17.7 times expected earnings.

Shares of **McKesson** (MCK – $156.32) rose more than 13% last week after the drug distribution titan reported better-than-expected fiscal Q3 2020 bottom-line results. A cloud continues to hang over the company as it deals with the seemingly constant negative headlines concerning subjects like cutting prescription drug costs and the opioid crisis. Nevertheless, business continues to boom, as MCK turned in adjusted Q3 EPS of $3.81, more than 9% greater than expectations. Revenue for the period was $59.2 billion, slightly trailing consensus forecasts of $59.4 billion. The company also reaffirmed its fiscal 2020 adjusted EPS guidance range of $14.60 to $14.80.

Company Updates

Q3 Adjusted Earnings Exceeded Expectations; Reaffirmed Full-Year Guidance

Company Updates

- On February 4, 2020, a McKesson wholly-owned subsidiary filed a registration statement with the Securities and Exchange Commission relating to a potential exit of the company from its investment in the Change Healthcare joint venture
- McKesson was recently selected by the Department of Veterans Affairs as prime pharmaceutical vendor
- In December, announced creation of a joint venture in Germany with Walgreens Boots Alliance
- Nancy Flores appointed as EVP, Chief Information and Technology Officer, following Kathy McElligott's retirement

Business Summary

- Revenue growth of 5%[1]
- Adjusted Earnings per diluted share of $3.81, up 12% year-over-year
  - Excluding $43 million of prior year items[2], Q3 results per diluted share increased 7%
- Reaffirmed Fiscal 2020 Adjusted Earnings outlook of $14.60 to $14.80 per diluted share
  - Previously raised from $14.00 to $14.60 on January 13, 2020
- For the first 9 months, returned $2.2 billion of cash to shareholders

[1] 6% on an FX-adjusted basis
[2] For additional detail related to prior year items, see slide 5 of this presentation

3

McKESSON

"We delivered solid operating performance and we are pleased to report third-quarter adjusted earnings results ahead of our expectations," said CEO Brian Tyler. "McKesson's unwavering focus on strategic and operational execution is demonstrated in the adjusted operating profit growth we reported in the third quarter across our core operating segments. Additionally, we have deployed meaningful capital toward share repurchases year-to-date, delivering further value to our shareholders."

While there remain no shortage of stiff headwinds for MCK and its operations, the company has continued to show signs of stability across its businesses. Certainly, the many hurdles and challenges in front of MCK could still cause a near-term squeeze, but we continue to believe that the stock price greatly discounts a tremendous amount of bad news, given that current analyst EPS estimates for fiscal '20, '21 and '22 now stand at $14.70, $15.71 and $17.23, respectively. MCK still plays an important role in getting medical supplies and medicines from manufacturers to pharmacies, clinics and hospitals, while continued integration of acquisitions and pending improvements in its health care IT business should help drive growth. MCK trades for 10.1 times NTM earnings expectations and our Target Price resides at $192.

Cruise line operator **Royal Caribbean Cruises Ltd** (RCL – $111.55) earned $1.42 per share in fiscal Q4 2019 (vs. $1.42 est.). RCL had sales of $2.5 billion (vs. $2.5 billion est.). Shares rose

1.3% following the announcement but slumped about 5% for the week as a result of the negative impact on the industry from the coronavirus.

"Obviously, the biggest issue of the day is the Wuhan coronavirus. And as you all know, this virus has infected over 20,000 people in China, and they have taken unprecedented steps to contain it. They've essentially locked down the country and they're acting quickly and aggressively to combat the spread, so have other countries. Unfortunately, no one knows how this outbreak will play out, and we don't know how it will ultimately impact us. So far, we've canceled some sailings, and we've modified some itineraries that extend through March 4," said CEO Richard Fain. "These actions will cost us approximately $0.25 per share. But it seems likely that we will have to cancel more, but we don't yet know how many. We also expect that there will be an impact on future bookings in China, especially in the immediate aftermath of the illness. But again, we just don't know. One important bright spot is that looking beyond the current outbreak, we aren't seeing a big impact on overall bookings elsewhere. But again, and here I'm sounding like a broken record, we just don't know."

Mr Fain added, "To put things in context, China was expected to account for about 6% of our full year capacity and 4% of the capacity in the first quarter. Spectrum of the Seas is currently our only ship in China with 2 other ships scheduled to enter the market in May and July, respectively. Spectrum was doing very well before this outbreak. So this is all very disappointing to us. So far, we've had to cancel 8 China sailings and modified several itineraries that go through March 4. Unfortunately, there are still too many variables and uncertainties regarding the situation to calculate the overall impact on the business or give you a good estimate of what the ultimate impact will be. That said, we continue to feel positive about and committed to the long-term growth potential in China, a market that we've been in for more than 10 years."

The company said that it expects full year adjusted EPS to be in the range of $10.40 to $10.70 and Q1 adjusted EPS between $0.80 and $0.85, but CFO Jason Liberty was quick to add, "As a reminder, there remains too many variables and uncertainties to reasonably estimate the overall financial impact relating to the Wuhan coronavirus outbreak. As such, our guidance and key metrics for the full year and the first quarter do not include any financial impact that relates to this very fluid situation. Our yield outlook for 2020 is very strong. We expect net revenue yield growth of 2.25% to 4.25% for the full year, which makes 2020 our 11th consecutive year of yield growth. The underlying yield improvement is driven by new hardware, strong demand for our core products and continued growth from our onboard revenue areas. As I previously mentioned, we are very excited about the introduction of our 4 new ships during 2020 as they will be important contributors to the overall net yield growth."

Despite the obvious hit to the near-term top and bottom lines from the virus, we remain enthused about the overall prospects of the cruise industry, especially given favorable demographic and cruise-pricing trends, not to mention strong experience-oriented travel demand and the long-term potential in emerging markets. And, lost in the coronavirus news, Royal Caribbean just announced its *20>25 by 2025* program, which "includes several goals by 2025: delivering $20.00 adjusted earnings per share; further reducing the company's carbon footprint by 25%; delivering strong returns on invested capital; and continuing to improve on record guest satisfaction and employee engagement metrics."

Notwithstanding the long-term EPS goal, shares trade inexpensively, changing hands at less than 11 times NTM projected adjusted EPS and offering investors a 2.8% dividend yield. Our Target Price sails in at $162.

Hard disk drive maker **Seagate Technology PLC** (STX – $54.10) reported earnings per share of $1.35, versus the $1.32 estimate, in fiscal Q2 2020. STX had sales of $2.7 billion (vs. $2.7 billion est.). While shares gained to start the week, they slipped 7.2% following the announcement and finished the week down 5%, despite the bottom-line beat.

CFO Gianluca Romano said, "Looking ahead to our outlook for the March quarter. As the coronavirus outbreak continues, we have made our first priority the health and well-being of our employees and partners. We are also working with our suppliers to meet customer demand and mitigate risk to production. While we currently do not expect any material financial impact in the March quarter, there is still a lot of uncertainty. And therefore, we are widening our revenue and EPS guidance ranges. With this in mind, we expect revenue to be in the range of $2.7 billion plus or minus 7%. At the midpoint of our revenue guidance, we expect non-GAAP operating margin to be at the high end of our long-term target range of 13% to 16% of revenue, and non-GAAP EPS is expected to be $1.35 plus or minus 7%. In general, we are seeing a change in typical seasonality as HDD demand shift away from consumer-oriented legacy markets and towards mass capacity storage driven by data growth in the cloud and at the edge. The demand environment has continued to steadily improve, particularly for high-capacity nearline drives. With the positive customer momentum we have established for our 16-terabyte products, we continue to expect both revenue and profitability to grow in fiscal 2020 with the second half revenue slightly higher than the first half of this fiscal year."

STX CEO Dave Mosley added, "Overall, we are excited by the momentum of our 16-terabyte drives, the competitive strength of our technology road map and the breadth of our product portfolio, all of which we believe position Seagate to address well the growing demand for mass capacity storage and the need for data management solutions."

We like the company's strong cash flow and solid balance sheet. We also are fond of STX's 4.8% yield, which increased last quarter to $0.65 per share, and think that while the long-term growth target is a little on the low end, there's plenty of room to outperform. Our Target Price for STX has been boosted to $67.

Movies, entertainment and theme park company **Walt Disney** (DIS – $141.02) earned $1.53 per share in fiscal Q1 2020 (vs. $1.46 est.). DIS had sales of $20.9 billion (vs. $20.8 billion est.). Shares fell 2.3% following the announcement but shrugged off fears related to the Wuhan coronavirus and gained 2% for the week as investors were pleased that the Disney+ streaming service has signed up 28.6 million subscribers in less than three months since its launch last November.

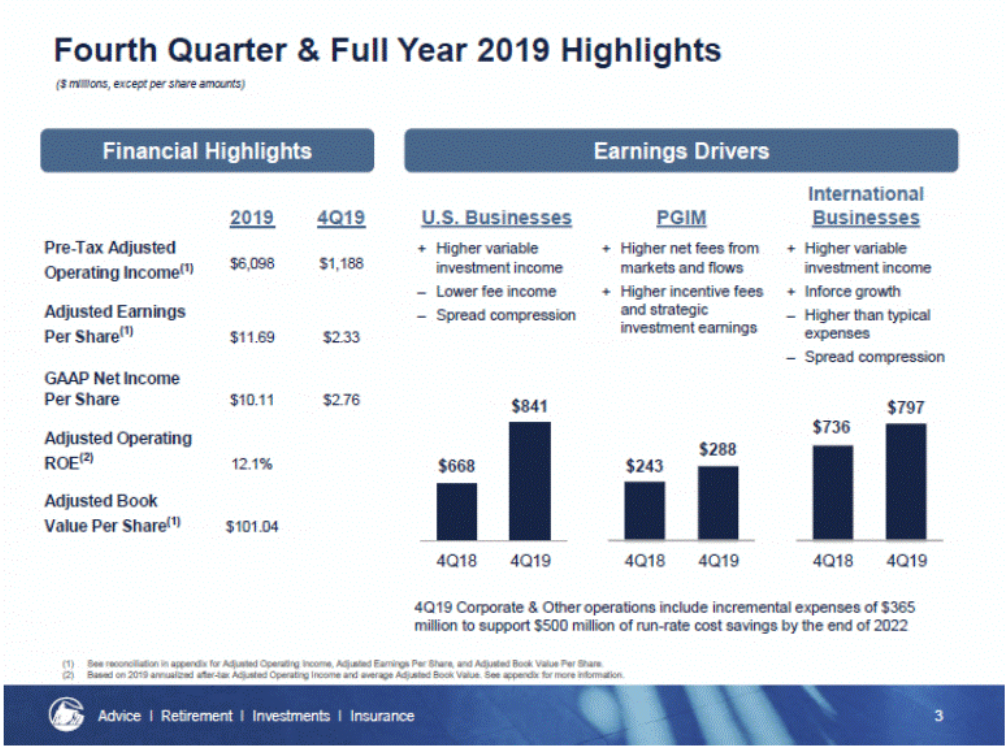
CEO Bob Iger commented, "It's often challenging for a company to pivot in a new strategic direction, particularly when it involves navigating between established and emerging business models. But since we announced our intention to shift our strategy, we have made an extraordinary amount of progress. This included a strategic reorganization of our company,

creating a Direct-to-Consumer & International segment. We believe the new structure would better position our businesses for the future and now that we've completed the reorganization and launched Disney+, I'm more confident than ever in that decision. I'm enormously proud of what we have accomplished in a relatively short period of time and believe we're now well positioned to not only withstand the disruptive forces of technology but thrive in today's increasingly dynamic media environment."

Disney's Parks, Experiences and Products operating income was up 9% in the quarter, a result of solid results from consumer products and strong performance in the company's domestic parks. Of course, with both Shanghai Disneyland and Hong Kong Disneyland closed due to concerns around the coronavirus, near-term results for this segment will take a hit.

Still, with the successful launch of Disney+, and continuing growth in its streaming content via channels such as ESPN+, Disney+ and Hulu, not to mention the ownership of a massive amount of unrivaled content and characters, we continue to think DIS should be a core holding in most portfolios. DIS shares yield 1.3%. Our Target Price for DIS has been lifted to $169.

Prudential Financial (PRU – $94.67) reported Q4 adjusted earnings last week of $2.33, which came in more than 15% above analyst expectations of $2.02. Notably U.S., International and Investment Management (PGIM) operating results showed profit growth, but higher expenses due to the company's continued restructuring offset some of the progress. The PGIM segment grew revenue by 12% and operating profit by 19%. Aided by market appreciation, assets under management grew 13% to $1.31 trillion. Despite the continued low interest rate environment, we saw PRU's adjusted ROE of 12.1% as quite reasonable.



PRU CEO Charles Lowrey commented, "During the fourth quarter, we made significant progress against our strategy to provide financial opportunity to more people and drive greater efficiency across our operations. For the year, we returned approximately $4 billion to our shareholders and generated an adjusted operating return on equity within our 12-14% target. Looking ahead, we remain focused on enhancing our customer experience while delivering on our cost savings initiative, increasing the percentage of earnings in international growth markets, and taking actions to mitigate the effect of low interest rates, which we expect will result in future earnings growth."

While there are continued operating headwinds and an ongoing restructuring, we still think PRU shares offer investors attractive long-term upside. Shares now trade at 7.6 times NTM adjusted EPS expectations and for 63% of book value. After announcing a quarterly dividend increase from $1.00 to $1.10, PRU shares now yield 4.6%. We applaud management's efforts to continue to repurchase shares at the current discount to book value. Our Target Price for PRU has been raised to $136.

German industrial conglomerate **Siemens AG** (SIEGY – $59.01) posted earnings per share of $0.73, versus the $0.70 estimate, in fiscal Q1 2020. SIEGY had sales of $22.5 billion, versus the $23.0 billion estimate. The stock sold off more than 4% on the news and, though the shares have climbed about 30% from last year's low on August 15, the price is down about 9% this year as

concerns about the company's future environmental impact have weighed. CEO Joe Kaeser, who is to step down next year, said that it is impossible to unwind the company's Australian coal contract and that the company would "pay more attention to the environmental impact of investment decisions." SIEGY will also take control of Gamesa, the Spanish wind-turbine manufacturer 59%-owned by Siemens.

Mr. Kaeser elaborated, "Five years ago, Siemens has been the first major industrial company which had itself set the target to be carbon-neutral by 2030, we have also come under active scrutiny by delivering a signaling system to a transport company associated with coal mining in Australia. While we do what we have to do, it still shows that the importance of adding ESG matters into strategic concepts and business plans along the value chain is a relevant topic. Siemens Energy, in particular, can and will play significant role in supporting the global energy transition from conventional generation to renewable energy and supplying technology to produce synthetic fuels for the hydrogen economy. And that's why, strong, profitable and innovative renewable energy business is a key element for this strategic direction, for the equity story of the newly founded Siemens Energy."

CFO Ralf Thomas added, "We expect a clear acceleration across all metrics throughout fiscal year 2020, starting with the second quarter. Our strategic companies, Siemens Healthineers and Siemens Gamesa Renewable Energy already reported their first quarter results, both unfortunately below our end-market expectations. They have clear plans and management commitments in place to improve performance going forward."

In fiscal 2020, Siemens expects to see adjusted EPS between $6.95 and $7.73 ($3.48 to $3.87 per ADR). Shares still trade below 15 times the current fiscal 2020 (ended Sept. 2020) consensus earnings estimate and yield 2.7% after foreign taxes. We believe that an improving global macro environment would reduce some of the headwinds the company has faced recently. Further. we think that while some of the renewable resource investments are expensive in the near term, they are likely to pay off over the longer term. Infrastructure project spending can be lumpy, but we think the exposure has a valuable spot in our portfolios. Our Target Price for SIEGY has been trimmed to $84.

Shares of **Biogen** (BIIB – $338.70) soared last week, jumping 26% after the biotech giant won a long-awaited decision in a patent case surrounding its multiple sclerosis (MS) drug Tecfidera. Administrative patent judge Sheridan K. Snedden wrote that Mylan (the generic drug company that filed the case against Biogen) had failed to show that parts of a key patent protecting Tecfidera were unpatentable, as the company had claimed. Now, Biogen could keep its exclusive rights over Tecfidera until early 2028, which is material as the drug generated almost a third of BIIB's 2019 overall revenue.

As a reminder of what we penned earlier in the week in *TPS 640*: BIIB turned in a solid Q4 head-lined by a top- and bottom-line beat (adjusted EPS $8.34 vs. $8.05 est. and revenue $3.7 billion vs. $3.5 billion est.). Additionally, the company offered full-year 2020 guidance for revenue between $14.0 billion and $14.3 billion, and adjusted EPS of $31.50 to $33.50. Biogen has strong retention in its older MS drugs despite competition, while its U.S. royalty stream has benefitted from Roche's $4 billion MS therapy, Ocrevus. While we would expect in¬creased

spending around a potential launch later in the year for the company's Alzheimer's drug, if the medication is widely accepted and effective, Biogen would have a mega-blockbuster on its hands. Further, we think Biogen's specialty-market-focused drug portfolio outside of MS, keying in on cancer and neurology disorders, is a positive long-term driver. The firm's pipeline has also seen progress in MS, pain management, Parkinson's and ALS.

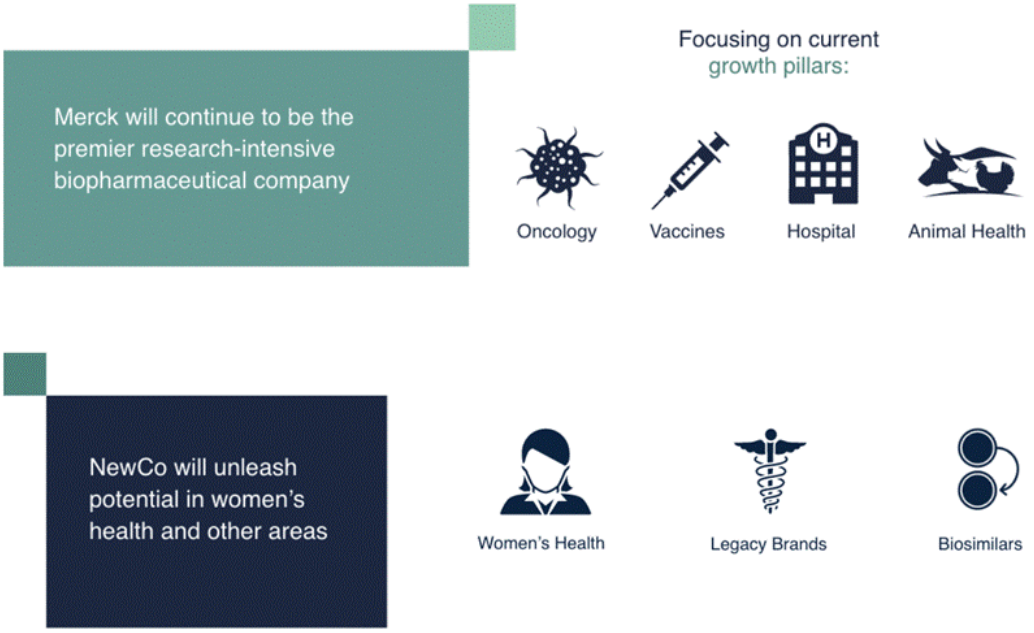
BIIB generates robust cash flow. Even after the big jump this past week, shares still trade at 10.3 times NTM adjusted EPS expectations. Our Target Price for BIIB has been increased to $471.

Shares of **Merck & Co.** (MRK – $86.66) dropped 4.5% last week as the pharmaceutical giant posted Q4 financial results and announced details surrounding the spinoff of 90 different products accounting for about $6.5 billion in annual sales. Merck turned in adjusted EPS of $1.13, versus consensus expectations of $1.15. Revenue for the quarter was $11.98 billion, near the top of management's guidance of $12.0 billion. MRK's key growth driver, oncology drug Keytruda, experienced sales growth of 55% throughout 2019, producing revenue of $11 billion as it continues to account for a higher percentage of the company's top line. The firm's vaccine portfolio also contributed nice growth at 15% year-over-year with an $8.4 billion contribution to revenue.

CFO Robert Davis elaborated on the results, "Our strong performance reflects the continued execution of our science-led strategy, and we expect our business momentum to continue, particularly as we enhance our focus on our key growth drivers through the spin-off. Total company revenues were $11.9 billion in the quarter, an increase of 8% year-over-year or 9% excluding the negative impact from foreign currency. Both our human health and Animal Health divisions contributed to the growth this quarter. The remainder of my comments pertaining to sales will be on an ex-exchange basis. Our human health revenues grew 8%, led by products in oncology and hospital. In oncology, KEYTRUDA fourth quarter sales were $3.1 billion, and for the full year, sales exceeded $11 billion, representing 58% growth versus 2018. In the U.S., growth was driven by strong demand across all indications. KEYTRUDA continues to lead across many indications, including lung, bladder and head and neck cancers with strong momentum in adjuvant melanoma and renal cell carcinoma, where we are seeing strong uptake across all patient subgroups."

MRK – Spinning Off Slower Growers

We have made the decision to separate into two growth companies: Merck and NewCo. By optimizing our human health portfolio, Merck can move closer to its aspiration of being the premier research-intensive biopharmaceutical company, while also properly prioritizing a set of products at NewCo that are important to public health and the patients who rely on them, and which present real opportunities for growth." - ***Kenneth C. Frazier*** *Merck Chairman and CEO*



Regarding the spin-off, he continued, "Now turning to our announced spin-off. As Ken noted, by further evolving our operating model and separating into 2 simpler, more focused and agile companies, both will be better positioned to respond to the changing external landscape, improve efficiency and accelerate growth, creating greater value for patients and shareholders than would be achieved as a single company. Spinning off NewCo accelerates Merck's revenue growth by up to 1 percentage point on a compounded average basis through 2024, but more importantly, it allows Merck to enhance focus on its key growth drivers and robust pipeline. This gives us confidence that Merck will realize even greater incremental revenue growth over time. We will also benefit from more streamlined processes and operations, enabling further operating model efficiencies across the value chain. For context, the products to be spun off into NewCo represents about 15% of Merck's human health revenues based on 2020 forecast. While consuming a much larger share of our operations and resources, in fact, separating NewCo will reduce Merck's human health manufacturing footprint by about 25%, the number of products by 50% and the number of SKUs by 60%. The products represented by [NewCo] are expected to achieve 2020 revenue of approximately $6.5 billion with an operating margin of approximately 45% as part of Merck. As an independent company, NewCo is expected to achieve low single-digit revenue growth off of a 2021 base of $6 billion to $6.5 billion. Taking into consideration the cost to operate as an independent company, operating margins for NewCo are expected to be in the mid-30% range and increase over time. And finally, we anticipate EBITDA margins to be in the low to mid-40% range in 2021 and also increase over time."

Management expects 2020 EPS to be between $5.62 and $5.77, which represents growth of 8% to 11%. It also says that the dividend will be unaffected by the spinoff, and anticipates future dividend increases from the current 2020 dividend rate of $2.44 per share post separation, with the goal of achieving a 47% to 50% payout ratio over time. We think that the continuing successful data on Keytruda in several indications offers Merck significant growth potential and reinforces the strong pricing power for the drug. MRK also has a wide lineup of high-margin drugs outside of Keytruda, as well as a pipeline of new drugs which should ensure strong returns on invested capital over the long term. MRK boasts a history of returning cash to shareholders, a diversified revenue stream and solid free-cash-flow generation. The current dividend yield is 2.9%. Our Target Price for the combined MRK remains $100.

General Motors (GM – $33.63) released its Q4 and full-year results on Wednesday. The quarter is usually a key one from a seasonal standpoint, but this time around, the numbers were marred by the 40-day United Auto Workers strike, which ultimately ended in a new collective bargaining agreement to extend 4 more years. While analysts expected costs in the quarter to completely wash out earnings, the auto and truck maker managed to eke out $0.05 per share in profits on revenue of $30.8 billion. For the year, GM produced $4.82 of earnings per share on revenue of $137. 2 billion. Management calculates that the strike took $1.39 from usually seasonally strong fourth-quarter EPS.

While labor negotiations are a very real cost of doing business in the automotive industry, we find that the company's profitability despite the hurdle to be very constructive and we think that it adds support to our view that the stock deserves to trade for a higher multiple. At the company's Capital Markets Day on Wednesday, an analyst brought this up in a question to CFO Dhivya Suryadevara.

She responded, "If you look at the strike-impacted results of $4.82, which we put up in '19, that was after taking into account the impact of about 320,000 units down because of strike. When you market share-adjusted, it translates to industry being down about 2 million units. And so thinking about it as a curve from our earnings at 17 million units to our 25% downturn scenario, this matches quite nicely with what you would expect in an industry down. So to your point, it does validate the downturn thesis. With the actions we've taken, we've maintained the 10 million to 11 million breakeven point for North America. I would say we were probably hovering in the higher end of that range, and with the cost savings, we've come closer to the lower end of the range. And as we continue to strengthen the business and the rest of the operations around the globe, our downturn scenario looks better because you have fewer cash-burning operations around the globe. So I'd say, yes, it grants some credence to the downturn thesis, and you will see us address some of the other problematic areas, which should be better for downturn protection as well."

Management also released fiscal 2020 guidance, stating that the company expects EPS in the range of $5.75 to $6.25 and adjusted automotive free cash flow of $6.0 billion to $7.5 billion. Buybacks are also returning in 2020 (to the tune of $2 billion to $3 billion), but China will remain a headwind for the next few years. CEO Mary Barra said that it is too early to comment on the impact of the coronavirus, but voiced concerns about the effects of the trade war between the U.S. and China on Chinese consumer confidence.

We remain fans of GM as the company continues to execute its core business well, control costs and maintain liquidity. We look forward to the latter part of the year as the new Cadillac Escalade and a few other models incorporate autonomous Super Cruise technology. Shares trade at just 5.4 times NTM earnings estimates and offer an attractive 4.5% dividend yield. Our Target Price is presently $48.

French health and pharmaceutical concern **Sanofi** (SNY – $51.03) released its Q4 and full year financial results last week. In the quarter, SNY earned $0.74, some 3.5% ahead of analyst forecasts, on revenue of $10.6 billion. EPS and revenue for the full year tallied $3.35 and $40.44 billion, respectively. Dupixent (eczema, asthma and chronic rhinosinusitis therapies) sales continue to grow rapidly, representing 6.4% of revenue at year-end, compared to 2.1% a year ago. Vaccines sales were also strong, increasing 22.0%, mostly resulting from U.S. influenza vaccine shipments in Q4.

CEO Paul Hudson offered the following color on the quarter, "3% on the top line, 7% on EPS. I think strong performance. A lot of good discipline from the organization to deliver those numbers. Our pipeline innovation continues at some pace. On accelerating efficiency, we were almost a point — a full point down on operating expense. And that is the discipline that I referred to, and it's going to be essential that we continue with this level of reallocation of resources and discipline to deliver on our short-, medium- and long-term objective. We went through the strategy and prioritization exercise as an Executive Committee throughout the back end of last year…As we outlined, the strategy was quite clear that we wanted to allocate more of our central expertise into our business units and increase the accountability."

He continued, "Specialty up, close to 23%, and it hides in there 11% in onco and 7% in rare diseases. A very strong performance indeed. General Medicines, whilst declining, I'll talk about how it's stabilizing a little bit later. We are beginning to see the impact, of course, of the VBP in China, and the continued decline in diabetes although moderating, and I'll touch on that. Vaccines overall performance continues to stay within the boundaries of our mid- to high single digit, a strong Q4. Of course, there is a phasing and some other bits and pieces that we can get to, but fundamentals are very strong in Vaccines. And of course, consumer. I think recognizing that it's a little bit overdue making it stand-alone and given its agility and speed and optionality. And we took a hit on the Zantac recall amongst other things."

We remain excited about the future and expect that Sanofi will continue to benefit from a pipeline that is increasingly more focused on areas of unmet medical need, such as oncology and immunology. We also expect Dupixent to continue growing rapidly as new indications come online. Shares trade for 15 times estimated earnings and yield a net 2.8%. Our Target Price has been nudged up to $60.

Luxury lifestyle brand **Tapestry** (TPR – $27.97) jumped more than 8% last week after the company reported fiscal Q2 2020 results that beat consensus analyst estimates on both the top- and bottom-line. Despite the positive reaction, TPR shares gave back some of its gains on Friday as concerns over the coronavirus impact on its business in China picked up again. Revenue for the period of $1.82 billion came in slightly higher than forecasts of $1.81 billion, while adjusted EPS of $1.10 was more than 11% greater than what investors were expecting.

CEO Jide Zeitlin commented, “We are pleased with our overall holiday results, which outperformed plan driven by continued momentum at Coach and a sequential improvement at Kate Spade. In addition, we exited the quarter in a good inventory position. Coach delivered its ninth consecutive quarter of positive comparable store sales growth. North America led the global comp, with notable strength online, and higher average unit retail driving gross margin expansion. In aggregate our international business was even with the prior year with strong comp growth in Other Asia, Europe and Mainland China, offsetting continued weakness in Hong Kong SAR and a slight decline in Japan, reflecting the impact of the consumption tax increase. Kate Spade’s comparable store sales improved sequentially as we further implemented key product and merchandising actions to strengthen the assortment and enhance the brand’s novelty offering, while also moving through excess inventory.”

He continued, “Stuart Weitzman sales were impacted by softer demand across channels as we lacked compelling newness in our heritage boot offering. We have built on these learnings and are reinvigorating our footwear icons, while injecting innovation into the overall assortment in keeping with market trends.”

Looking ahead, Mr. Zeitlin continued, “At Tapestry, we entered our third fiscal quarter with strong underlying trends, notably at Coach, as sales growth accelerated from the holiday period. Therefore, we had anticipated maintaining our FY20 guidance despite continuing headwinds in Hong Kong SAR and challenges at Stuart Weitzman. However, the escalating coronavirus outbreak is now significantly impacting our business in China, resulting in the closure of the majority of our stores on the Mainland…We now expect that our second half results could be negatively impacted by approximately $200-$250 million in sales and $0.35-$0.45 in earnings per diluted share, given current trends in China. If the situation further deteriorates, or the outbreak affects demand outside of the country, this impact could be worse. Our strong balance sheet, cash position and globally diversified sourcing base and supply chain provide the flexibility to operate our company for the long term and to emerge stronger, as we have many times in the past.”

While there will continue to be some near-term ups and downs, and the impact of the coronavirus could carry for more than a quarter, we think Tapestry is putting in the focus and energy necessary to get all the brands rowing the boat in the right direction. As Tapestry evolves, we can’t help but be excited by the fact that the stock trades for just 11 NTM earnings expectations, and current respective EPS forecasts for fiscal ‘21 and ’22 stand at $2.63 and $2.77. Shares presently yield a very generous 4.8%, and we continue to like the free-cash-flow generation and willingness of the company to buy back stock at these inexpensive prices. Our Target Price now stands at $41.

Health care distributor **Cardinal Health** (CAH – $58.24) posted fiscal Q2 2020 financial results last week that were better than expected on both the top- and bottom-lines. Shares reacted quite positively, jumping almost 14% for the five days. For the three-month period, CAH said its adjusted EPS was $1.52, 24% above forecasts. Revenue came in at $39.74 billion, versus expectations of $39.41 billion. Strong tailwinds in generic drugs and initial traction of the company’s long-term cost savings initiatives proved to be bright spots in the quarter.

“With the first half of the year behind us, we are raising our fiscal year 2020 guidance,” said CEO Mike Kaufmann. “This increase was driven by improved performance across our Pharmaceutical segment, particularly within our generics program. As we look forward, we remain focused on executing our strategic growth initiatives.” Management lifted the company’s full-year projected adjusted EPS outlook from a range of $4.85 to $5.10 to an increased range of $5.20 to $5.40.

We were pleased to see a solid quarter, despite the continued black clouds surrounding drug pricing and opioids. We believe that CAH will benefit in the long term from demographic trends in the U.S. as the population continues to age and requires greater health care usage. CAH continues to generate strong free cash flow, which can be used to increase the dividend (the yield is currently 3.3%), buy back stock and invest in the business via research & development and mergers & acquisitions. CAH shares trade for less than 9 times NTM earnings expectations. Our Target Price has been boosted to $77.

Following a terrific 2019 that saw shares of **Tyson Foods** (TSN – $80.35) surge more than 73%, 2020 has seen a retreat, with the stock of the protein producer now down almost 12%. Tyson reported fiscal Q1 2020 results last week that were generally in-line with expectations as revenue came in at $10.82 billion, while adjusted EPS totaled $1.66.

CEO Noel White explained, “Our Beef and Pork segments performed well as the effects of African swine fever are beginning to materialize. Our Chicken segment performed better operationally, although in a soft pricing environment. Our Prepared Foods segment produced its sixth consecutive quarter of retail consumption growth, demonstrating the strength of our brands and innovation as we grew or held market share in all core categories.”

Looking ahead, Mr. White said, “With improved access to global markets resulting from recent trade developments, there are reasons to be optimistic about fiscal 2020 and beyond and we are well-positioned to capitalize on opportunities in the global marketplace. Although we anticipate the challenges and volatility typical in our second fiscal quarter, our long-term outlook remains positive.”

While higher production and size hurt poultry prices during the period, Tyson said it believes meat exports and fast-food battles over chicken sandwiches will likely help lift poultry demand this year. One area of support comes from China reopening its markets to U.S. chickens to help offset the impact of African swine fever on its pork supply, and in recent days there have been growing concerns that millions of chickens in China could die as the coronavirus quarantines and lockdown on the movement of many resources in China take their potential toll.

Overall, we see conditions meaningfully improving in the back half of this year. Exports for TSN should pick up as China will need supply, as well as other countries, beef margins should remain high due to less U.S. imports of Australian beef (caused by the bushfires), China could further reduce tariffs, momentum in high-margin Prepared Foods should continue and there are plans to launch more alternative protein products, which if nothing else will keep its name in the news. Considering the alternative proteins, given the relationships the company boasts, along with its

preparation facilities and logistics, we would think that with the right offerings, Tyson could really pressure the Beyond Meat's of the world.

We also believe that in the future chicken can take share from other protein sources as it offers a relatively better cost and health profile to consumers. And, increasing protein consumption around the globe, especially in emerging economies, should provide a solid footing for top-line growth. TSN currently trades at 12.1 times NTM EPS and carries a dividend yield (2.1%) slightly above that of the 30-year U.S. Treasury. Our Target Price for TSN is now $103.

Electronic manufacturing services firm **Benchmark Electronics** (BHE – $26.63) earned $0.27 per share in fiscal Q4 2019. BHE had sales of $508.0 million. Shockingly, given that those numbers were both above the mid-point of the revised guidance the company issued the week prior, shares tumbled 12.5% in the aftermath of the report, this after taking a pounding when the warning was announced.

We wrote in our *Market Commentary* last week that Benchmark had issued a Q4 guidance warning due to a ransomware incident that encrypted information on its systems and disrupted customer and employee access to its applications and services. With that news last week, it was almost unbelievable to witness BHE miss on the final Q4 results. CEO Jeff Benck commented, "I just want to express thanks to our customers for their incredible partnership and our teams who work diligently to quickly restore operations. As you might expect, we have further increased our spending in IT security, including both hardware and software investments guided by third-party consultants. This additional spend is reflected in our full year SG&A guidance. With this incident behind us, we're looking forward to continuing to serve our existing customers, ramp a number of new customers and execute on our growth strategy and the corresponding initiatives to build a better Benchmark."

BHE – Diversified Customer Base

Q4-19 Notable New Business Wins by Market Sector

Industrials	▶ Facial imaging instrument (mfg.) ▶ Security scanning system (design & mfg.)
Medical	▶ Advanced DNA testing platform (process design & mfg.) ▶ Defibrillator product (mfg.) ▶ Fetal monitoring device (process design & mfg.)
Semi-Cap	▶ Front-end semi-cap in-chamber tool (precision technologies) ▶ Semi-cap tool electronic sensor device (mfg.)
Aerospace & Defense	▶ Satellite communication device (process design & mfg.) ▶ F-16 cockpit electronics (design & mfg.) ▶ Munition system electronics (mfg.)
Computing & Telco	▶ High-performance computing (process design & mfg.) ▶ 3-D holographic display device (design)

Continued Progress in Capturing the Right Mix

Benchmark | 5

We didn't think any additional punishment was warranted as BHE said that it expects to generate revenue of $530 million to $570 million in Q1, with adjusted EPS for the three-month period projected to come in between $0.32 to $0.38. We continue to like that Benchmark is expanding its product offerings and appreciate that it has been pushing for growth outside of its original markets. Along with other EMS companies, we expect improving free cash flow generation from slimming inventories and the U.S.-China trade conflict easing, though the recent coronavirus health emergency may adversely impact operations over the near term. BHE has a terrific balance sheet with more than $5 per share of net cash and its shares have a current dividend yield 2.3%. Our Target Price remains $36.

Shares of **National Oilwell Varco** (NOV – $24.18) spiked 11% last week following the oil service company's Q4 earnings release and conference call. Revenue of $2.28 billion was well ahead of estimates. And, while adjusted EPS of $0.10 fell short of consensus expectations of $0.17, a second consecutive quarter of strong free cash flow ($406 million) evidently excited long-suffering energy sector investors. With a massive transformation underway throughout the year, full-year revenue remained flat compared to 2018, while the recorded a loss of over $2.00 was mainly due to a large impairment charge taken in the second quarter.

On the company's earnings call, CEO Clay Williams had plenty of interesting commentary…

2019 was a pivotal year for the energy industry. We entered 2019 with commodity and equity markets signaling strongly to market participants that growth for growth's sake with commensurate returns to capital providers would no longer be tolerated. Sources of all forms of capital to the industry: public equity, private equity, bank debt, public debt, became scarce and expensive, as evidenced, for example, by the collapse in trading multiples of oilfield public equities in early 2019.

At the time, we interpreted this as the evaporation of a widely held narrative, [gauzy] conventional wisdom that a commodity price spike would someday soon lead us back to a more prosperous oilfield and save us all.

Through the first 4 years of the downturn, 2015 to 2018, this narrative was responsible, we think, for a significant structural option value component in equities and asset values in the oilfield. This makes sense to me, because the oil and gas industry has a 160-year history of extreme volatility and sophisticated investors recognize the corresponding option value that goes with this volatility.

As the leading provider of capital-intensive capital equipment to oilfield service companies, we tend to watch such trends. Our customers frequently rely on external capital to buy the equipment that we provide them. And by the beginning of 2019, providers of external capital to oil and gas producers and service companies were exhausted. Tired of waiting patiently for recovery, that felt like it continued to slip over the horizon. So they choked back on the capital that they were previously pumping into the operations of our customers.

Now capital is to oil and gas what oxygen is to the rest of us. Petroleum is arguably the most capital-intensive undertaking of all industrial enterprises, and oilfield services is probably second. Operators react quickly when you choke off the air supply. They pulled back hard on CapEx budgets, particularly in the U.S. unconventional plays, resulting in a peak-to-trough decline of 27% in the U.S. land rig count over the course of the year. While international and offshore projects with favorable return characteristics continued to receive FID green lights, the industry as a whole, particularly the U.S., finally seemed to be resigning itself to the fact that commodity price spike is not going to save the day and the old way of doing business is not going to cut it. It will unfortunately be lower for longer, and that's the new conventional wisdom that emerged at the beginning of 2019.

He also offered details around the significant steps the company has taken to become a leaner, returns-on-capital focused business.

Since 2015, we've closed 483 facilities to shrink our own internal capacity to better fit market demand. We've adopted a more efficient shared services model in many regions. And through the hard work of our team through this past year, we've established a clear and tangible path to at least $230 million in annual cost savings as compared to the first quarter of 2019. Thus far, we have attained approximately $170 million in annualized savings, up about $82 million sequentially in the fourth quarter, and we continue to evaluate every opportunity to increase that number.

Second, every product line, no matter how well established, has fallen under the microscope of an in-depth returns analysis. Those that do not currently meet our internal threshold have either developed a tangible plan for near-term improvement or have been slotted for divestiture or closure. Ultimately, 2019 was a year about building and solidifying our staying power. Operationally, we're leaner, more efficient and more agile to react to the shifts in the market.

Third, from a balance sheet perspective, we continue to increase the strength of our capital structure in order to maintain the flexibility to act opportunistically. During the fourth quarter, we called $1 billion in debt due in 2022. We're paying a portion with cash and a portion with longer tenor notes in a new issue that is due 2029.

Fourth, we tailored our strategy to fit a world where oilfield services customers have limited access to capital. Commercially, NOV won much of this race during the period from 2006 to 2014 when we won a significant portion of the largest build-out of oilfield service equipment the industry has seen in a generation. We delivered 379 offshore new build drilling packages since 2006, for instance. So today, we benefit from having the largest installed base of oilfield equipment in the world.

Plenty to digest in the above, but we view the company's transformation as favorable and like the focus on implementing big data to improve oil and gas development efficiencies. We still believe in long-term energy demand growth with the global population expected to expand from 7.6 billion to 9 billion and worldwide economic output more than doubling by 2040, and we think that NOV and its relatively solid balance sheet will survive the current energy difficulties and thrive during the next leg up. With the recent cost control initiatives taking hold, as well as other improvements, we have edged up our Target Price to $33.

Internet security firm **NortonLifeLock** (NLOK – $19.73) posted earnings per share of $0.25, versus the $0.08 estimate, in fiscal Q3 2020. NLOK had sales of $618.0 million (vs. $608.0 million est.). Shares traded higher by 12% following the announcement and gained 18% for the week. We note that while shares posted a significant gain on a percentage basis, they may appear to have taken a large haircut using unadjusted price data. NLOK had a special $12.00 per share distribution on Friday, January 31, 2020, as a result of **Broadcom's** (AVGO – $315.23) acquisition of the Symantec enterprise business. At present, custodians are treating the big payment as a dividend, though we would think some or all of it will eventually be treated as a return of capital for tax purposes, but such a determination would not likely come until 2021.

Looking at the ongoing business, CEO Vincent Pilette said, "Since the close of the sale of our enterprise business on November 4, we have been removing stranded costs at an accelerated pace. Previously, our estimated cumulative stranded costs post close were $1.2 billion with cash cost of $900 million to remove these stranded activities. We have accelerated our transition to be done in Q2 fiscal year '21, 3 months ahead of plan. Cumulative stranded costs post close are now tracking to less than $1 billion in total, of which $750 million are in cash. We are making good strides towards exiting or rightsizing the cost base to achieve target operating margin of 50% for the total company by the end of the transition period. When I started as CEO, I talked about some key priorities for us in the short term: first, establish credibility by consistently delivering on what we say; secondly, accelerate the transition to quickly get to a long-term business model

with 50% profitability for the company; and lastly and more importantly, free up investment capacity to return the company to sustainable growth, delivering on the full potential of a stand-alone consumer business. I also said that it would take time to reach our full potential. I think it goes without saying that we have delivered on our commitments in terms of executing on the sales of the enterprise business, accelerating the elimination of stranded costs and maximizing the value of our underutilized assets."

We believe that Norton's prospects in data security remain bright. We are also intrigued by the company's commitment to executing the remaining $1.6 billion of its share repurchase authorization. With a dividend yield of 2.5%, our revised Target Price, post-$12-payout, for now-pure-play consumer cyber security concern NLOK is $24.