Focus List

Investment Rationales

Focus List Criteria

The Focus List includes 25 stocks and represents a combination of the equity sector guidance from Wells Fargo Investment Institute and security selection from our Wells Fargo Advisors Equity Sector Analysts. The objective is to exceed the total return of the S&P 500 over an approximate one-year timeframe. Stocks for the Focus List are selected through independent research, evaluating the fundamentals of each individual company. The Focus List is concentrated in only 25 individual stocks, each with a four percent weighting. Client risk tolerance and suitability should be considered when participating in this strategy.

All financial data as of January 3, 2020 and sourced from FactSet and Wells Fargo Advisors.

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Communication Services

**Verizon Communications, Inc. (VZ - $60.40)**

**Company Description**
Verizon Communications, Inc. (Verizon) is the one of the largest telecommunications services providers in the U.S. The company has leading market share in both the wireless and wireline markets.

**Investment Thesis**
We are attracted to Verizon’s leading market share in the U.S. wireless industry, strong and stable margin and return profile, conservatively-financed balance sheet, and well-supported above-market dividend yield.

We would note that the Verizon’s market share has remained between 41-42% for the last seven years and we believe that the current industry backdrop is supportive of a relatively stable rate environment. Although there are occasional episodes of increased price competition, we believe Verizon’s high level of existing share, strong network quality metrics, continued investment in current and future bandwidths, and strategic focus on the wireless space should allow the company to maintain its strong competitive position.

Turning to the balance sheet and cash flow, we view Verizon as appropriately levered with the financial capacity to support continued investment in its network and continue to modestly increase its quarterly dividend.

**Risks**
Operating and maintaining an advanced technology telecom network is capital intensive. Verizon’s services are often sold on the availability, speed, and reliability of its network. Network shortcomings, either real or perceived, can impact sales and customer retention. Competition across Verizon's business lines is intense, with several formidable competitors in each area. Technology advancements could disrupt each of the company's product offerings. The Communication Services sector is subject to various levels of regulation which could impact Verizon's investment opportunities and potential returns.

**Valuation**
Shares of VZ currently trade at around a 4.1% dividend yield on the next twelve month (NTM) consensus dividend per share estimate of $2.47 compared to the 5-year historical average of 4.8%. Relative to the S&P 500, VZ trades at 0.7x compared to historical levels of 0.6x.

**The Walt Disney Company (DIS-$146.50)**

**Company Description**
The Walt Disney Company (Disney) is a worldwide diversified international family entertainment and media enterprise. The company operates in four business segments – Media Networks, Parks & Resorts, Studio Entertainment, and Consumer Products & Interactive Media.

**Investment Thesis**
We believe Disney is unique in its ability to convert its intellectual property across its media networks portfolio, film studio, parks and resorts, and consumer products businesses. Media Networks, which includes ESPN, ABC, and assets from Twenty-First Century Fox is entering a period of transition. Although the company’s mix of subscribers is changing to a combination of traditional pay TV and streaming, which is likely to create a negative near-term impact on financial results,
we believe the company’s direct-to-consumer service, named “Disney+”, which launched in November of 2019, could exceed near-term investor expectations for subscriber growth. Meanwhile, the Parks & Resorts division continues to benefit from global development projects and a shift in consumer spending toward experiential categories. The Studio Entertainment division has performed well; however, this business has the potential for inconsistent performance due to the timing of major box office releases. Although we expect several years of transition, we believe the company’s enhanced content offering post-Fox should make it one of the two dominant players in streaming television condition.

**Investment Risks**

The media landscape is shifting, creating uncertainty regarding future consumption of television programming and the evolution of the cable/media ecosystem, potentially impacting the value of Disney’s network properties (i.e., ESPN, ABC, Disney Channel). Live programming content costs, for sports in particular (ESPN), have been increasing rapidly and may not be matched by growth in the affiliate fees ESPN commands from pay-tv distributors. Most DIS businesses are vulnerable to a slowdown in consumer discretionary expenditures. A slowing Chinese economy may impact Disney’s new theme park in Shanghai when it opens. Developing hit films and TV shows can be volatile.

**Valuation**

Shares of DIS trade around 27x the NTM consensus earnings per share (EPS) estimate of $5.45 compared to its historical valuation of around 20x forward estimates. Relative to the S&P 500, DIS trades at 1.4x compared to historical levels of 1.2x.

**Consumer Discretionary**

**Amazon.com, Inc. (AMZN-$1,874.97)**

**Company Description**

Amazon.com, Inc. (Amazon) offers services to consumers, sellers, and developers through its retail websites. It also manufactures and sells the Kindle e-reader and the Echo, which features its virtual assistant Alexa. The company offers programs that enable sellers to sell their products on its websites and their own branded websites.

**Investment Thesis**

We believe Amazon offers the best customer experience due to the combination of the company’s low prices, broad product offering, and seamless customer service – three keys to successful retailing. The company’s structural advantages versus traditional retail include lower capital requirements, highly efficient marketing, business-to-customer distribution expertise, pricing flexibility and lack of channel conflicts, providing a runway for continued market share gains over the coming years. Online sales have grown at a mid-double-digit compound annual growth rate (CAGR) in recent years, outperforming offline retail growth by a low double-digit percentage annually. We expect e-commerce to continue to gain share in the coming years, and the strength of Amazon’s Prime membership program and overall value proposition should position the company for continued success.

We also believe Amazon Web Services (AWS) revenue will continue to grow at a strong pace given that the company is the leading provider of computing services in the public cloud. The company’s scale in this segment provides a strategic competitive advantage and when combined with data from Amazon’s retail operations, puts the company in possession of a uniquely large and deep set of data. We expect Amazon to continue expanding into other areas, including advertising and media, utilizing its ever-expanding streams of data to better understand what consumers want and deliver it accordingly.
**Investment Risks**

Risks to AMZN include lofty expectations evidenced by strong year over year comparisons, high capital expenditures needed for integration into highly competitive business segments, aggressive competition in e-commerce, as well as regulatory implications on both a domestic and international scale.

**Valuation**

We believe valuing Amazon's shares on a free cash flow and market capitalization-to-sales basis are more appropriate than on a traditional price-to-earnings (P/E) basis. We are using free cash flow given that the company continues to benefit from a positive working capital cycle, which we believe is inherent to the business model, and will continue to drive strong top line growth. Our usage of market capitalization-to-sales valuation provides an insight as to what investors are willing to pay for every $1 worth of sales coming from the company – and provides a basis to compare/contrast versus other Internet sector companies. Currently, shares of AMZN trade at 32.2x consensus NTM free cash flow per share of $58.19 and 19.7x consensus NTM EV/EBITDA (Enterprise Value to Earnings before Interest, Taxes, Depreciation and Amortization) of $91.10. On a market capitalization-to-sales, AMZN shares trade at 3.4x the NTM consensus sales estimate of $279.1 billion, which compares favorably to a peer group Internet and Retail Internet sector averages.

**Home Depot, Inc. (HD - $218.93)**

**Company Description**

Home Depot, Inc. (Home Depot) is the largest home improvement retailer in the U.S. in terms of revenue, operating stores in the United States, Canada, and Mexico, catering to do-it-yourself and professional customers. The company sells a wide assortment of building materials, home improvement, and lawn and garden products, as well as providing a number of home-related services.

**Investment Thesis**

Home Depot operates in an oligopolistic market structure, where only a few companies dominate with meaningful economies of scale and brand equity. Home improvement spending trends have improved from cyclical lows but we believe the age of the American housing stock, combined with solid underlying consumer spending trends, should continue to support mid-single-digit same-store-sales comparisons for the next several years.

Home Depot has made its distribution channel more productive in recent years, partially through implementing rapid distribution centers. While not immune from online retail competition, we believe Home Depot is relatively well insulated from the disintermediation that traditional brick and mortar retailers have experienced. With the business generating meaningful free cash flow supported by above-peer operating cash flow margins, we expect share repurchases to rise over time. With the downside exposure reduced by its share buybacks and strong longer-term competitive positioning, we see an attractive risk/reward for Home Depot so long as spending on home improvement remains strong.

**Investment Risks**

Home Depot’s success is highly correlated to private fixed residential investment which is driven by consumer confidence and the wealth effect associated with increases in housing prices. Unusual weather patterns could have a harmful impact on same store sales. Potential disruptions in the supply chain could also impact financial performance. Other risks here could include a slowdown in the U.S. economy, a weaker housing market, higher interest rates and declines in consumer confidence and consumer spending. Finally, e-commerce competition is impacting all retailers of late. However, we note Home Depot’s digital business has grown nicely in recent times and now accounts for nearly 10% of total sales.
Valuation
Shares of HD currently trade around 21x the NTM consensus EPS estimate of $10.38 compared to its 5-year historical average of 16x. On a relative P/E basis (S&P 500), HD shares trade at 1.1x compared to the 5-year historical average of 1.0x. When factoring in earnings growth expectations, HD’s P/E to Growth (PEG) ratio is currently 2.1x compared to its 5-year historical PEG ratio of 1.7x. On an EV/EBITDA basis, HD shares trade at 15x compared to the 5-year historical average of 12x.

**McDonald’s Corporation (MCD - $200.08)**

**Company Description**
McDonald’s Corporation (McDonald’s) is one the largest restaurant companies in the world. McDonald’s is the leader in the quick service restaurant industry, traditionally focused on a value orientation and limited menu breadth, although this has been evolving. The company’s stores are 93% franchised and the company generates revenues primarily via fees (rent and royalties) from operators. McDonald’s generates the largest amount of its revenues in the U.S. and Canada, while also having significant exposure to Europe and China. McDonald’s owns the majority of its real estate in the U.S. and a significant portion of its real estate in international markets.

**Investment Thesis**
We are attracted to McDonald’s franchise model, believe that same-store-sales trends should be resilient and could potentially accelerate, and view McDonald’s strong cash flow generation and stable balance sheet as increasingly valuable in an uncertain macro environment.

We continue to be impressed by the stability of McDonald’s overall top-line algorithm. Despite the fact that U.S. guest count has remained muted, same-store-sales have continued to grow in the low-single-digit range annually. Although the company clearly still has room for improvement and competition remains fierce in the restaurant industry, McDonald’s has continued to press the right buttons (evolving ‘value’ options, all-day breakfast, increasing customization, ‘premiumization’, and store investment) to drive higher overall sales levels. The company’s international trends have also continued to outpace the company average, suggesting that the quick service concept has further room for market share gains in both developed and emerging markets. We believe that the company’s myriad efforts to improve U.S. traffic should at the very least keep guest count relatively stable and we see the possibility of improved traffic trends should the U.S. consumer begin to ‘trade down’ in the coming quarters.

We expect McDonald’s EBITDA margins to continue to expand modestly, while the company’s asset base continues to transition more toward a franchise/capital-light model, and share count/net capital invested continues to decline. The company has already made significant progress in moving further toward a franchised model but based on future unit opening plans we expect this trend to continue. We believe that these factors should continue to drive return on invested capital higher, ultimately supporting McDonald’s premium valuation.

Meanwhile, we view the company’s level of leverage as relatively conservative for a business model with such a high mix of franchised stores, low capital requirements, and stable sales trends. Even while maintaining a responsible level of leverage, McDonald’s has returned a material amount of capital to shareholders in recent years. We would expect consistent returns of capital to shareholders to remain a hallmark of this story, and while it is not our base case scenario, we believe the company could modestly increase its target leverage ratio to push share repurchases to a higher run-rate.
Investment Risks
Risks to McDonald's include 1) deterioration in U.S. same store sales trends 2) failure to execute on growth objectives in international markets 3) currency fluctuations 4) rising costs (i.e. ingredients, freight, labor) 5) financial difficulties for franchisees 6) increased competition due to growth of delivery options 7) failure to adapt to evolving consumer tastes (i.e. healthier eating).

Valuation
Shares of MCD currently trade around 24.1x the NTM consensus EPS estimate of $8.30 compared to its 5-year historical average of 21.9x. On a relative P/E basis (S&P 500), MCD shares trade at 1.3x compared to the 5-year historical average of 1.1x.

Consumer Staples

Constellation Brands, Inc. Class A (STZ - $189.53)

Company Description
Constellation Brands, Inc. (Constellation) is a leading player in the alcoholic beverage industry. The company’s largest source of revenue, beer (61% of revenues in fiscal 2018), is primarily driven by Corona and Modelo, with Constellation being the number one ‘high end beer’ company in the U.S. Wine (34% of fiscal 2018 revenues) includes brands such as Robert Mondavi, Meiomi, and Kim Crawford. Spirits (5% of fiscal 2018 revenues) is led by the company’s vodka offering (Svedka), although the company has been investing in other categories. Lastly, although the company does not yet own a controlling stake in Canopy Growth Corporation (CGC-$19.90), Constellation has increased its ownership in Canopy and has warrants that give it the right to achieve majority ownership in the future.

Investment Thesis
We are attracted to 1) continued strong top-line trends for Constellation’s beer labels 2) optionality from Constellation’s investment in a leading cannabis products company 3) relatively attractive valuation compared to other beverage companies and the company’s historical ranges 4) domestic-heavy focus and relatively low exposure to cost pressures and 5) the potential for a moderation in political risk in the coming quarters.

High-end beer sales have consistently grown mid-single-digits in recent years, with Constellation steadily outperforming this range via continued innovation in its beer portfolio. We expect relatively strong Hispanic population growth, increasing purchasing power for millennials, strong distribution capabilities, weak performance from large peers, and continued product extensions to drive above-market top-line growth for the company’s beer business in the coming years.

We have a measured level of enthusiasm concerning Constellation’s investment in Canopy, the leading cannabis producer in Canada, where recreational consumption of the substance became legal in October 2018. Cannabis remains illegal for recreational use in most U.S. states and we are not assuming widespread legalization as part of our investment thesis. We find the potential for growth in the Canadian market and for cannabis products globally outside of the U.S., as attractive enough to see value in the investment. We do believe that Constellation’s investment in Canopy provides Constellation with a unique first-mover advantage in the food and beverage industry and would view Canopy as well-placed to benefit from potential further liberalization of cannabis laws in the U.S and elsewhere in the world.

Investment Risks
Risks to Constellation include 1) weak trends in the company’s largest end market, beer 2) increased tensions related to NAFTA (North American Free Trade Agreement) 3) cost pressures including in commodities and freight 4) high levels of
competition across the company’s end markets 5) continued high levels of uncertainties in the nascent legal cannabis industry and 6) acquisition integration risk.

Valuation
Shares of STZ trade at a P/E ratio of approximately 22.1x NTM mean consensus EPS estimate for the company of $8.57, which compares to a 5-year average P/E multiple of approximately 19.0x. On a relative P/E basis to the S&P 500, STZ shares trade at 1.1x compared to its 5-year historical average of 1.1x.

Costco Wholesale Corporation (COST - $291.73)

Company Description
Costco Wholesale Corp. (Costco) engages in the operation of membership warehouses. Its product categories include food and sundries, hardlines, fresh foods, softlines, and ancillary. It operates through the following segments: Unites States Operations, Canadian Operations, and Other International Operations. The company was founded by James D. Sinegal and Jeffrey H. Brotman in 1983 and is headquartered in Issaquah, WA.

Investment Thesis
We believe that Costco’s strategy – limited assortment, high quantities, attractive price points, and steady but strategic assortment growth – is relatively simple, but has proven difficult for competitors to replicate. The company attempts to maintain stable gross margins and sustainably grow the top line by re-investing cost savings into its customer base, supporting strong loyalty and driving a positive feedback loop. We believe that this is evidenced by the company’s membership program, which boasts strong retention rates, continued growth in households and cardholders, and continued growth in higher membership tiers.

We cannot be certain of the timing or amount of another potential special dividend, but based on past capital allocation practices and the current state of Costco’s balance sheet, we believe that the company could choose to pay another sizeable special dividend in the near future. In any event, we believe the company’s balance sheet position is enviable, leaving management significant room to maneuver. We also take comfort in the knowledge that the company’s use of capital in the past has been focused (modest store count growth, strategic supply chain investments, and shareholder returns) and conservative (share repurchases and special dividends funded primarily by free cash flow or existing cash, not net debt issuance).

In a persistently competitive retail operating environment, we believe the consistency of the Costco’s results will continue to command a premium valuation. We also believe that the value of Costco’s Kirkland Signature private label brand is possibly under-appreciated by the market. Lastly, we believe that occasional special dividends can provide conservatively-financed incremental income to shareholders, thereby enhancing the stock’s attractiveness from a relative yield standpoint.

Investment Risks
Risks to Costco include 1) weakness in higher-income consumer fundamentals 2) tariffs on consumer products which could negatively impact gross margins due to higher product costs and/or drive weaker consumer spending growth 3) an increasingly aggressive retail pricing environment driven by elevated inventory levels 4) increasing costs to compete in e-commerce 5) failure to adapt quickly enough to the evolving retail landscape and 6) difficulty in expanding international operations.
Valuation
Recently, COST shares traded at roughly 32.7x the NTM mean consensus EPS estimate of $8.91, which compares to a 5-year average of approximately 27.5x. We would note that when adjusted for the size of Costco’s net cash position, shares trade at approximately 32.1x, only modestly above the 5-year average of approximately 31.2x. We also believe that the company’s consistent mid-single-digit same-store-sales growth should allow the stock to continue to trade at a premium multiple. On a relative P/E basis (relative to the S&P 500), COST shares trade at 1.8x compared to the 5-year historical average of 1.7x. In terms of yield, Costco has a current common dividend yield of 0.9% compared to its 10-year historical average of 1.4%.

Energy

**Chevron Corporation (CVX—$121.01)**

Company Description
Chevron Corp. (Chevron) is one of the largest global integrated oil companies. The company generates the majority of its cash from its upstream division, with key assets in the Permian basin, Australia, California, and Kazakhstan. Chevron also has a large portfolio of midstream and downstream assets, primarily in the Americas and Asia-Pacific, a portion of which are operated as part of a joint venture with Phillips 66 (PSX-$108.49).

Investment Thesis
We believe Chevron’s production growth expectations are particularly attractive when viewed relative to the level of capital required to generate this growth, which is approximately half of the company’s annual capital budget, suggesting ample flexibility in various oil price environments. We believe the company’s efficiency gains in the Permian basin in the U.S. and on its liquefied natural gas projects in Australia are likely to be key positive drivers of this story in the years ahead.

This growth outlook is supported by what we view as a solid combination of a strong balance sheet, solid cash flow generation, and shareholder-friendly capital allocation priorities. The company has an AA credit rating (as assigned by S&P) and maintains a below-peer average net debt-to-equity ratio. We believe that the company has proven its assertion that it can continue to cover its dividend with benchmark Brent crude oil prices of at least $50 per barrel. As production growth ramps in the areas mentioned earlier, we would also expect cash margins and cash returns to continue to improve, potentially pushing this ‘breakeven’ point even lower. Should oil prices rally, we would expect much of Chevron’s surplus free cash flow to fund its share repurchase program, an incremental positive for shareholders.

Investment Risks
Chevron faces strong competition in all sectors of the petrochemical chain and competes for the acquisition of crude oil and natural gas leases and other properties on a global scale. The energy industry tends to be capital intensive, cyclical and commodity price sensitive. Chevron has operations in historically unstable areas of the world which could impact the company’s results should tensions or conflicts arise. Environmental, political and regulatory risks are also important.

Valuation
Shares of CVX currently trade at around a 6.1% dividend yield on the NTM consensus dividend per share estimate of $2.41 compared to the 5-year historical average of 6.3%. On a relative P/E basis (S&P 500), CVX shares trade at 1.0x compared to the 5-year historical average of 1.0x.
Financials

Allstate Corporation (ALL - $112.83)

Company Description
Allstate Corporation (Allstate) is the second largest publicly-traded provider of auto and homeowners insurance in the country in terms of market capitalization. Originally, Allstate was a part of Sears, Roebuck and Co., founded in 1931 but has been independent since 1993. Currently the company is headquartered in Township, Illinois.

Investment Thesis
We believe Allstate is positioned to continue growing its personal lines business at a mid-single-digit pace, resulting in modest market share gains and continued underlying margin constancy. Allstate’s outsized leverage to personal lines products should provide stability to revenue and earnings relative to commercial lines and reinsurance, where rates have been disappointing. We prefer to see margin improvement over policy growth in Auto and management recognizes it has work to do increasing the number of policyholders in its direct-to-consumer business known as Esurance. Due to higher loss frequencies, Allstate has been aggressively raising premiums which has been flowing through to improving operating results. On the homeowner side, we think margins will continue to expand as Allstate prices ahead of modestly increasing cost trends, partially offset by higher catastrophic and non-catastrophic weather costs.

From our perspective, Allstate has a solid balance sheet with meaningful amounts of excess capital supporting future share repurchases. Management has historically done an admirable job of returning capital to shareholders. Moreover, reserve adequacy for Allstate appears to be stronger than peers that have higher exposure to commercial lines. Reserve releases and a declining share count support our expectation of EPS growth for Allstate to be better than peers. We believe this should enable Allstate to generate a sustainable 10%+ return on equity (ROE) over the next several years, especially considering the relatively stable personal lines pricing environment and favorable reinsurance markets.

Investment Risks
An unexpected rise in cost trends, pricing below trend due to competitive pressures, unfavorable development, unusually high catastrophic losses and potential increased scrutiny by regulators could negatively affect our positive outlook for the stock.

Valuation
Shares of ALL currently trade around 11x the NTM consensus EPS estimate of $10.22 compared to its 5-year historical average of 9x. On a relative P/E basis (S&P 500), ALL shares trade at 0.6x compared to the 5-year historical average of 0.5x. On an EV/EBITDA basis, ALL shares trade at 5x compared to the 5-year historical average of 4x.

Berkshire Hathaway Inc. Class B (BRK.B-$226.18)

Company Description
Berkshire Hathaway Inc. (Berkshire) is a diversified insurance company or a conglomerate, or both, depending upon one’s view. It is one of the largest companies in the United States, with strong franchises in insurance, industrials, utilities, and consumer and financial services. The insurance business, particularly the consumer lines (i.e. GEICO) form the foundation for the rest of the entity, providing a steady supply of float, better known as the amount paid in by policyholders in excess of casualty claims paid by the company in a given period. This float has allowed for the purchase of whole operating companies and minority stakes in public equities over the years.
**Investment Thesis**

We see Berkshire as solid way to maintain exposure to banks (a material portion of the company’s equity portfolio is invested here), while diversifying into insurance and gaining exposure to additional, generally more defensive sectors as well. As it pertains to the operating units, we believe they are generally well managed. GEICO, the company’s consumer insurance business, maintains robust market share and demonstrates solid underwriting. Burlington Northern Santa Fe, the country’s largest railroad, continues to sport industry-leading efficiency metrics (car miles per day and revenue per carload). The company’s ‘energy’ segment assets are primarily regulated utilities with minimal volatility in earnings trends. We believe the company’s manufacturing portfolio is also generally less cyclical than for instance, the S&P 500’s Industrials components, with the largest operating segment, Precision Castparts, operating primarily in one of our favored sub-industries (aerospace and defense). A large portion of Berkshire’s other manufacturing entities produce consumer non-durables and/or building materials. The remaining operating businesses, while generally more cyclically-oriented, are well-diversified, and represent a minority of Berkshire’s operating company profits.

Meanwhile, we estimate that Berkshire’s equity portfolio has lower volatility than the S&P 500 with its largest investments outside of the banks in generally stable companies. We believe that downside risk for Berkshire could be further mitigated by a strong balance sheet and a more aggressive stance on share repurchases. The company recently announced that it would relax a long-standing rule that it would only repurchase shares when they were trading below 120 percent of book value. This stance is supported by an AA credit rating (by S&P) and a large cash balance. What debt the company does have is largely supported by stable long-term real assets (primarily utilities and railroads). As an alternative to share repurchases, we believe persistent market dislocation could present Berkshire with unique investment opportunities.

**Risks**

Risks to investing in Berkshire include, fluctuations in the value of the company’s equity holdings, management succession / transition (primarily related to the advanced ages of Warren Buffett and Charlie Munger), an ill-timed or over-priced acquisition of operating companies, underwriting losses in the company’s insurance businesses, weakness in the U.S. and/or global economy which would negatively affect Berkshire’s industrial and consumer businesses, and the complexity of investing in a holding company structure.

**Valuation**

Shares of BRK.B trade at a Price to Book ratio of approximately 1.3x the NTM mean consensus book value per share estimate for the company of $164.59, which compares to a 10-year average Price to Book multiple of approximately 1.4x.

**JPMorgan Chase & Co. (JPM - $138.34)**

**Company Description**

JPMorgan Chase & Co. (JPMorgan) is one of the largest banks in the United States. The company operates market-leading franchises in consumer, commercial, and investment banking.

**Investment Thesis**

Why do we view JPMorgan as a conservative high quality idea in the banking sector? To start with, we believe it is one of the best operated universal banks in the U.S., with an industry-leading return on tangible common equity and efficiency ratio. Management has outlined further improvements on both measures and based on the company’s track record, we have a relatively high degree of confidence that even in a moderate growth environment, further modest improvement in margins and returns is likely. The company has also continued to play offense, gaining market share in retail deposits, moving up (or maintaining leading positions) in investment banking and trading tables and expanding in areas of consumer
credit (notably credit cards) and commercial lending. Bottom line, we believe JPMorgan sports some of the strongest operating metrics among its peers and is continuing to play offense.

Investment Risks
Risks to investing in JPM include more aggressive regulatory scrutiny/risk (as the company is seen as a systematically important firm), risk of facing higher capital requirements, macroeconomic risk as interest rates may remain low (flat yield curve), a forced restructuring, and potential slow economic growth and weaker loan demand than anticipated.

Valuation
Shares of JPM currently trade around 13.3x the NTM consensus EPS estimate of $10.38 compared to its 5-year historical average of 8.6x. On a relative P/E basis (S&P 500), JPM shares trade at 0.7x compared to the 5-year historical average of 0.5x.

US Bancorp (USB - $58.51)
Company Description
US Bancorp is a diversified financial services company that provides banking and investment services in 25 U.S. states, primarily in the Midwest and Western markets. The company operates four segments: wholesale and commercial real estate banking, consumer and small-business banking, wealth management and securities services, and payment services.

Investment Thesis
From our perspective, best-in-class operating efficiency, industry-leading fee income generation, and low levels of excess capital drive US Bancorp’s industry leading returns, which we view as repeatable and sustainable. The company’s limited capital markets exposure, combined with effective risk mitigation, served it well going into the financial crisis, enabling US Bancorp to come out of the 2008-2009 period stronger than when it went in. From our perspective, US Bancorp remains low in complexity and high on execution.

US Bancorp’s highly regarded management team is responsible for the company’s position as the most efficient bank in the industry. Payment services, wealth management and securities services segments have been the engines of fee income growth for the past few years. These businesses are less capital-intensive and generate higher returns than traditional bank lending businesses. We believe effective balance sheet management enables US Bancorp to run at the lowest level of excess capital in the industry. The company targets a dividend payout of 30-40%, a buyback of 40-50%, and retention of the remaining 15-25% of earnings to help support growth. In the current environment, we see little value to excess capital, based on our view that much of what’s in the system today is trapped by regulation and represents a drag on shareholder returns. As a result, we view favorably that US Bancorp has the lowest level of excess capital in the industry.

Investment Risks
A deceleration in economic growth, which intensifies the lack of appetite for credit among consumers and limits commercial investment in working capital, capital expenditure, and mergers and acquisitions. Lack of regulator willingness to allow excess capital to leave the system could lead to meaningful increases in capital levels, which would exert downward pressure on returns and negatively affect valuation. Significant amounts of deposits could eventually leave the system as rates increase, which may lead to a larger mix of wholesale borrowings that drives funding costs higher and compresses margins.
Valuation
Shares of USB currently trade around 13x the NTM consensus EPS estimate of $4.37 compared to its 5-year historical average of 12x. On a relative P/E basis (S&P 500), USB shares trade at 0.7x compared to the 5-year historical average of 0.7x.

Healthcare

**Abbott Laboratories Inc. (ABT—$85.89)**

Company Description
Abbott Laboratories (Abbott) operates in four primary markets: nutritional products, branded generic drugs in emerging markets, diagnostic equipment, and medical devices. Abbott has the number one market share in both adult (via Ensure) and pediatric (via Similac) nutrition products. The company also has a sizeable position in branded generics within emerging markets, where the products Abbott sells have a strong marketing platform and reputation. Abbott’s diagnostics business sells into the laboratory and point-of-care end markets, where the company’s Alinity line is a market leader. The company’s recent acquisition of St. Jude has expanded Abbott’s position in the medical device segment, with full-scale offerings of both cardiovascular and diabetes related product lines.

Investment Thesis
Abbott has engaged in meaningful portfolio reshuffling in recent years, diversifying Abbott away from generating a majority of its revenues from pharmaceuticals in 2012 to a majority from its diagnostics and devices segments today. We are attracted to Abbott’s collection of businesses as the company has balanced exposure to markets that are generally growing at or above market rates, leading market share in most of the segments it operates in, ample opportunity to drive operating efficiency as it integrates acquisitions and hones its focus, and an extremely strong balance sheet.

Diagnostics and devices both have continued to grow at a mid-single digit pace and we believe the company’s new product introductions (updated Alinity line, new diabetes and cardiovascular products) should drive above market growth in market segments and we expect to outpace GDP (gross domestic product) in the intermediate to longer-term. We would also expect synergies from the Alere and St. Jude acquisitions to boost profitability in the coming quarters and years. The branded generics segment, while subject to currency fluctuations in emerging markets, also continued to grow nicely on an organic basis. Although nutritionals, the company’s second largest segment, has been relatively slow growing, top line trends have been stable and the company continued to expand operating margins.

Given the company’s strong balance sheet, strong cash flow generation, and improved return profile after recent acquisitions, we believe that Abbott remains well-positioned to generate both organic and inorganic growth. Additionally, Abbott has relatively limited exposure to potentially negative regulatory outcomes in the U.S. given the company’s lack of exposure to proprietary pharmaceuticals and tilt toward devices, diagnostics, and nutritional products in this market.

Investment Risks
Abbott’s future revenues and operating income may be impacted by the expiration or loss of patent protection and licenses. The company’s products are subject to rigorous regulation by the U.S. FDA and international authorities which may cause delays or failure to obtain approvals for new products. Other risks include potential changes in health care regulations, inability to develop and launch new products, and fluctuating exchange rates.
Valuation
Shares of ABT currently trade around 24.4x the NTM consensus EPS estimate of $3.52 compared to its 5-year historical average of 16.6x. On a relative P/E basis (S&P 500), ABT shares trade at 1.3x compared to the 5-year historical average of 1.0x.

Danaher Corporation (DHR—$154.15)

Company Description
Danaher Corp. (Danaher) is one of the leading companies in the medical equipment space. Danaher has been built through a long-term acquisition and portfolio upgrading process and ultimately spun off the vast majority of its industrial assets (creating an entity named Fortive Corp) following the acquisition of Pall Corporation.

Investment Thesis
Before and after the spin-off of its industrial assets, Danaher has garnered a well-earned reputation of operational excellence (via the Danaher Business System) and efficient capital allocation (largely via continued value accretive mergers, acquisitions, and divestitures). We would note that roughly half of the current mix of business has only been in the Danaher portfolio for six years or less, which in our view provides scope for continued upside surprises on margin expansion. We also expect more recent acquisitions (Cepheid, Phenomenex, Pall) as well as the company’s remaining quasi-industrial exposure (at least 10% of revenues in our estimation) to drive above-peer revenue growth. Lastly, we believe Danaher’s two latest transactions, the spin-off of its dental business and the acquisition of General Electric’s Life Sciences unit to result in continued mix improvement and higher overall asset quality.

Investment Risks
Investment risks associated with Danaher include sensitivity to economic conditions and customer capital expenditure budgets, exchange rate risk given the company’s strong international presence, and acquisition integration and overpayment risks. Some of the company’s businesses are subject to regulatory risk due to third party oversight such as with the U.S. Food & Drug Administration. Health care reform may result in an effort to reduce costs by the customers the company serves, which may negatively impact the company’s growth and profitability.

Valuation
Shares of DHR trade at a P/E ratio of approximately 29.7x NTM mean consensus EPS estimate for the company of $5.20, which compares to a 5-year average P/E multiple of approximately 20.0x. On a relative P/E basis to the S&P 500, DHR shares trade at 1.6x compared to its 5-year historical average of 1.0x.

Zoetis, Inc. Class A (ZTS - $134.16)

Company Description
Zoetis, Inc. (Zoetis) is the world’s largest provider of animal health products. Zoetis’ revenue is roughly evenly split between companion animal (i.e. pets) and livestock. The company’s portfolio includes anti-infectives, vaccines, and parasiticides, as well as diagnostic equipment. Zoetis was formerly a subsidiary of Pfizer Inc. and was spun out in 2013.

Investment Thesis
We are attracted to the animal health industry for several reasons. First, growth in the number of pets and the propensity to spend on healthcare for pets continues to increase. Second, on the livestock side, protein consumption continues to increase, driving higher demand for drugs that ensure animal health and assist in boosting productivity. Third, although drugs and treatments must be vetted and approved by governmental bodies such as the U.S. FDA, the drug development
process is usually shorter and overall government regulation/involvement in the sector is quite low compared to human pharmaceuticals. Fourth, animal health also lacks many of the potential headwinds present in human health, namely third-party payor risk and competition from generics.

We like Zoetis specifically due to the company’s leadership position in the market (it is the largest animal health company by revenue in the world). The company has the largest internal sales force and the largest research and development budget by dollars in the industry. Additionally, many of Zoetis’ products are well-established in the marketplace and we would expect the company to be difficult to displace in most areas. We also believe the company’s pipeline could deliver positive results in the near future with a flea/tick/heartworm product awaiting FDA approval. Lastly, we believe the company’s recent acquisition of Abaxis could drive synergies on the top-line over the longer term as Abaxis benefits from the breadth of Zoetis’ salesforce and the combined entity’s product portfolio gains further heft with animal health providers globally.

Investment Risks
The largest risk we see to Zoetis is the company’s material overseas exposure, most notably in emerging markets. Zoetis generates an above average percentage of its revenues in these regions compared to other pharmaceutical companies as well as the health care sector overall. Secondarily, there is always the risk that competitors could develop superior products and gain market share at Zoetis’ expense. Lastly, the company recently acquired diagnostics equipment provider Abaxis, and the strategy of cross-selling diagnostics and drugs is unproven in the animal health industry.

Valuation
Shares of ZTS trade at an enterprise value multiple of approximately 23.6x NTM mean EV/EBITDA estimates for the company of 2,752 million, which compares to a 5-year average EV/EBITDA multiple of approximately 13.1x.

Industrials

*Honeywell International Inc. (HON - $178.86)*

**Company Description**
Honeywell International Inc. (Honeywell) is a diversified technology and manufacturing company serving customers worldwide across four segments – Aerospace, Building Technologies, Performance Materials & Technologies, and Safety & Productivity Solutions. As a leading software-industrial company, Honeywell blends software with physical products in an effort to take advantage of an increasingly connected world.

**Investment Thesis**
We believe the company possesses one of the more attractive portfolios among the late-cycle-oriented multi-industrials. Broadly speaking, the company operates in four large end markets, aerospace and defense, energy, automation, and non-residential construction. We believe over half of the company’s portfolio has very strong organic growth drivers, while the remainder fall into sectors that traditionally perform well against late cycle fundamentals.

We believe Honeywell has one of the best balance sheets and cash flow generation profiles in the entire industrial sector. The company is net-debt free. It also recently executed agreements to transfer several sets of liabilities to two spin-offs. Free cash flow conversion could approach 100% after recently announced spin-offs are completed. We believe this positions Honeywell in an ideal position to either be a) well-positioned for a downturn and/or b) execute on additional software acquisitions to build on an already solid platform across its segments.
Speaking of software, we believe Honeywell has one of, if not, the strongest digital industrial profiles among its larger cap peers. We believe that the company has strong and growing offerings in automation (Intelligrated), aerospace (avionics, connectivity), energy (process automation systems), and construction/buildings (smart meters). We expect an increasing amount of the value from capital goods to come from the software and services over the longer term and we believe Honeywell is well-positioned to benefit. We believe the company’s balance sheet also provides ample opportunity to make strategic acquisitions.

**Investment Risks**
A portion of the market’s positive outlook for Honeywell centers around an uptick in organic sales growth. If organic growth doesn't materialize, HON shares may react negatively. A slowdown in global GDP growth would potentially negatively impact Honeywell's growth trajectory as well. With approximately 40% of sales generated outside the United States, strength in the U.S. dollar relative to other currencies would negatively impact Honeywell's results. Honeywell's CEO is new to the role, having assumed the position in early 2017.

**Valuation**
Shares of HON trade at a P/E ratio of approximately 20.9x the NTM mean consensus EPS estimate for the company of $8.55, which compares to a 5-year average P/E multiple of approximately 17.1x. On a relative P/E basis to the S&P 500, HON shares trade at 1.1x compared to its 5-year historical average of 0.9x.

**L3Harris Technologies, Inc. (LHX - $210.47)**

**Company Description**
L3Harris Technologies, Inc. (L3Harris) was formed by a merger of equals between Harris Corp and L3 Technologies. We would note the former Harris Corp is the surviving entity and was in substance the acquirer. The combined company is the fifth largest defense contractor in the United States and has leading franchises across the broadly-defined communications end market.

**Investment Thesis**
We see four key tenets to our positive thesis on L3Harris. First, we believe that the company is poised to generate some of the strongest medium term revenue growth amongst the large defense contractors. Although the Department of Defense’s procurement is set to largely plateau in the near future, we believe the end markets and programs that L3Harris has a strong presence in should continue to grow strongly. We see a positive growth outlook for key L3Harris end markets including tactical communications (radios, drone operating terminals, secure networks), space (small satellites and other classified programs), aviation components (countermeasures, avionics, missile systems), and multi-service communications (i.e. aircraft-warrior coordination). Several smaller businesses for L3Harris, notably pilot training, could also see near term tailwinds. Longer term we believe L3Harris’ strong installed base on many programs across numerous operators (countries, branches of service, and other public entities), sustained investment in research and development, and enhanced scale post-merger should keep the company well-positioned.

Second, we believe the new entity has significant opportunities to reduce expenses and improve cash flow generation. Management has guided toward $500 in net cash synergies by the end of the third year as a combined company. We see these savings as highly achievable given the two predecessor companies’ significant overlap and legacy Harris’ reputation for operating and working capital efficiency. We would also note that legacy Harris management over-delivered on initial synergy projections on its last merger (Exelis).
Third, we believe the amount of capital return post-merger is highly attractive. Based on commitments at the close of the merger, L3Harris expected to return nearly 8% of its market capitalization to shareholders in the following twelve months. We believe this conveys a high degree of confidence in the entity’s projected three year free cash flow generation profile.

**Investment Risks**
Risks to L3Harris include 1) merger integration 2) customer concentration 3) pension funding status 4) defense spending levels 5) and loss of key programs/failure to win new contracts.

**Valuation**
Shares of LHX currently trade around 18.3x the NTM consensus EPS estimate of $11.48 compared to its 5-year historical average of 17.7x. On a relative P/E basis (S&P 500), LHX shares trade at 1.0x compared to the 5-year historical average of 0.7x.

**Information Technology**

**Accenture Plc Class A (ACN—$209.80)**

**Company Description**
Accenture plc (Accenture) is a global management consulting, technology services and outsourcing company operating in more than 120 countries. Accenture operates through the following business segments: Communications, Media, Technology, Financial Services, Health and Public Service, Products, and Resources.

**Investment Thesis**
We view Accenture as having a solid market position based on intellectual leadership, a broad portfolio mix of contracts across diverse industries and geographies and a strong balance sheet. We also consider Accenture a premium Information Technology (IT) services firm that generates significant and predictable free cash flow. We view Accenture as an attractive defensive opportunity for investors seeking exposure to the technology sector. Accenture has deep relationships with clients aided by its consulting practice that leverages a significant body of knowledge as it relates to clients’ processes. We believe this business model is sticky and allows for high barriers to entry as switching costs can be high for its clients. The company’s breadth of clients is also impressive in our opinion as Accenture has more than 150 clients contributing to more than $100 million in annual revenue.

Accenture operates a conservative balance sheet with little debt, which provides flexibility and the potential for increased capital return to shareholders in the form of buybacks and dividends. In the event of macro deterioration, we view Accenture as having significant flexibility to reduce headcount faster than most industries. Over the past few years, Accenture has successfully reduced costs as evidenced by an improved Selling, General, and Administrative (SG&A) to sales ratio. From our perspective, the company’s diversified business and improving capital returns to shareholders make Accenture an attractive defensive opportunity in the event of a macro slowdown.

**Investment Risks**
Accenture operates in highly competitive industries against very strong competitors, some of whom may be able to offer better pricing or service. The company’s results are dependent upon IT and consulting spending at the client level, i.e. corporations, governments. Global economic conditions can cause spending to slow and subsequently lead to lower growth and profitability at ACN.
Valuation
Shares of ACN currently trade around 26x the NTM consensus EPS estimate of $7.99 compared to its 5-year historical average of 18x. On a relative P/E basis (S&P 500), ACN shares trade at 1.4x compared to the 5-year historical average of 1.1x. When factoring in earnings growth expectations, ACN's PEG ratio is currently 2.8x compared to its 5-year historical PEG ratio of 2.0x. On an EV/EBITDA basis ACN shares trade at 16x compared to the 5-year historical average of 11x.

**MasterCard Inc. Class A (MA - $300.43)**

Company Description
MasterCard Inc. (MasterCard) is the second largest player in the payment processing industry. The company processes transactions for networks of merchants via both debit and credit cards both in the U.S. and globally. MasterCard also has growing operations in business-to-business payments, non-card transactions, and payment processing related services.

Investment Thesis
We see the potential for MasterCard's core payment processing market to post strong growth in the coming years based on 1) increasing penetration of credit cards globally 2) growth in U.S. and global consumer spending 3) new payment methods that continue to reduce friction for cashless payments and 4) the continued outgrowth of e-commerce (where credit card utilization rates are higher than brick-and-mortar). MasterCard is the second largest payments processor globally with a notably strong position in international markets where card penetration rates are typically lower than in the U.S. We also believe that MasterCard has some unique opportunities outside of its payment processing business, such as add-on services (security, analytics) and business-to-business/consumer-to-business payments (enhanced by the acquisition of Vocalink).

MasterCard and other leaders in the payments processing space have proven difficult to displace as they have extensive networks of cardholders, strong technology systems with a first-mover advantage over competitors, and deep knowledge of security and regulatory concerns. We expect this to remain the case at least in the intermediate term and we believe MasterCard will utilize its strong position to continue to expand its addressable market.

MasterCard scores very highly on key quality metrics in our eyes. The company has no net debt, generates high returns on invested capital, returns significant amounts of capital to shareholders with room for growth (dividend and shareholder payout ratios remain conservative), and runs a business model with significant operating leverage (i.e. expenses have traditionally grown at less than the rate of revenue growth).

Investment Risks
We believe key risks related to MasterCard include: trends in global consumer spending, the rate of penetration of credit cards, intense competition with existing peers in the payment processing industry, the rise of new competitors both geographically and in terms of new technology, acquisition integration, regulation, and currency fluctuations.

Valuation
Shares of MA currently trade around 34.9x the NTM consensus EPS estimate of $8.61 compared to its 5-year historical average of 17.8x. On a relative P/E basis (S&P 500), MA shares trade at 1.8x compared to the 5-year historical average of 1.1x.
Microsoft Inc. (MSFT - $158.62)

Company Description
Microsoft Inc. (Microsoft) operates three primary segments, Productivity and Business Processes (Office, LinkedIn), Intelligent Cloud (Enterprise Services, Azure) and More Personal Computing (Windows, Bing, Surface, Xbox). Although Microsoft has long been known for its leading positions in the operating system and office productivity areas of the software universe, the company also has a robust offering of enterprise and personal computing solutions.

Investment Thesis
We expect companies to continue to migrate increasing portions of their IT infrastructure onto cloud-based platforms. We anticipate Microsoft’s Azure offering to be a primary beneficiary of this trend. We believe Microsoft has a unique and broad range of solutions, combining on-premise applications (i.e. various .NET programs), public cloud computing infrastructure and applications (Azure), productivity software (Microsoft Office/Office 365), and a host of complimentary programs (i.e. LinkedIn). We view this stable of applications and services as providing the opportunity to gain an increasing share of customer IT spend as corporations progress through the various stages of cloud migration.

We believe Microsoft’s broad and high quality product offering allows the company to act as a sort of ‘one-stop-shop’ for enterprise IT spending in a ‘hybrid cloud’ world. This is the central tenet of our positive investment outlook on the company, although we also believe the change to a perpetual license model at Microsoft Office and strong operating expense control should remain intermediate term positives for earnings growth. We are comfortable with consensus expectations for revenue and earnings growth to accelerate further in the coming years as we expect Azure and the company’s overall enterprise offering to gain market share in a rapidly expanding marketplace. We expect valuations to remain near newly established highs as the company’s growth outlook continues to improve and an increasing portion of Microsoft’s revenue is generated on a recurring basis.

Investment Risks
Investment risks include cannibalization of Microsoft’s core PC market by mobile tablet devices, limited success to date with the company’s online and smartphone strategies, threats from competitive cloud-based services, piracy of MSFT software, particularly in emerging markets, and ongoing antitrust and other litigation.

Valuation
Shares of MSFT currently trade around 29x the NTM consensus EPS estimate of $5.48 compared to its 5-year historical average of 16x. On a relative P/E basis (S&P 500), MSFT shares trade at 1.5x compared to the 5-year historical average of 0.9x. On a price-to-sales basis, MSFT shares trade at 8.5x compared to the 5-year historical average of 3.9x. On an EV to FCF (Free Cash Flow) basis the shares trade at 27.2x compared to the 5-year historical average of 10.4x. Although Microsoft’s valuation multiples are above the company recent averages, we believe the company’s transition to a more recurring revenue based model is likely to boost the stability of the company’s cash flow generation profile, making price-to-sales and EV to FCF (which are used for evaluating most pure software companies) more relevant.

PayPal Holdings, Inc. (PYPL - $108.76)

Company Description
PayPal Holdings Inc. (PayPal) is a leading technology platform company that enables digital and mobile payments on behalf of consumers and merchants worldwide. It also facilitates person to person payments through PayPal, Venmo, and Xoom. The company was founded in 2015 as the result of a spin-off from eBay Inc.
**Investment Thesis**
We are attracted to PayPal’s superior growth prospects, strong brand recognition, global scale, and strategic market position in e-commerce and the burgeoning digital payments business. Analysts currently estimate mid double-digit annual revenue and EPS growth for PayPal from a number of potential drivers: (digital payments) market growth, new/emerging markets (e.g., credit, in-app and in-store payments), an increase in users, greater frequency of use, expansion of its merchant base now that it is untethered from eBay, increasing share with existing merchants, international expansion, etc. PayPal expects double-digit growth in its total payment volume (TPV) to continue for the next several years as e-commerce continues to gain market share. PayPal’s open system architecture, ease of use, variety of funding options and security make its platform appealing to both commercial and individual customers. We also believe past successful acquisitions (Braintree, Paydiant, Venmo, Zoom) have solidified PayPal’s offering in the rapidly growing mobile and person-to-person (P2P) digital payments space.

**Investment Risks**
PayPal’s risks include (1) as a commerce enabler, PYPL’s business is correlated to changes in consumer discretionary spending – therefore, any deterioration would impact top-line growth; (2) PYPL faces competition from a host of products offered by both incumbents and new players in the payment space; (3) increased concerns over online privacy and/or identity theft, fueled by growth in malware, adware, malicious Websites, phishing scams, and/or spam could lead to increase in user perception of fraud in online activity and hurt growth in e-commerce and, ultimately, online payments; and, (4) foreign exchange risks given that around 50% of PYPL’s sales occur outside the U.S.

**Valuation**
Shares of PYPL currently trade around 32x the NTM consensus EPS estimate of $3.36, compared to its historical average of 21x. On a relative P/E basis (S&P 500), PYPL shares trade at 1.7x compared to the historical average of 1.2x. PYPL’s PEG ratio is currently 1.6x compared to its historical PEG ratio of 1.0x. On an EV/EBITDA, PYPL shares trade at 22x NTM EBITDA compared to the historical average of 14x.

**salesforce.com, inc. (CRM - $166.17)**

**Company Description**
salesforce.com, inc. (Salesforce) is a leading provider of customer relationship management (CRM) software. The company sells its on demand applications to businesses of all sizes in almost every industry worldwide on a subscription basis, primarily through direct sales efforts and also indirectly through partners. Salesforce also provides a hosted platform for third parties to develop additional functionality and new applications that are sold separately from, or in conjunction with, its core applications offerings.

**Investment Thesis**
We are attracted to the company’s near-dominant position in salesforce management software and believe the executive team is one of the most effective in all of software at acquiring, integrating, and cross-selling complementary offerings.

The migration to cloud software has been highly disruptive in the tech sector and Salesforce has been on the leading edge since the beginning. We believe the company’s core customer relationship management software program will continue to hold and potentially expand its already high market share in this space. Salesforce has a strong history of expanding its product suite and we believe the recent acquisitions of MuleSoft and Tableau should further strengthen the company’s position.
Salesforce’s overall financial profile is amongst the best in the software industry. Salesforce continues to stronger generate growth and profitability metrics, even from a higher base level, than many smaller peers. The company also has minimal net debt.

**Investment Risks**
If the global economy or specific end markets significantly worsen, contracting IT spending and impairing software growth would impact revenue and EPS growth opportunities for CRM. Additionally, the rate of Service-as-a-Solution (SaaS)/Cloud adoption slows, resulting in prolonged sales cycles and higher-than-anticipated quarterly volatility. Increased competition from Adobe, Oracle and/or SAP (SAP-EUR) would likely limit Salesforce’s share gains. Finally, emerging competition at the low-end cannibalizes CRM’s small/medium business base, would increase churn rate and limit overall growth.

**Valuation**
Shares of CRM trade at an EV to sales ratio of approximately 7.4x NTM mean revenue estimates for the company of 13,282 million, which compares to a 5-year average P/E multiple of approximately 3.7x.

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**Texas Instruments Inc. (TXN - $127.85)**

**Company Description**
Texas Instruments Inc. (Texas Instruments) is a globally integrated analog chipmaker with significant share in all end-markets, except wireless communication.

**Investment Thesis**
Texas Instruments reports in two business units: the diverse Analog segment has provided steadier growth than the more volatile Embedded Processing segment. In our opinion, its diverse customer base and exposure to sectors such as industrials and automotive will likely result in stable growth. Revenue for the industry is estimated to increase at a multiple of the global GDP growth rate. An exit from its cellular baseband business and a more diversified profile are likely to yield more stable sales growth vs. peers. Industrial systems and autos that use the chips made by Texas Instruments have long product cycles, need high reliability and, after stringent quality checks, don’t change chipmakers over shorter periods. These sectors also have higher, more stable gross margins.

While the company is gradually upgrading technology in its facilities, less exposure to the fast-evolving consumer chip market lets it hold spending at less than half its peer average allowing it to free up cash for capital return. Management is committed to returning capital to shareholders with a generous dividend payout ratio and attractive yield while continuing to reduce the share count via buybacks.

**Investment Risks**
Increased competition in some of TXN’s strategic businesses including analog is a risk that could lead to market share losses or pricing compression negatively impacting gross margins. Lower end chips are commodity semiconductors and can be subject to intense pricing pressures. Pricing pressures represent a risk to revenue and gross margin leading to potential oversupply which could result in inventory unloading.

**Valuation**
Shares of TXN currently trade around 27x the NTM consensus EPS estimate of $4.69 compared to its 5-year historical average of 20x. On a relative P/E basis (S&P 500), TXN shares trade at 1.4x compared to the 5-year historical average of
1.1x. When factoring in earnings growth expectations, TXN’s PEG ratio is currently 3.6x compared to its 5-year historical PEG ratio of 2.6x. On an EV/EBITDA basis TXN shares trade at 18x compared to the 5-year historical average of 14x.

Real Estate

**Realty Income Corporation (O - $73.79)**

**Company Description**

Realty Income Corp. (Realty Income) is a real estate company with diverse properties and tenants spread across the U.S. The company’s primary objective is to generate dependable monthly cash dividends from a consistent and predictable level of cash flow from operations. The company typically leases properties to regional and national commercial enterprises and acquires properties that are freestanding, commercially-zoned with a single tenant.

**Investment Thesis**

We view Realty Income favorably given the company’s large and diverse portfolio of single tenant properties leased under long term leases, a conservative financial position, and an impressive common dividend track record. Although the company is predominantly focused on U.S. retail assets, the company does have sizeable holdings in industrial and other asset classes, as well as retail properties in Europe. Realty Income maintains investment grade credit ratings from both Moody’s and Standard & Poor’s which we view as important in the Real Estate sector given the high cash flow distribution requirements of real estate investment trusts (REITs). Realty Income has raised its common dividend for 87 consecutive quarters and has grown its common dividend by a compound annual rate of roughly 4.6% since its initial public listing in 1994. We view both of these dividend growth achievements favorably and believe this common dividend growth demonstrates the stability of Realty Income’s cash flows along with management’s commitment to providing consistent common dividend growth.

**Investment Risks**

The real estate market is highly competitive. Cash flow may be affected by factors such as lack of demand, inability to retain existing tenants and attract new ones, oversupply of space, changes in market rental rates, tenant financial health, etc. Lack of liquidity or access to capital markets could impact the company’s financial position and ability to pursue acquisitions. Bankruptcies or financial distress among the company’s tenant base could negatively impact the company’s financial results. O shares tend to be interest rate sensitive (with a negative correlation).

**Valuation**

O shares recently traded at 21.6x the consensus next twelve months FFO per share estimate of $3.45, compared to the 5-year historical level of 17.1x. In terms of common dividend yield, O has a current common dividend yield of 3.7% compared to its 5-year historical average of 4.6%.

Utilities

**NextEra Energy, Inc. (NEE—$240.32)**

**Company Description**

NextEra Energy Inc. (NextEra) is one of the largest electric power companies in North America. NextEra’s business can be divided into two main segments- a well-run, high-quality regulated utility primarily situated in Florida and one of the world’s leading renewable electricity companies. NextEra also owns a majority stake in NextEra Energy Partners LP (NEP-$52.22).
Investment Thesis
We are attracted to NextEra’s balanced defensive and growth characteristics which are supported by the company’s regulated operations in a favorable regulatory and geographic environment, operating excellence, and renewable generation expertise and positioning.

Investment Risks
NextEra's business operations are subject to federal, state, and other regulations that may impact its allowed returns. The company is subject to numerous environmental laws and regulations which may result in significant capital expenditures, increased operating costs, and various other liabilities. Weakening economic conditions, slower growth in customer accounts or in customer usage may directly influence the demand for electricity. Extreme weather conditions can cause power outages and property damage, reduce revenue, effect fuel supply, and require the company to incur additional costs which may not be immediately recoverable through rates.

Valuation
Shares of NEE currently trade around 27.9x the NTM consensus EPS estimate of $8.62 compared to its 5-year historical average of 21.0x. On a relative P/E basis (S&P 500), NEE shares trade at 1.5x compared to the 5-year historical average of 1.0x. The shares currently trade at a premium P/E ratio as a result of the increased attractiveness for income oriented investors seeking perceived stability in higher yielding investments following the sharp drop in benchmark interest rates witnessed year to date.
IMPORTANT DISCLOSURES

Disclosure information . . . For important disclosure information, please contact:
Wells Fargo Advisors
Attn: Advice & Research (Disclosure Information)
One North Jefferson, St. Louis, MO 63103 Or call (877) 785-4332
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Definitions
Consensus Next-12 Months (NTM) earnings per share (EPS): Street consensus earnings per share estimate for the next 12 months. For REITs we use adjusted funds from operations (AFFO). For MLPs we use Distributed Cash Flow (DCF).

Next-12 Months (NTM) price-to-earnings (P/E): Price to earnings ratio based on the next 12 months EPS. For REITs we use P/AFFO. For MLPs we use P/DCF.

Super-voting stock is a class of stock that provides its holders with larger than proportionate voting rights compared with another class of stock issued by the same company.

Disclaimers
All prices are as of January 3, 2020 unless otherwise indicated.

You should be aware that investments can fluctuate in price, value and/or income, and you may get back less than you invested. We recommend that existing shareholders consider their objectives, their risk tolerance, and the size of their positions relative to their portfolios when evaluating their holdings.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. There is no guarantee dividend-paying stocks will return more than the overall market. Dividends are not guaranteed and are subject to change or elimination.

The prices of mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Investments in the energy sector are subject to the adverse economic events within that industry. A downturn in the energy sector of the economy, adverse political, legislative or regulatory developments or other events could have a large impact on a portfolio’s investments.

There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner’s tax bracket.
Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

MLPs are not for all investors, and are particularly not usually appropriate for retirement-related accounts. Also, an MLP shareholder, i.e. a limited partner unit holder, receives a K-1 instead of a 1099. Investors should contact their tax accountant for further tax implications before investing in MLPs. Wells Fargo Advisors is not a legal or tax advisor.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

### Credit Ratings

<table>
<thead>
<tr>
<th>Credit quality</th>
<th>Moody's</th>
<th>Standard &amp; Poor's</th>
<th>Fitch</th>
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</thead>
<tbody>
<tr>
<td>Prime</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
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<tr>
<td>Excellent</td>
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<td>Lower medium</td>
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<td>BBB</td>
<td>BBB</td>
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<td>B, CCC, CC</td>
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<tr>
<td>Default</td>
<td>Ca, C</td>
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<td>DDD, DD, D</td>
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</table>

Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category. Standard and Poor’s ratings from ‘AA’ to ‘CCC’ may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

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