Miller Howard INVESTMENTS

Drop in Free Cash Flow Raises Concerns

QUARTERLY REPORT 2Q 2022

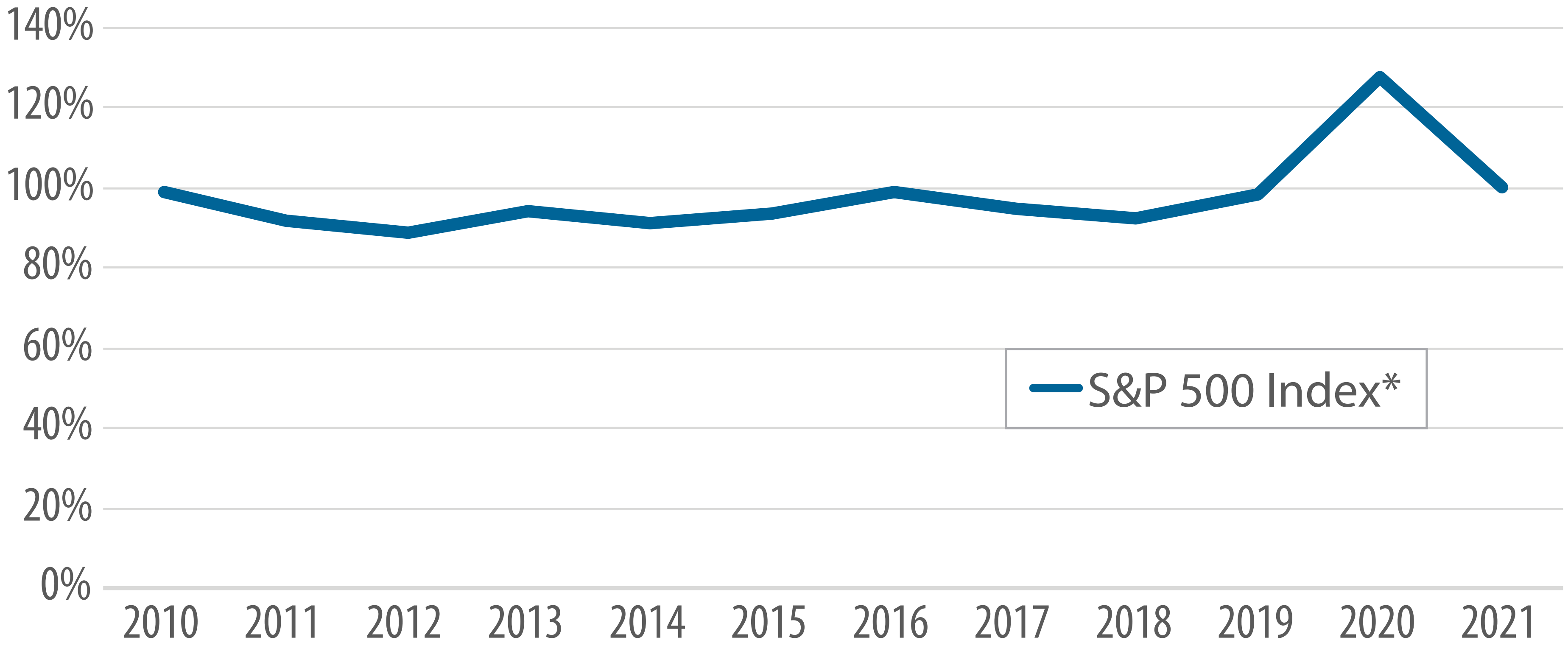
Everybody loves a good story. The stock market is filled with stories of strong earnings, future growth, and a better tomorrow just around the corner. Some of it will actually come true. Income investors tend to view these opportunities with skepticism—growth forever sounds great, but we have more confidence in the companies that back up their stories with dividends that grow over time.

While not agreeing on the importance of dividends, investors of all stripes have adopted an appreciation for free cash flow (FCF) in recent years. Focusing on cash flow after capital expenditures appeals to income investors as free cash flow represents the cash available to pay dividends, reduce leverage, or buy back shares. This new focus also represents distrust of stock market stories that are based on earnings as defined by accrual accounting.

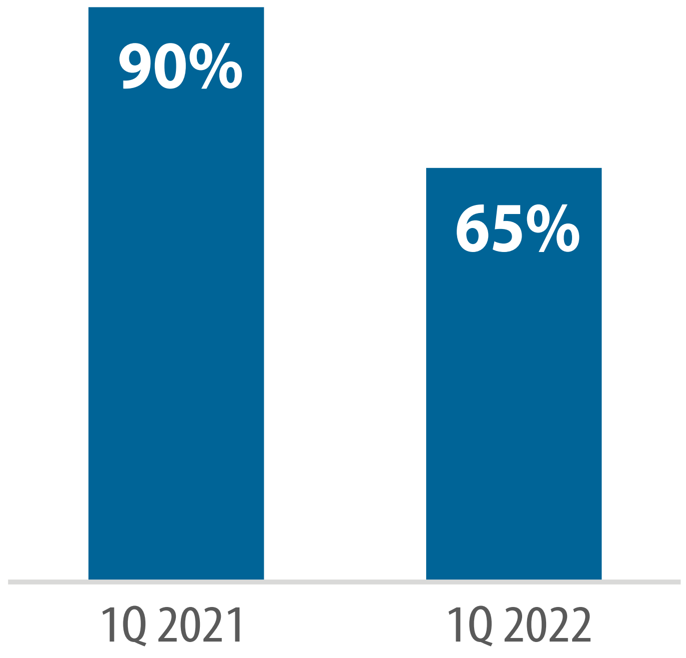
Looking at the core of the S&P 500 Index, where free cash flow is a useful metric (i.e., leaving out financials, real estate and utilities where free cash flow does not apply), free cash has generally ranged from 90-100% of net income. The first year of pandemic, 2020, was an outlier as profits swooned with the economy, but many companies cut capital spending and made sales out of inventories. The relationship between net income and free cash flow normalized in 2021.

Free Cash Flow/Net Income Ratio Declined in 1Q 2022

By Calendar Year



1Q 2021 / 1Q 2022 Comparison

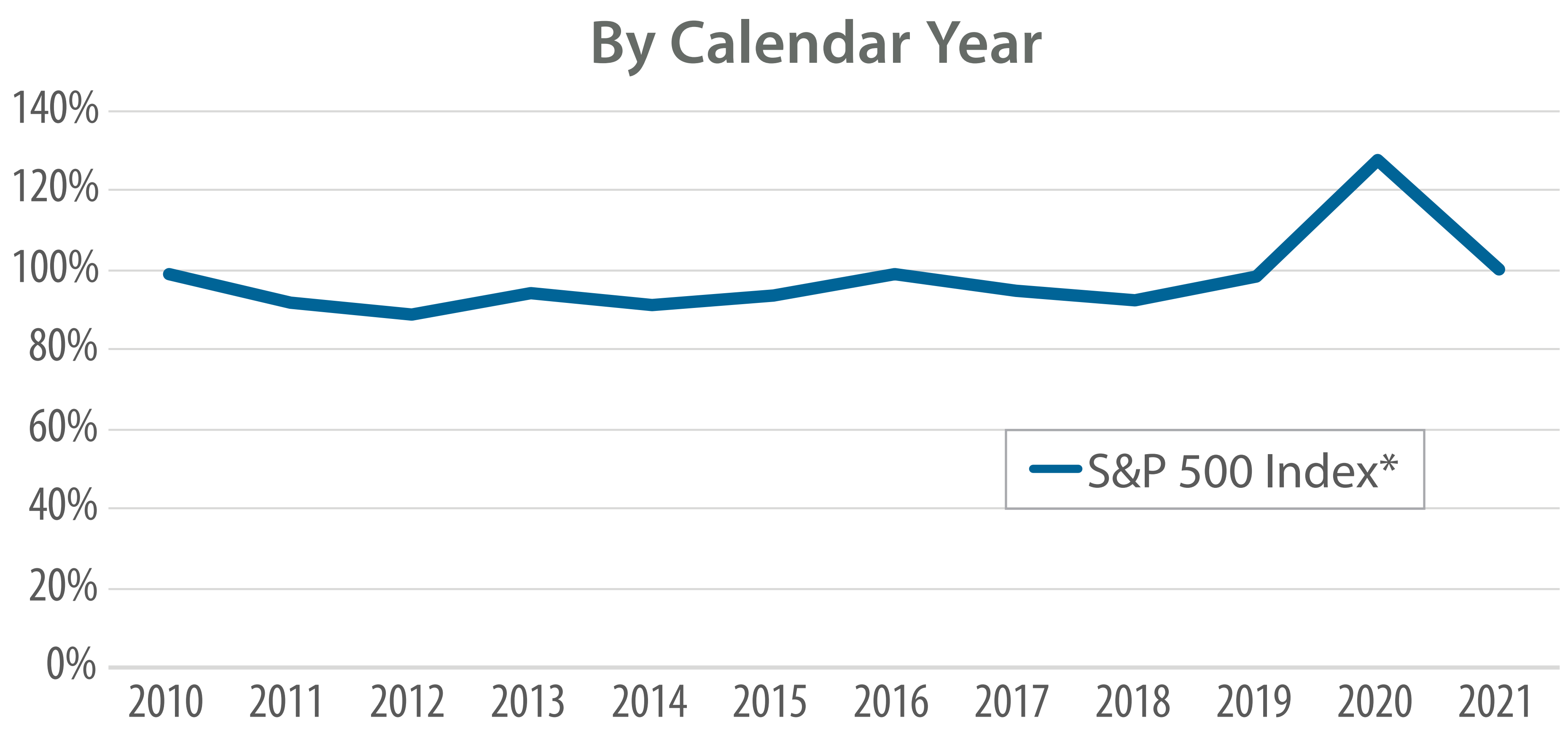


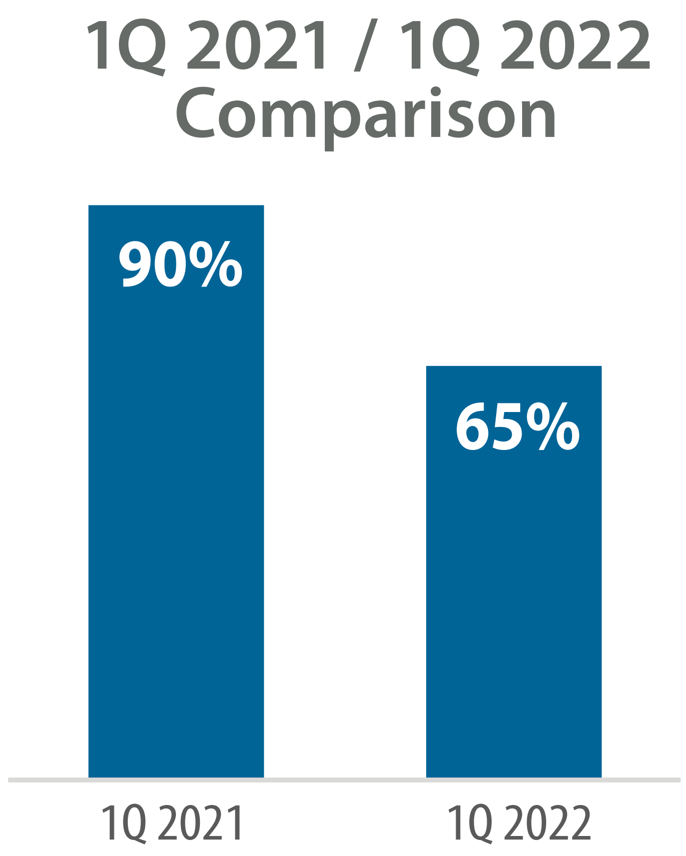
As of March 31, 2022. Sources: Bloomberg; Miller/Howard Research & Analysis.

*Created by screening all members of the S&P 500 Index as of calendar year end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Free cash flow and adjusted net income are 12-month trailing. Values are aggregate.

In the first quarter of 2022, the market witnessed a crack in the link between free cash flow and net income—free cash flow was only 65% of net income in 1Q 2022 compared to 90% in 1Q 2021. There is some seasonality to free cash flow, but the drop versus 1Q 2021 is concerning.

Free Cash Flow/Net Income Ratio Declined in 1Q 2022





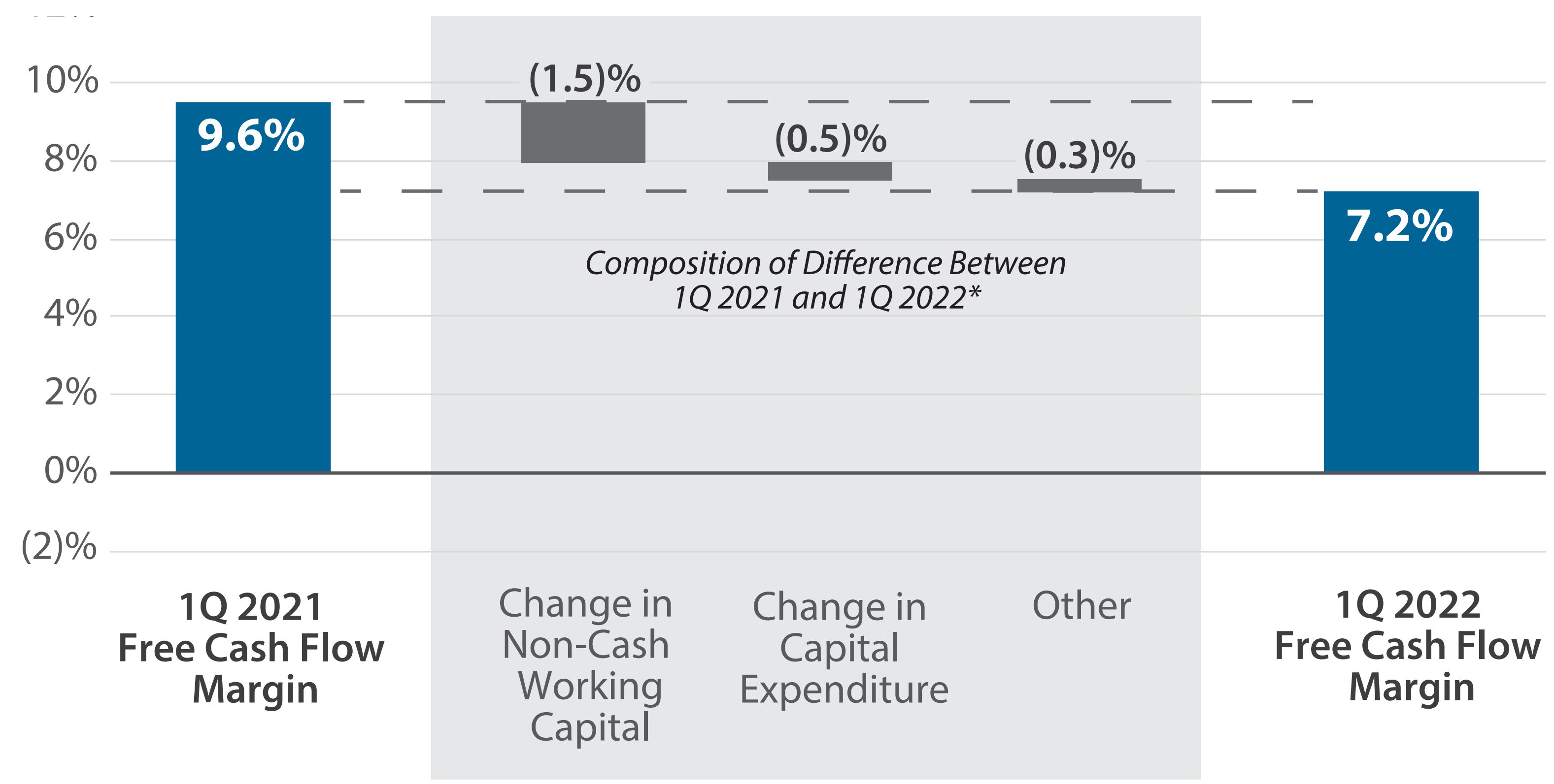
As of March 31, 2022. Sources: Bloomberg; Miller/Howard Research & Analysis.
*Created by screening all members of the S&P 500 Index as of calendar year end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Free cash flow and adjusted net income are 12-month trailing. Values are aggregate.

Investors who focus solely on earnings were enthused to see net income for the core S&P 500 (adjusted for unusual charges) rise 18% year-over-year in 1Q 2022. But in contrast, free cash flow fell by 15% year-over-year in 1Q 2022. **According to accrual accounting, 1Q 2022 was a great quarter, while through the free-cash-flow lens, we see signs of a potential recession.**

The earnings that Wall Street tracks are based on accrual accounting. Much of accrual accounting makes sense, but **investor skepticism mounts when normally stable financial line items begin to bulge, reducing free cash flow.** A spike in noncash working capital can signal a breakdown in the conversion of revenue into free cash flow. Higher receivables may indicate that collections are becoming difficult. Higher inventories frequently result in price discounts to "blow out" inventories in future periods. In some industries, such as apparel or technology, inventories can diminish in value over time. A barrel of oil will still be worth the going price for oil a year later, but last year's clothes or mobile phones will need to be discounted to compete with new goods.

Increases in capital spending can also be a warning sign for investors. Accrual accounting spreads capital spending over time, reducing the impact on earnings. In contrast, **the free cash flow approach recognizes that an increase in capital spending immediately reduces a firm's ability to pay dividends or any other positive use of cash.**

Drivers of the Free Cash Flow Margin

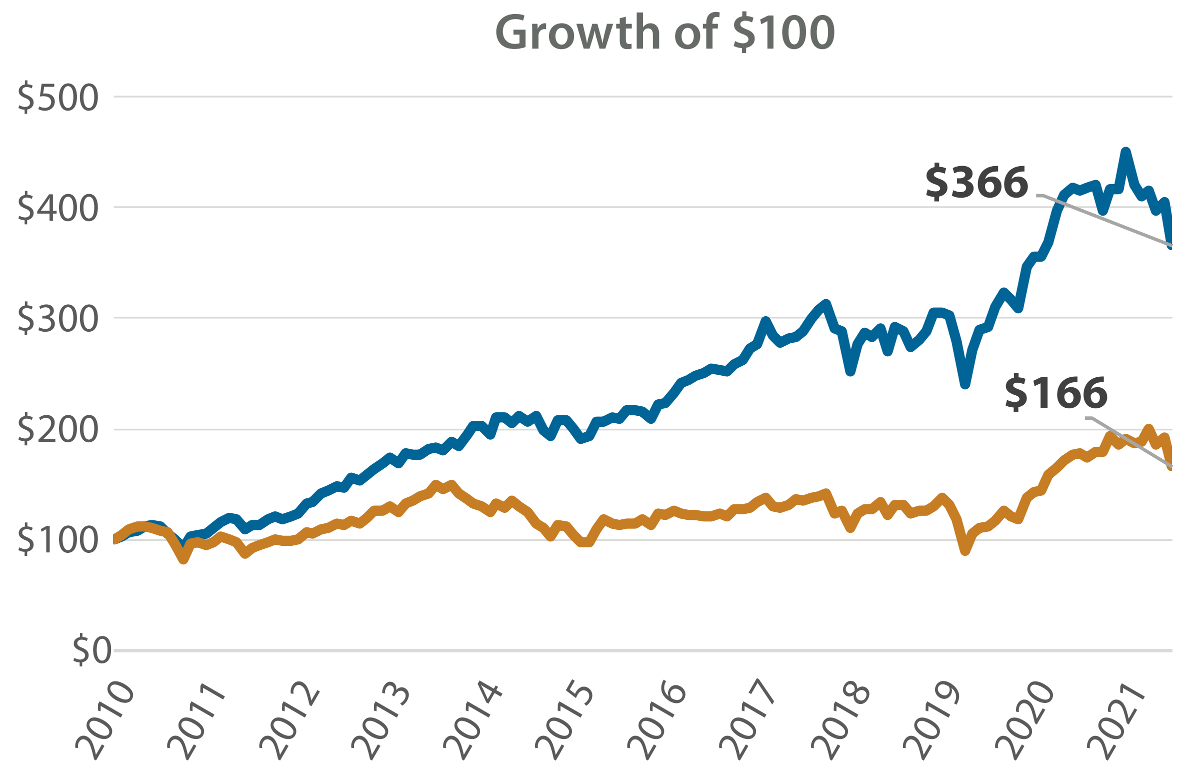


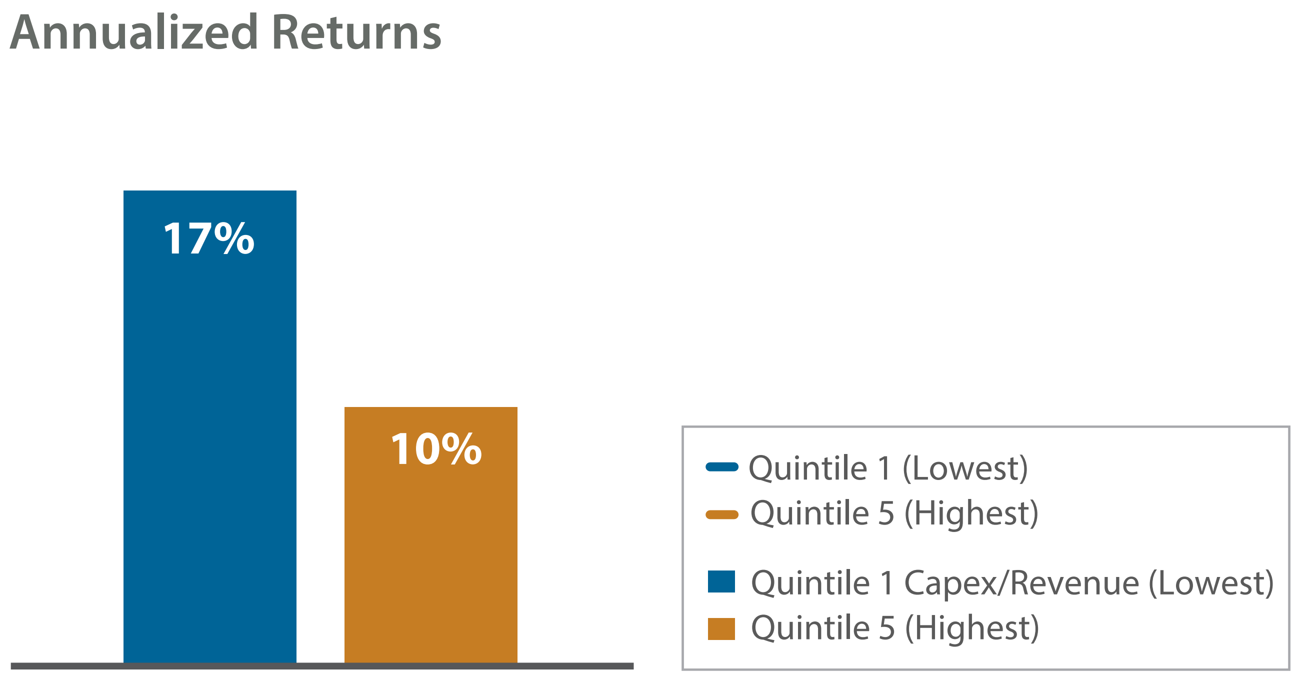
As of March 31, 2022.
Sources: Bloomberg; Miller/Howard Research & Analysis.
*Change in non-cash working capital, change in capital expenditure, and other are measured as a percentage of revenue. Created by screening all members of the S&P 500 Index as of calendar year end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Aggregate values for free cash flow, capital expenditures (capex), non-cash working capital and revenue are as of the reported quarters based on calendar year date. Free cash flow margin is free cash flow divided by revenue.

Last year, in 1Q 2021, revenue was converted into free cash flow at a rate of 9.6% for the core of the S&P 500. In 1Q 2022, this conversion rate dropped to 7.2%, roughly 25% lower. Delving into the causes for this remarkable drop, we see that two-thirds of the issue came from an increase in non-cash working capital, primarily from higher inventories. **As companies were reporting their 1Q 2022 earnings, we noted bulging inventories at a number of companies**—it even drove some of the portfolio sell decisions in our Income-Equity Strategies. An optimistic explanation for the increase would be that supply chain difficulties are causing managers to build inventories to reduce the chance of stock-outs, either of inputs or finished goods. It is possible, however, that aggregate demand is slowing down, clogging the system with inventories that may be hard to sell in the future. No one knows exactly how this will play out, but **we believe higher inventories represents a red flag for investors,** causing us to redouble our focus on companies with good free cash flow.

While a secondary cause of the recent drop in revenue-to-free cash flow conversion, we are watching trends in capital spending with a wary eye. Since the Global Financial Crisis, companies in the S&P 500 that spend a higher percentage of revenue on capital expenditures have underperformed those spending less. The quintile with the lowest ratio of capital spending-to-revenue had almost double the annual returns as the quintile with the highest ratio. This is an astounding result given that it does not involve the type of variable that either growth or value investors focus on, such as sales growth, price momentum, or valuation.

Companies with Lower Capex to Revenue Ratios Outperform





As of June 30, 2022. Sources: Bloomberg; Miller/Howard Research & Analysis. Portfolios for growth of $100 were created by screening all members of the S&P 500 Index as of calendar year end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. The resulting universe of stocks was then quintiled by trailing capex/revenue where quintile 1 had the lowest capex/revenue and quintile 5 the highest. All quintiles are equal-weighted. Growth of $100 is through 6/30/2022 where annualized is for the period 2011 – 2021.

We'd note that this analysis does not include regulated utilities for a reason—the regulatory construct limits competition and allows utilities to raise rates to generate a reasonable return on capital. For utilities, a higher fraction of revenue going to capital expenditure has led to higher total shareholder returns over the same period.

Setting regulated utilities aside, why would higher capital spending be bad for equity returns? After all, society needs companies to build factories and office buildings and the like. Part of the answer lies at the heart of how capitalism works—a large number of companies see an opportunity and many make the investment required. If we had only one auto company or one airline, no doubt prices would be sky high. Multiple companies chasing the same opportunity drive down prices, reducing the return on capital investment. Sometimes the result is a reasonable return, but competition can also be so fierce that the return on investment is subpar. Examples include decades of losses in the US airline industry, and, more recently, the price wars that have dampened profits in the wireless phone industry.

Competition isn’t the only cause of poor investment returns for capital expenditure. Frequently, business cases are built on forecasts that turn out to be wildly wrong. The best-known examples tend to be acquisitions rather than capital expenditures, but the principle is the same. Consider Time Warner’s purchase of AOL, or, more recently, AT&T’s acquisition of Time Warner*. Writing big checks based on long-term forecasts can be a risky enterprise. New technology, or new competition, is hard to foresee.

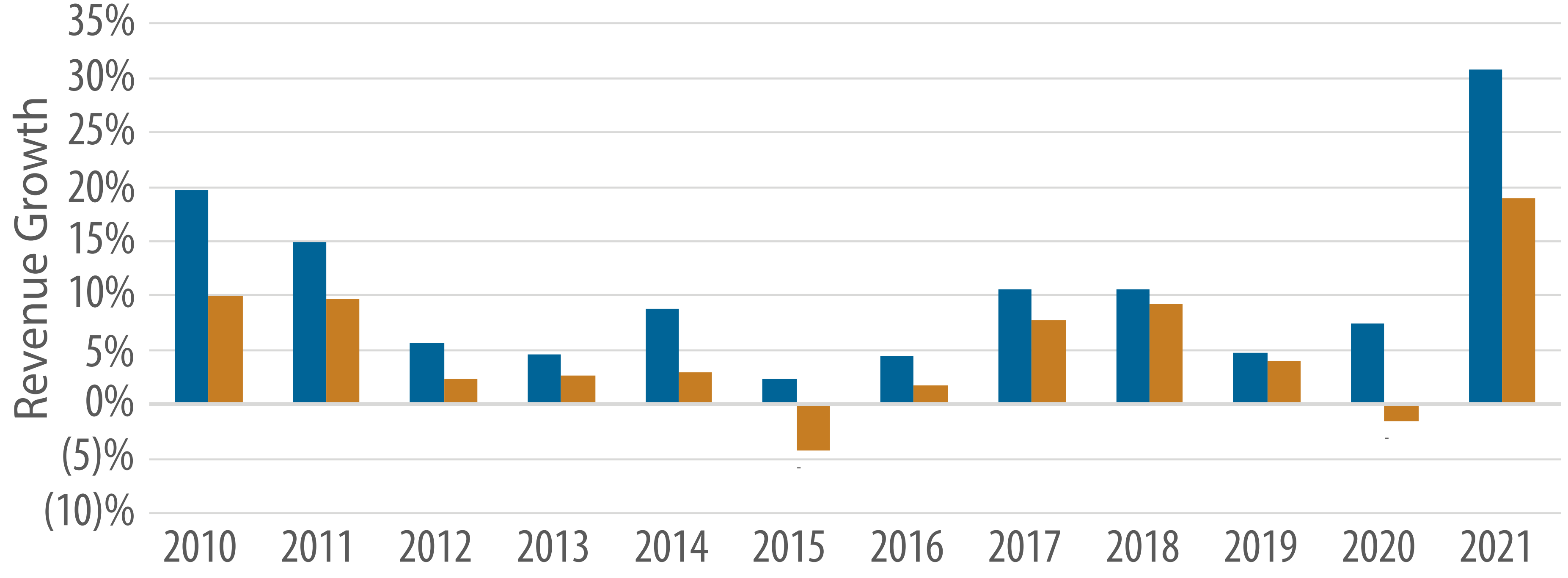
What of the notion that, **“You have to spend money to make money”?** The rise of capital-light business models shows that this just isn’t so. The best examples of capital-light business models come from the software industry. Once written, a software program can be replicated with a finger click on a keyboard. Clearly, this is a better business model than one that requires high and ongoing capital spending, with one important caveat—there needs to be barriers to entry, otherwise the bountiful cash flows can be competed away.

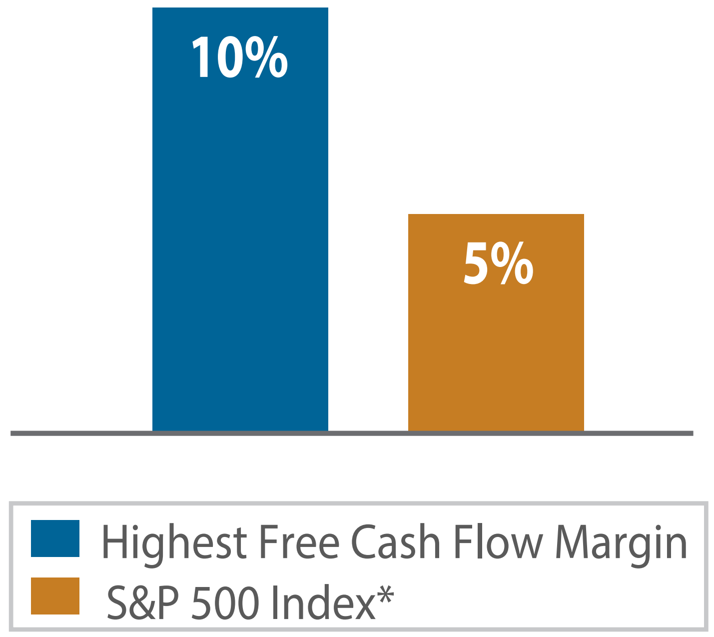
*Note: AT&T was not held in any Miller/Howard portfolios as of June 30, 2022.

In the period following the Global Financial Crisis, there was a confluence of factors that gave growth investors a tailwind. It turns out that the companies with the higher conversion rate of revenue-to-free cash flow also had higher-than-average revenue growth. Google, Facebook, and Amazon† are examples. Combined with low interest rates, growth investors were able to enjoy ever increasing revenues being converted into free cash flow at a high rate without paying heed to valuations.

†Google, Facebook, and Amazon were not held in any Miller/Howard portfolios as of June 30, 2022.

Companies with Strong Free Cash Flow Margins Have Seen Faster Revenue Growth

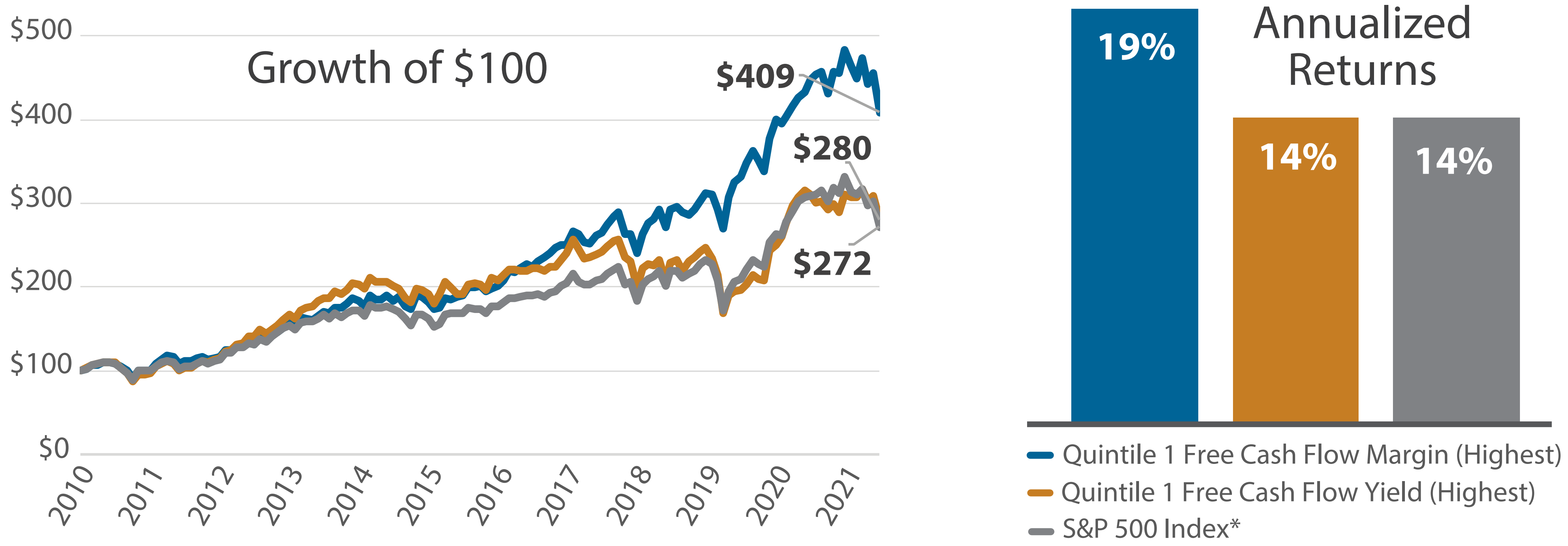




As of June 30, 2022. Sources: Bloomberg; Miller/Howard Research & Analysis. Year-over-year revenue growth. *Created by screening all members of the S&P 500 Index as of calendar year end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Aggregate revenue is trailing 12-Month. Calculated growth is year-over-year revenue growth. The resulting universe of stocks was then quintiled by free cash flow margin (free cash flow margin is free cash flow divided by revenue) where quintile 1 had the highest free cash flow margin and quintile 5 the lowest. Revenue growth for quintile 01 is aggregate.

Illustrating the point, the top quintile of free cash flow-to-revenue handily outperformed the market averages, while the top quintile of the value-based metric free cash flow yield (i.e., free cash flow to market capitalization) only performed in line with the market average.

High Free Cash Flow Margins Have Outperformed High Free Cash Flow Yields



As of June 30, 2022. Sources: Bloomberg; Miller/Howard Research & Analysis. Free cash flow margin is free cash flow divided by revenue. Free cash flow yield is free cash flow divided by market capitalization Portfolios for growth of $100 were created by screening all members of the S&P 500 Index as of calendar year end dates. *Members of GICS sectors financial, real estate, and utilities have been excluded. The resulting universe of stocks was then quintiled by free cash flow/revenue as well as by trailing free cash flow yield where quintile 01 had the highest value and quintile 05 the lowest. All quintiles are equal-weighted. Growth of $100 is through 6/30/2022 where annualized is for the period 2011 – 2021.

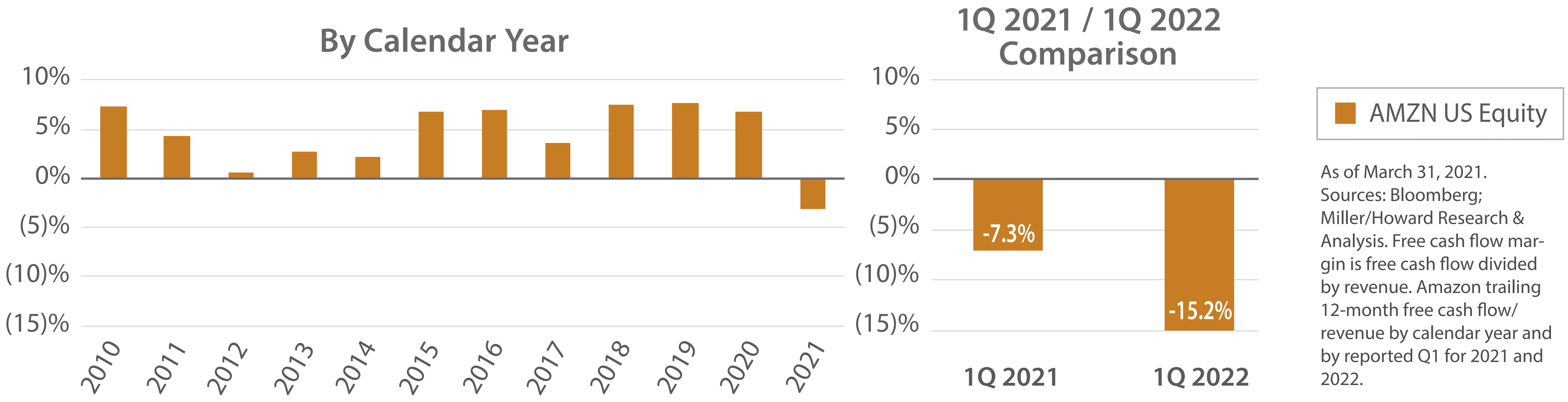
Our view at Miller/Howard is that the market's focus on free cash flow has been correct, but over the longer term, the analysis of free cash flow must be combined with a sensitivity to valuation. Our mission is to build portfolios that produce high and rising income, so we have to start out with investments that have a high current dividend yield. Like growth investors, we appreciate business models with higher conversion rates of revenue into free cash flow because it allows for healthy production of free cash flow, the essential ingredient for paying dividends. Some may think that only "growthy" stocks have this characteristic, but pharmaceuticals and mature technology companies are two categories that tend to convert revenue to free cash flow at high rates.

The Danger of Extrapolation: Amazon

As we watch some companies face free cash flow challenges in the current market, it's worth pointing out that for Amazon, one of only three companies with over a $1 trillion market capitalization, the evaporation of free cash flow has been mind-boggling. Many know Amazon as the poster child for the "valuation doesn't matter" mentality that gripped the investment world over the last decade. What is less well known is that Amazon[††] has been losing control of its free cash flow.

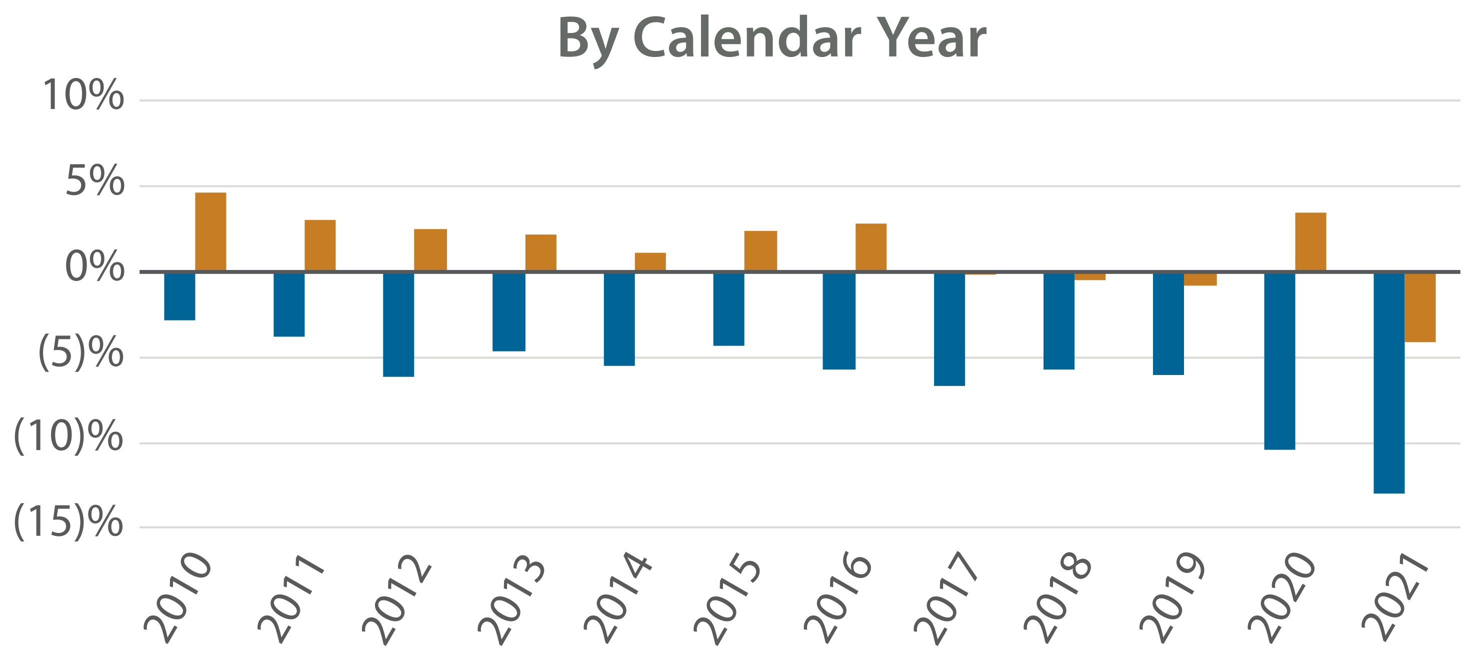
[††]Amazon is an online retailer that offers a wide range of products. The company products include books, music, computers, electronics and numerous other products. Amazon offers personalized shopping services, web-based credit card payment, and direct shipping to customers. Amazon also operates a cloud platform offering services globally. Amazon was not held in any Miller/Howard portfolios as of June 30, 2022.

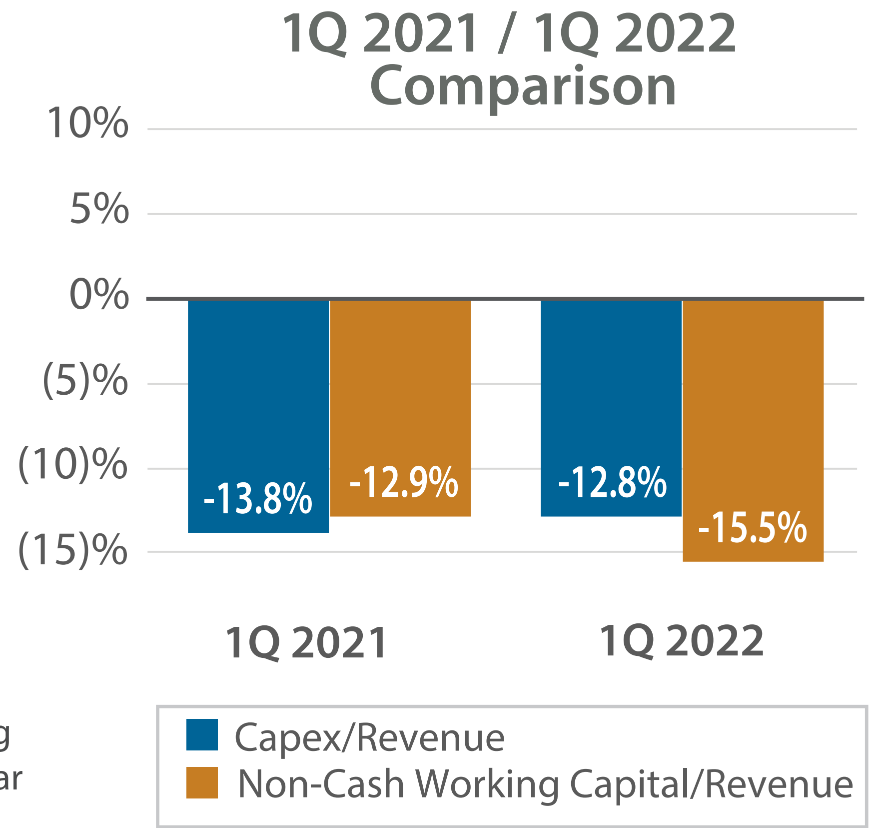
Amazon's Free Cash Flow Margin Has Gone Negative



As of March 31, 2021. Sources: Bloomberg; Miller/Howard Research & Analysis. Free cash flow margin is free cash flow divided by revenue. Amazon trailing 12-month free cash flow/revenue by calendar year and by reported Q1 for 2021 and 2022.

Amazon's Non-Cash Working Capital and Capital Spending Are Growing Faster than Revenue





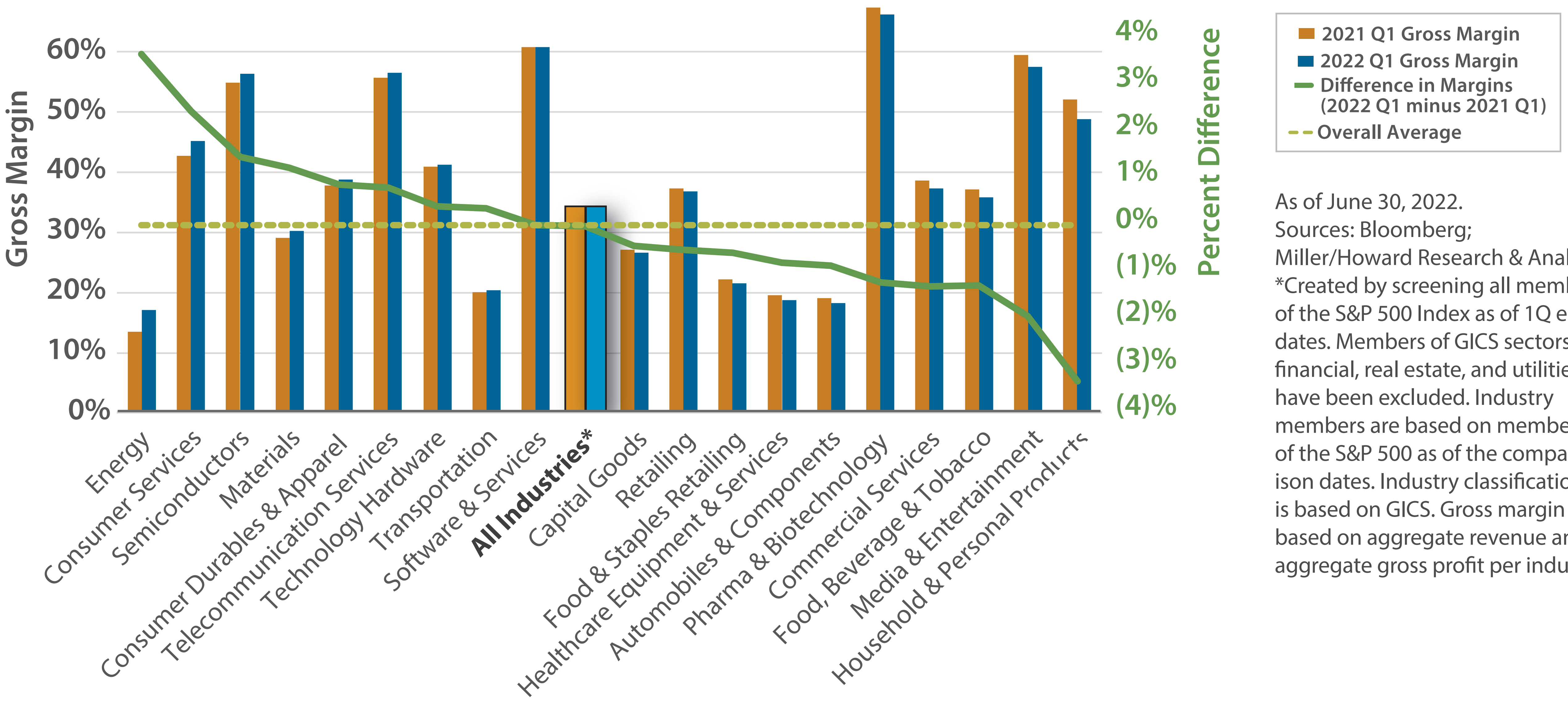
As of March 31, 2021. Sources: Bloomberg; Miller/Howard Research & Analysis. Amazon trailing 12-month capex/revenue and trailing 12-month non-cash working capital/revenue by calendar year and by reported Q1 for 2021 and 2022.

The story is simple—Amazon extrapolated the business trends experienced during the pandemic, assuming that massive increases in capital spending and working capital would be rewarded. Free cash flow went negative beginning in 2021, forcing Amazon to borrow in order to fund its operations. Our view is that the discipline of paying a dividend (which Amazon does not) forces management to set priorities and be prudent with shareholder capital.

Since inflation began to spike in 4Q 2021, we have been charting the year-over-year comparison of gross margins. The chart on the next slide assesses how well companies in each industry have been able to adjust pricing and take other actions so that rising costs do not squeeze gross margins.

In the past two quarters, the average company in the S&P 500 successfully raised gross margins. In the most recent quarter, gross margins were unchanged, on average. In all cases, some industries struggled more than others with household and personal products showing the largest gross margin deterioration in each of the last three quarters.

Change in Gross Margin by Industry

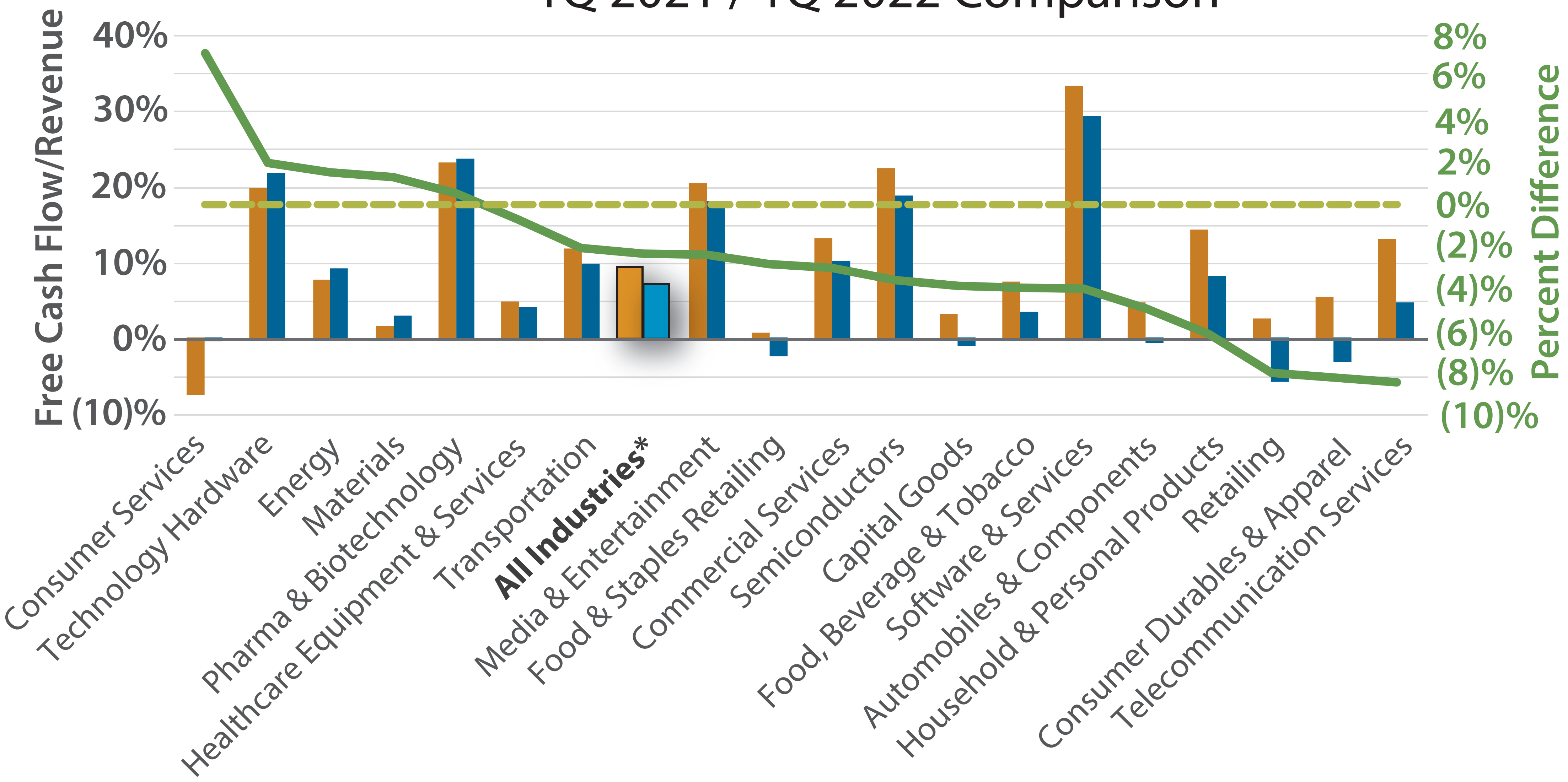


As of June 30, 2022.
Sources: Bloomberg; Miller/Howard Research & Analysis.
*Created by screening all members of the S&P 500 Index as of 1Q end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Industry members are based on members of the S&P 500 as of the comparison dates. Industry classification is based on GICS. Gross margin is based on aggregate revenue and aggregate gross profit per industry.

Looking at the average of gross margins across industries, it's fair to conclude that prices for goods actually sold have kept up with costs. The problem is that gross profit is based on accrual accounting which tends to view rising inventories as innocuous, at least early in a downturn. Given our concerns over faltering free cash flow, we also reproduced the industry chart using free cash flow-to-revenue rather than gross margins.

Free Cash Flow Margin by Industry

1Q 2021 / 1Q 2022 Comparison



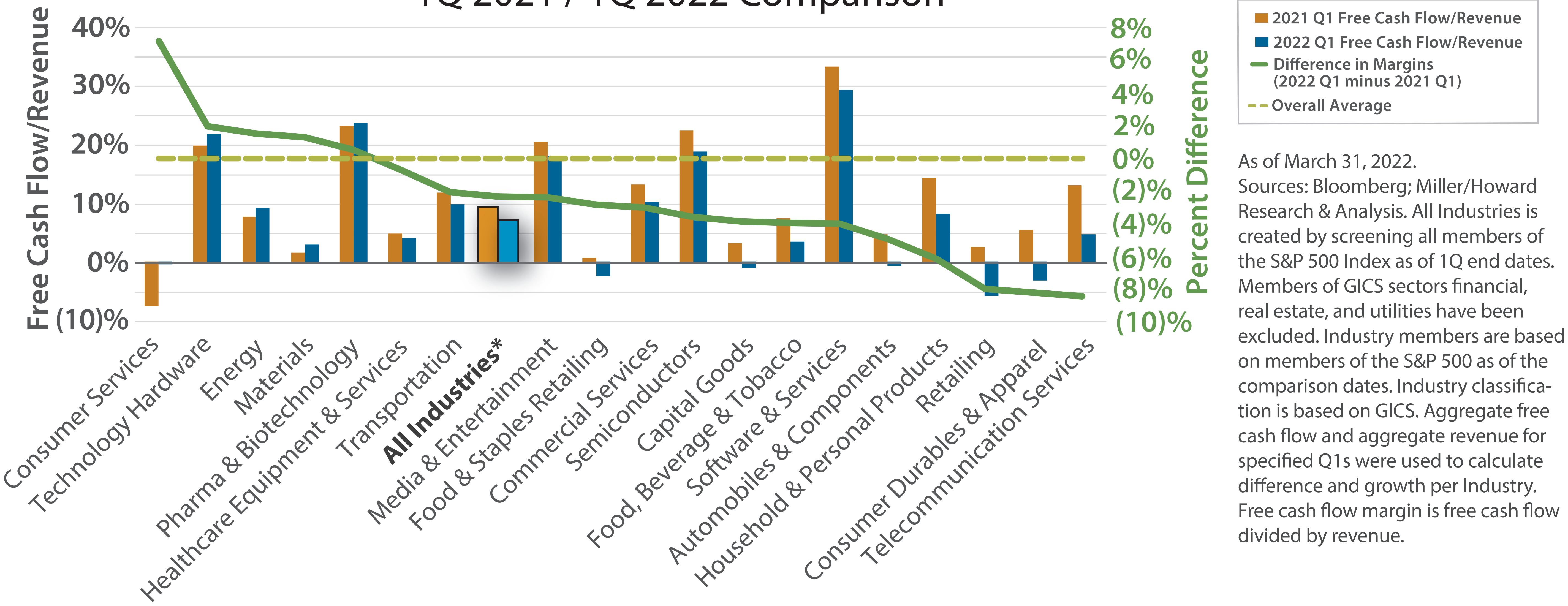
As of March 31, 2022.
Sources: Bloomberg; Miller/Howard Research & Analysis. All Industries is created by screening all members of the S&P 500 Index as of 1Q end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Industry members are based on members of the S&P 500 as of the comparison dates. Industry classification is based on GICS. Aggregate free cash flow and aggregate revenue for specified Q1s were used to calculate difference and growth per Industry. Free cash flow margin is free cash flow divided by revenue.

As previously discussed, aggregate free cash flow margins are down substantially, but the results differ greatly by industry. A number of industries actually saw the free cash flow margin go up. The largest expansion was in the consumer service industry. The consumer service industry is dominated by restaurants and other types of food service businesses. These firms have prospered as the pandemic has faded, and the risk of food spoilage keeps inventories low. The second highest free cash flow margin expansion was for the technology hardware industry. This industry uses a great deal of contract manufacturing, allowing companies to maintain both low inventories and low capital spending budgets. The third best was for the energy industry, which is benefitting from higher oil prices while, at the same, time exhibiting tremendous capital discipline.

Even though some industries experienced expanding free cash flow margins in 1Q 2022, in aggregate we saw deterioration. The three industries with the largest deterioration in free cash flow margins were telecom services, consumer durables and apparel, and retailing. For all three industries, the growth in non-cash working capital was responsible for the largest drop in free cash flow.

Free Cash Flow Margin by Industry

1Q 2021 / 1Q 2022 Comparison



As of March 31, 2022.
Sources: Bloomberg; Miller/Howard Research & Analysis. All Industries is created by screening all members of the S&P 500 Index as of 1Q end dates. Members of GICS sectors financial, real estate, and utilities have been excluded. Industry members are based on members of the S&P 500 as of the comparison dates. Industry classification is based on GICS. Aggregate free cash flow and aggregate revenue for specified Q1s were used to calculate difference and growth per Industry. Free cash flow margin is free cash flow divided by revenue.

At Miller/Howard we believe bottom-up fundamental research is the best way to build strong portfolios. Sometimes it is useful, however, to take in the wider perspective. In the current environment, it might be easy to accept an explanation for high inventories from a single management team. You've read about supply-chain constraints, right? We're just building inventories to control risk. This might be a reasonable explanation for a single company, but when the trend exists in aggregate and across many different industries, we are forced to consider the possibility that we may be entering a downturn.

The current situation is very uncertain. **Our view is that the best approach is to stick with companies that are maintaining high levels of free cash flow while others are faltering.** These companies should be able to continue to pay high and rising dividends, in our opinion. It may turn out that the recent drop in aggregate free cash flow is just a momentary phenomenon, but either way, we expect our portfolios to continue to generate good income for our clients.

Some investors may wonder whether it is wise to hold equities in the face of a risky environment. **Our view is that we expect our portfolios, as a whole, to produce earnings, cash flow and dividends in all periods, including during economic downturns.**

Stock prices may fluctuate as investors worry about economic cycles, but recoveries have always come. Recoveries tend to be unpredictable yet vigorous, making sitting on the sidelines very risky for investors with long time horizons.

DISCLOSURE
Miller/Howard Investments Inc. is an independent, research-driven investment boutique with over three decades of experience managing portfolios for major institutions, mutual funds, and individuals in dividend-focused investment strategies. The firm is 100% employee-owned through an Employee Stock Ownership Plan (ESOP).

We continue to evolve and develop strategies that strive to provide investors with various levels of current income and dividend growth. Our objectives are to generate total returns in line with the broad equity market and provide a high and rising stream of income with the lower volatility that an investor might seek from bonds or other income alternatives. With a primary goal of reliable income and long-term returns, coupled with a belief that investors can play an important role in securing a sustainable future, our shareholder advocacy efforts include environmental, social, and governance (ESG) research and/or screening, direct engagement with companies, filing shareholder resolutions, proxy voting, coalition building, and public policy involvement.

This report represents Miller/Howard Investments' views. The statistics and projections cited in this report have been provided by sources generally considered to be reliable, but are not guaranteed. Opinions and estimates offered constitute Miller/Howard Investments' judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This material is solely informational. The information and analyses contained herein are not intended as tax, legal, or investment advice and may not be appropriate for your specific circumstances; accordingly, you should consult your own tax, legal, investment, or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such appropriateness. The material may also contain forward-looking statements that involve risk and uncertainty, and there is no guarantee they will come to pass. Any investment returns—past, hypothetical, or otherwise—are not indicative of future performance. The information provided should not be considered a recommendation to buy or sell any security, and should not be considered investment, legal, or tax advice. Securities mentioned are being shown for informational purposes only. Buy and sell rationales are the express opinions of MHI's investment team. These securities should not be considered a recommendation to buy, sell, or hold any of the securities and are not intended to imply that any one security listed above, or the portfolio as a whole, is suitable for a particular client. There is no assurance that the securities purchased have remained or will remain in the portfolio or that securities sold have not been or will not be repurchased. To receive a list of all recommendations for the previous year, please email compliance@mhinvest.com. Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors, and the amount of any dividend may vary over time. Dividend yield is one component of performance and should not be the only consideration for investment.

DEFINITIONS: S&P 500 Index® widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products. The Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

For more information and to request materials: Visit www.mhinvest.com or contact our Internal Sales Desk, email **internals@mhinvest.com** or call (845) 679-9166.

To receive the current ADV Part 2A free of charge email **compliance@mhinvest.com** / Call (845) 679-9166.

Notification to Clients: Contact your Advisor with any material changes to your financial profile that would impact your appropriateness for investment.

Miller/Howard Investments, The Fuller Building, 45 Pine Grove Ave, Suite 301, Kingston, NY 12401 | (845) 679-9166 | **mhinvest.com**