AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

United Technologies

We generally have two major behavioral biases to overcome when managing the AMM Dividend Growth Strategy:

Loss Aversion

Loss Aversion is the bias that losses weigh heavier on our thinking than gains. Take the following example from behavioral economist Daniel Kahneman's *Thinking, Fast and Slow*.

> You're offered a gamble on the toss of a coin.
>
> If the coin shows tails, you lose $100.
>
> If the coin shows heads, you win $150.
>
> Is this gamble attractive? Would you accept it?

Yes, you should accept this gamble. It has a positive expected outcome. But most people refuse this gamble. The potential loss of $100 looms larger than the potential gain of $150.

Research has found that most people would accept this gamble if the gain was at least 2x the potential loss (i.e. they could win $200 vs. losing $100).

The loss aversion bias causes investors to take bigger risks on losing positions. Those who succumb to this bias are unwilling to admit a mistake and accept a loss on a losing position. They are more likely to add and double down on a losing position in the hopes of making their money back.

When we say a losing position we're not talking about a position that is down on price. We define a losing position as a position where the fundamental thesis for the investment has changed for the worse. And usually, the stock price reflects the fundamental change.

For each position, we build our investment thesis and determine a fair value for the position. This dividend letter is an extension of that process. It helps us recognize when a business has fundamentally changed and our investment thesis is wrong.

This doesn't mean we're quick to recognize changes. It also doesn't mean that we'll misidentify a fundamental change to a business. If we sell a position and we were wrong to sell it, we can always buy it back. If we sell a losing position, we can book a capital loss in taxable accounts. We're also freeing up capital for other potential investments that could offer a better risk reward than the previous position. Because of all these options, loss aversion isn't our biggest fear.

Regret Aversion

Our biggest fear is regret aversion. Also known as the fear of missing out (FOMO).

Regret aversion, as described in the book *The Behavioral Investor* by Daniel Crosby, is when:

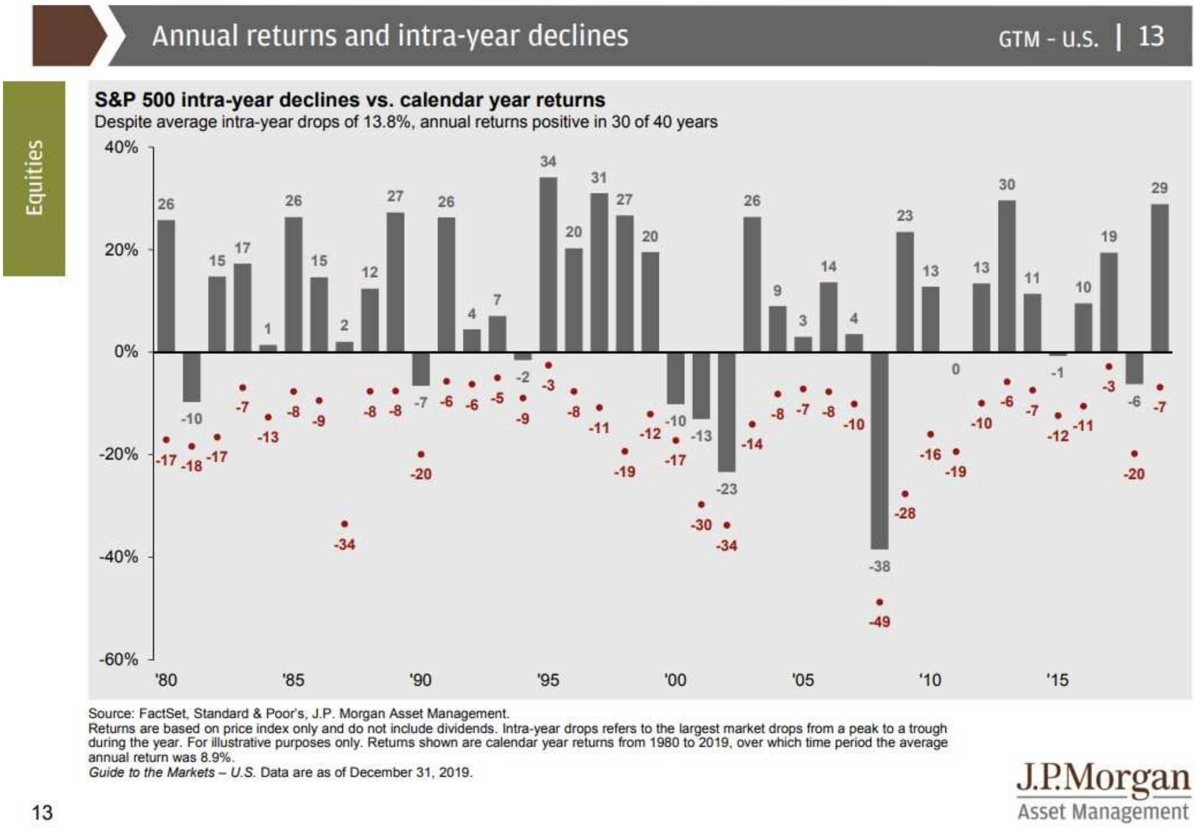
> "people are more upset with themselves when taking action and suffering a loss than when staying put and suffering the same loss."

The hardest thing for us in the day-to-day management of the dividend growth portfolio is to trim an overweight position. A position needs to be trimmed because it's a winning position. If we trim a position and its stock price continues to appreciate we feel like fools. We took action and we suffered a loss, the loss of more gains.

The easiest decision to make is to do nothing. Let the position ride. But the bigger a position gets, the riskier it gets. Your portfolio becomes too dependent on one position.

When a position becomes too big of a percentage of your portfolio, no matter how big of a winner it has been and no matter how high our conviction is in the stock, we will trim the position back down to an acceptable range.

The stock market doesn’t advance in a straight line. The market typically **averages intra-year declines of 13.8%** according to J.P. Morgan.



We can’t time the market and we don’t when the stock market might sell off. But we do know that at some point the stock market will sell off, it’s the nature of human driven markets. We want capital available to buy the companies we like at much better prices. Maximum position size rules helps us free up capital during the good times to take advantage of the bad times.

Dividend Stock in Focus

United Technologies (UTX): $153.06

Price as of the close February 13, 2020

We classify the positions in the AMM Dividend Growth Strategy into 3 categories.

1. Dividend Stalwarts: Companies that have paid and grown their dividend for 20+ years.
2. New Dividend Payers: Companies that initiated a dividend policy within the last 10 years and have the ability to grow their new dividend at above average rates of growth.
3. Special Situations: Companies undergoing a corporate restructuring. Usually a spin-off transaction. Either the parent company currently pays a dividend and/or the newly spun-off company will pay a dividend.

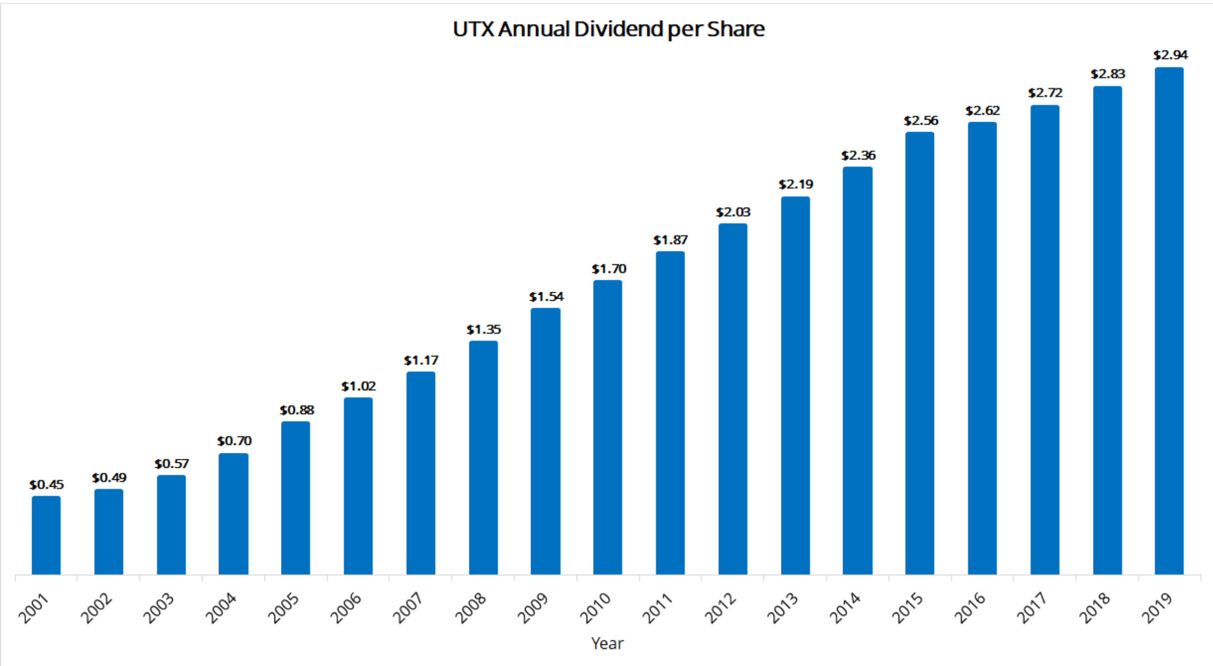
Sometimes a position fits into multiple categories. Our newest position in United Technologies is a good example as we view the investment as both a Dividend Stalwart and a Special Situation.

The company was officially named to Standard's and Poor's Dividend Aristocrat list in 2019. S&P's Dividend Aristocrats are companies that have raised their dividend every year for the last 25 years.

United Technologies is also undergoing some major corporate changes. First, it completed a major integration with Rockwell Collins. Next, it will split itself into 3 standalone companies. Then the new standalone aerospace company will merge with Raytheon.

Dividend History

Since 2001, UTX grew its dividend at a compound annual growth rate of 10.76%.



Over the last 10 years United Technologies grew its annual dividend at a compound annual growth rate of 6.27%.

Dividend Safety

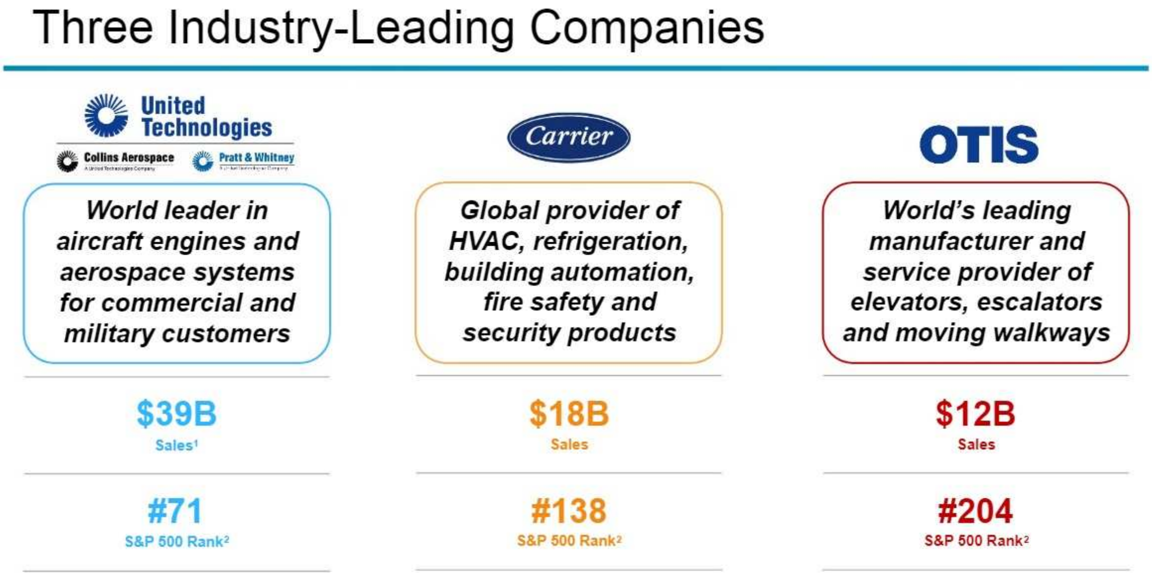
Dividend Payout Ratio < 60%?	49.24%	✓
Cash Dividend Payout Ratio < 60%?	42.67%	✓
FCFE Coverage Ratio > 100%?	1518.49%	✓
Debt to Equity < 1.00?	1.07	✗
Interest Coverage > 2.00?	7.06	✓

United Technologies passes all our categories for dividend safety except its debt to equity ratio. This is a recent development after the company completed its purchase of Rockwell Collins for $30 billion in 2018. We are comfortable with the current debt to equity ratio because of United Technologies' current interest coverage ratio.

Catalysts for Price Appreciation & Dividend Growth

Spin-Offs

United Technologies announced that they are splitting the company into three businesses: Otis Elevators, Carrier, and United Technologies



From UTX Presentation November 26, 2018.

The spin-offs are expected to be done by mid-2020.

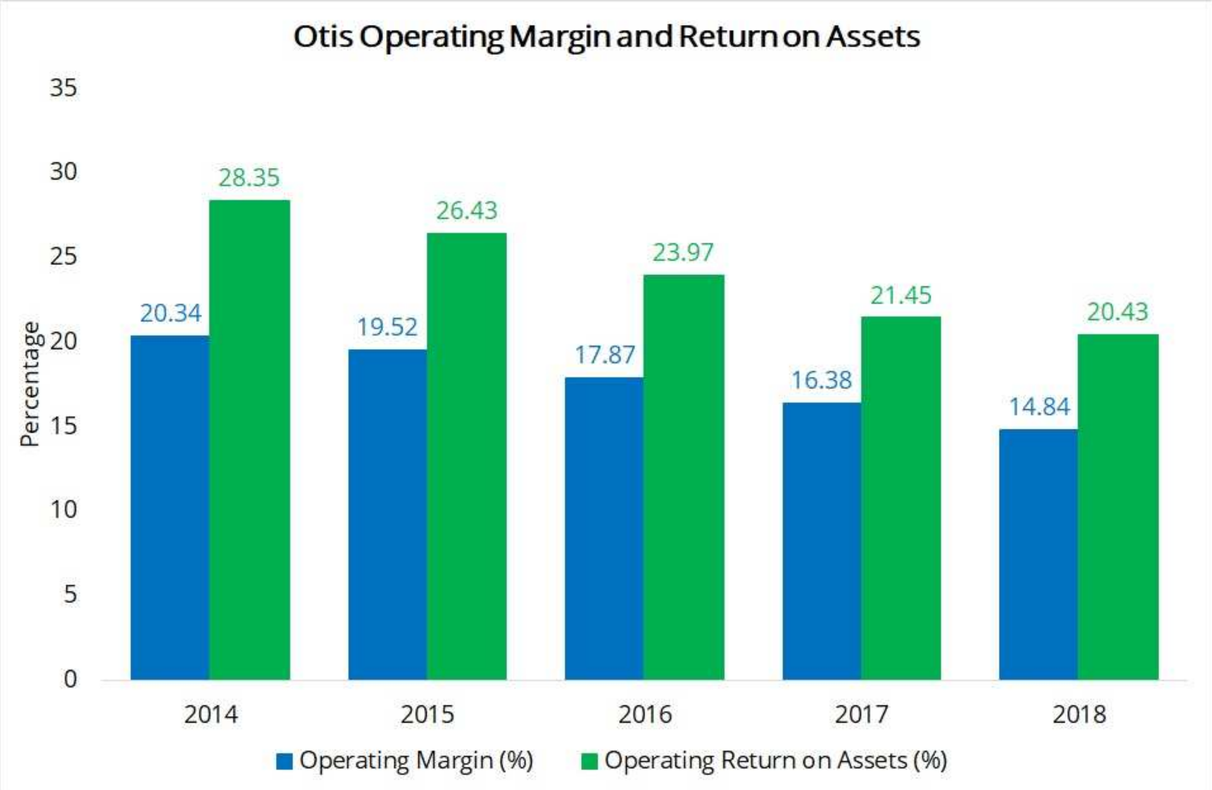
Otis Elevators

The elevator business is an oligopoly. The revenue from the top ten manufacturers accounts for about 83% of the total elevator/escalator market.

Otis is the leading manufacturer with around 16% of the global elevator revenue. Schindler is second and ThyssenKrupp is third.

The elevator business – this also includes escalators and people movers – is not a high growth business. Global Markets Insights expects the elevator industry to grow at a 4.5% compound annual growth rate from 2019-2026. With the Asia Pacific and Middle East regions driving the growth.

The real profits reside in the long-term service and maintenance contracts. These contracts can last from 5-20 years and they drive Otis' operating profits and returns on assets.

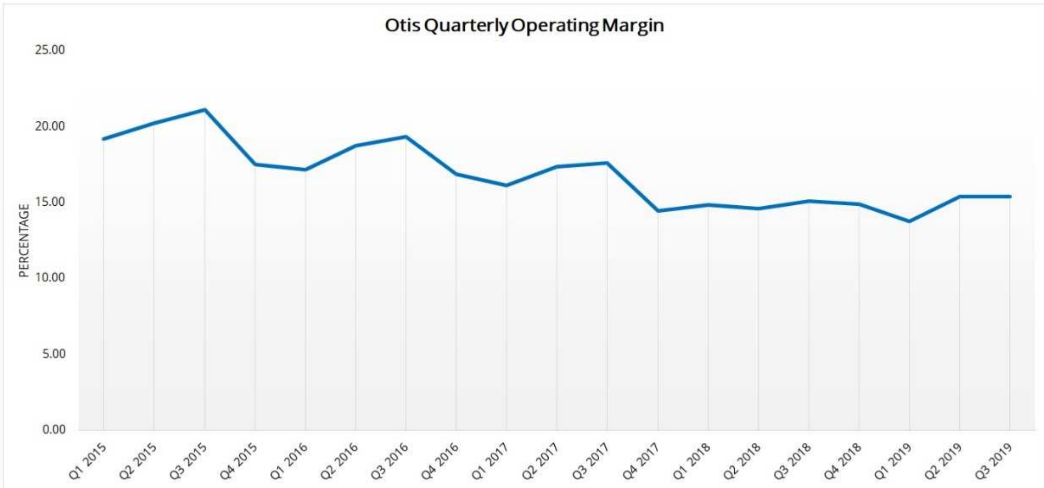


As you can see Otis' margins and return on assets have declined over the last few years.

Otis made some short-term strategic errors in China. They tried to keep their profit margins high at the expense of new business. They concentrated on China's commercial sector while ignoring residential construction. The short-term focus caused Otis to secede global market share to Kone, a Finnish company. Otis had aggressive economic and commercial construction projections for

China. Then China's economy slowed down and Otis' profits took a hit.

Since then the company recalibrated its efforts and projections. Now after a multi-year decline, Otis' quarterly operating margins are seeing sequential and year-over-year improvements.



	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019
Op. Margin (%)	19.20	20.24	21.10	17.52	17.16	18.76	19.35	16.85	16.12	17.37	17.59	14.46	14.82	14.59	15.08	14.88	13.76	15.38	15.36

The new equipment sales that drove sales in China before the slowdown are being displaced by the higher margin service revenues. The recent slow-down is also only a small set-back to the larger long-term urbanization of China. It's estimated that 12-50 million Chinese move from the farms to the cities each year.

Construction in the U.S. picked up recently replacing some lost China revenue. High rise construction is still booming in the rest of Asia too.

A long-term compound annual growth rate of 4.5% combined with increasing operating margins back up to 18-20%, 20%+ return on operating assets, and a lead position in their industry should create significant shareholder value after the spin-off.

Carrier

Carrier operates in the HVAC (Heating, Ventilation, and Air Conditioning) industry. Carrier has strong brand recognition and has been in business for 100+ years. Its brand and ability to help build and service out complex commercial HVAC projects give it a business moat but not a big one.

Investing in a HVAC company is not sexy and the HVAC business has endured a bit of a slowdown recently. Our guess is that after Carrier is spun-off its shares will sell off for a few reasons. Usually, the companies being spun-off are not the businesses investors wanted to invest in. A newly spun-off company’s size may not fit within the mandates of the institutional funds holding it. So they will sell their shares.

A standalone Carrier is not the investment we usually make. We might be one of those early indiscriminate sellers. But if Carrier pays a dividend we will most likely hold onto our shares until a better investment presents itself.

Aerospace Remain Co.

The jewel of the restructuring is the remaining United Technologies Company. It will house Collins Aerospace Systems and Pratt & Whitney.

The big trend in air travel is the rise of the narrow body aircraft, single aisle jets. Narrow body aircraft were once primarily used for short to medium length flights. Recent advances make it possible to fly narrow body aircraft further with increasing fuel efficiency. This opened up longer-distance flights to secondary airports that couldn’t handle large wide body planes. It also made these routes profitable to serve.

The other trend is the rise of the global middle class and their desire to travel. Airlines are increasing their routes and low-cost budget airlines are popping up to service these routes too. Narrow body aircraft allow airlines to better match supply with demand.

Two main aircraft manufacturers produce the majority of the world’s narrow body aircraft, Boeing and Airbus. Boeing’s main model is the now infamous 737 Max and Airbus has the A321 and A220. Demand for their narrow body aircraft is booming.

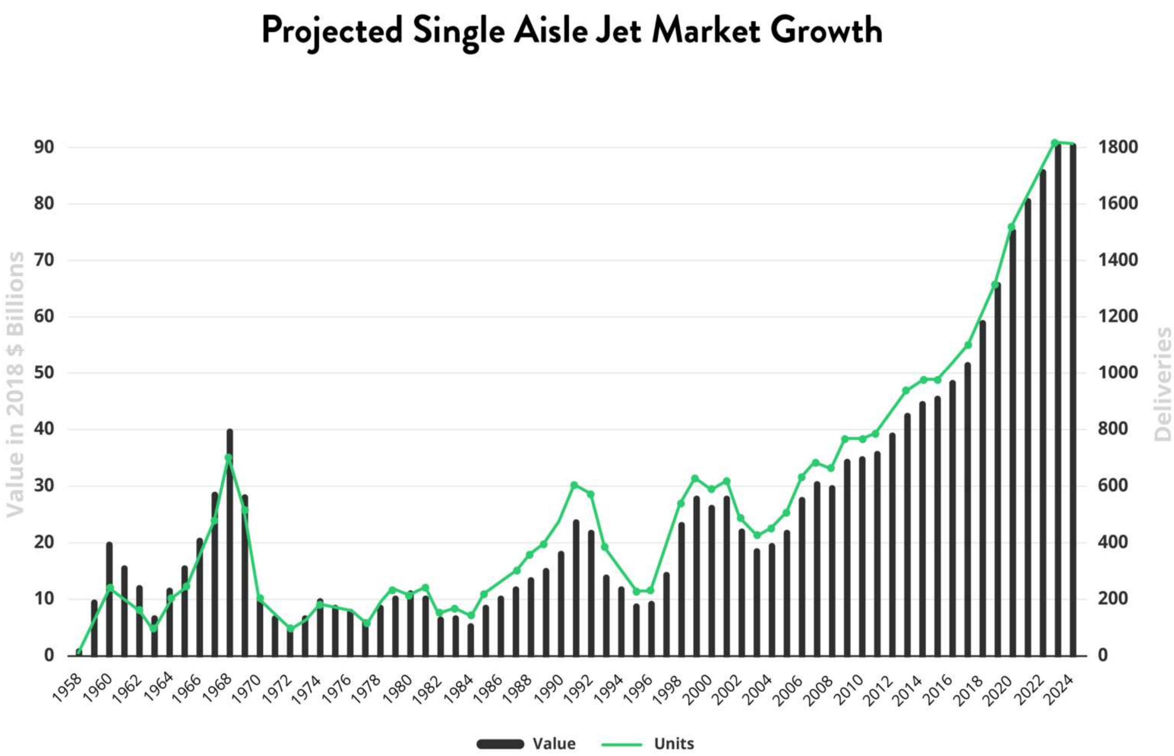


Chart from Yieldr

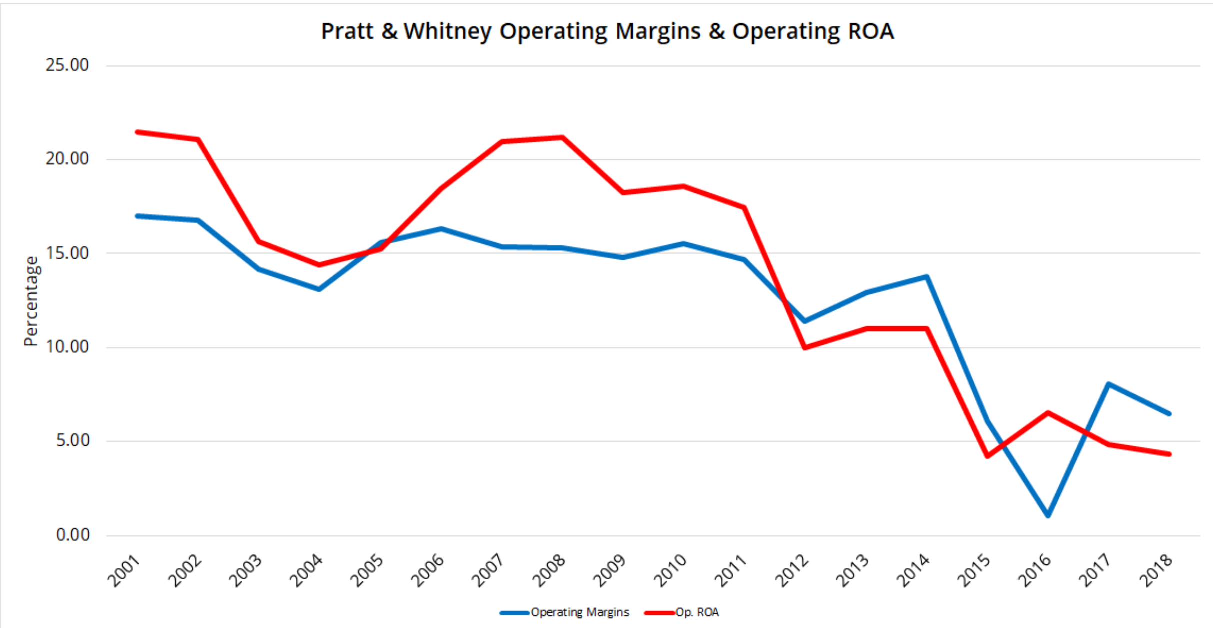
Boeing uses GE engines and Airbus uses the Pratt & Whitney GTF engines. The Airbus A321 is the more popular of the two models with about 60% market share.

Over half of the RemainCo's revenue comes from Pratt & Whitney and half of Pratt & Whitney's revenue comes from its commercial engine business. Around 25+% of the RemainCo's revenue will come from the rise of narrow body aircraft.

The added bonus is narrow body aircraft have longer service lives. The real profit in aircraft engines are the service contracts and aftermarket parts. Engine manufacturers will sell engines at a discount to gain access to the high margin service and parts business. Longer service lives combined with a large growing base of airplanes means Pratt & Whitney's revenue and profits have a long run growth runway ahead of it.

We want to invest in businesses that can grow their returns on invested capital. Pratt & Whitney invested a lot of upfront capital to build out the manufacturing and service lines for its GTF engines. With engine sales ramping and long service lives, we expect ROIC to continue grow for the foreseeable future.

We don't have enough segment information to build out the invested capital solely for Pratt & Whitney but we can use operating return on Pratt & Whitney's assets as a rough estimate.



Based on past investment cycles and the expected profitability of the GTF engine, we estimate that Pratt & Whitney can at least reach mid to high teen levels of ROIC.

Risks

Kone

ThyssenKrupp is selling its elevator division. Potential acquirers include Kone, the Finnish elevator builder, who has partnered with CVC Capital Partners, Blackstone and Carlyle Group (joint bid), and 3G.

Surprisingly Otis hasn't made an offer.

Letting a key competitor get bigger and better is not a good strategy. Especially Kone who was one of the big reasons why Otis lost global market share.

ThyssenKrupp's management hasn't decided if it is selling a stake or all of the division. Management is also looking for a quick close to the deal and to avoid any long anti-trust review. This may be why Otis hasn't made an offer. Otis can always buy it later from a private equity holder. Unless Berkshire Hathaway teams up with 3G to buy the whole business. And then maybe Berkshire Hathaway buys Otis to merge the two businesses.

While we wait or our Berkshire-Hathaway fan fiction to happen, Otis will have a stronger competitor going after Otis' business.

China

A small economic slowdown in China already hurt Otis Elevators. A larger slow down or recession would cause bigger issues for Otis. In the previous slowdown, a larger percentage of Otis' Chinese revenue was from selling elevators. Those previous new equipment sales are converting into the more profitable and consistent long-term service revenues.

China's growth also affects the Aerospace remain co. The country with the largest growing group of middle class global travelers and the greatest travel demand is China. If there is a recession or something worse in China, their middle class will cut their discretionary spending. The first item usually cut is travel.

Reduced travel demand will slow down new airplane orders and reduced demand for Pratt & Whitney's engines.

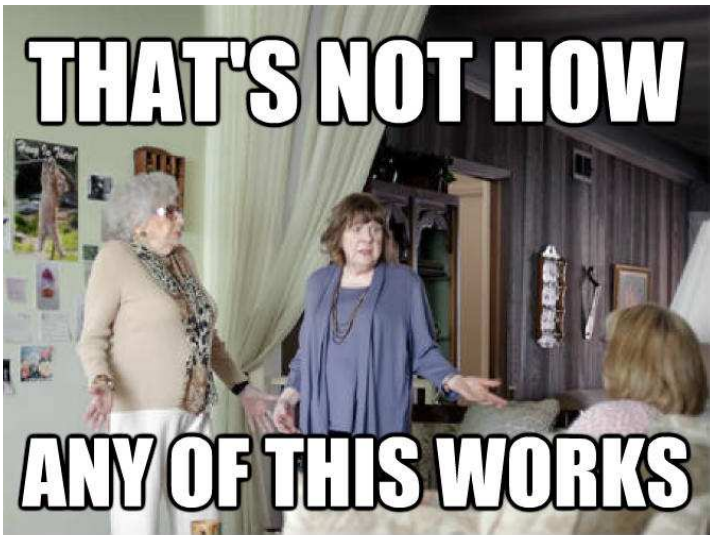
The good news for Pratt & Whitney is that Airbus has a huge backlog of orders for their narrow body planes. Once Airlines place an aircraft order they rarely cancel them. Airlines can sometimes reduce or adjust their orders but if they cancel completely and then want to restart later, they've lost their place in line. They'll need to start over or pay hefty fees to cut in front of others. Airlines don't like switching airplane manufacturers. They've invested a lot of capital into the infrastructure and the parts needed to service their chosen family of airplanes. Their pilots and staff are also certified for that specific family of aircraft. Airlines have immense aircraft switching costs.

Raytheon Merger

A big reason for a corporate restructuring is to reduce the conglomerate discount and unlock the value of its distinct business lines.

Before any spin-off was finalized United Technologies announced that the Remain Co will merge with Raytheon in a merger of equals. The new company will be called Raytheon Technologies.

United Technologies' management breaks up its conglomerate to create a new conglomerate.



Raytheon is a quality company and at the time of the deal it was trading at a discount to our estimate of its fair value.

Buying high quality companies cheaply is usually a recipe for success. The pro-forma put out by management shows significant synergy cost reductions, increased cash flows, and a large return of capital back to shareholders through increased dividend and share buybacks.

Pro-formas tend to be very optimistic and integrating two large companies usually takes longer than estimated and is ripe for potential problems.

Our main issue is the profits and returns from the investment in GTF at Pratt & Whitney will be hidden again inside a large conglomerate. It will still create value but at a much lower percentage of the combined company.

We think the value of the spin-offs are still worth the investment and the merger with Raytheon can surprise us further to the upside.

Valuation

Before the announcement of the Raytheon merger we did a sum of the parts analysis to determine the value of each business segment and United Technologies as a whole. We separated out Pratt & Whitney from UTC Aerospace even though both will be a part of the Remain Co. We gave them both the same EV/EBITDA multiple.

	EBITDA TTM (millions)	EV/EBITDA Multiple	Enterprise Value (millions)
Otis	2,256.33	13.00	29,332.26
Carrier	3,229.69	12.00	38,756.25
Pratt Whitney	3,270.68	14.00	45,789.45
UTC Aerospace	4,678.15	14.00	65,494.03
Corp Expense	(1,069.00)	14.00	(14,966.00)
			$179,372.00
Less Debt			($44,604.00)
add Cash & Cash Equivalents			$7,341.00
Equity Value			$142,109.00
Shares Outstanding			863
Value Per Share			**$164.67**

United Technologies will split first before the remaining aerospace company merges with Raytheon. We used the trailing twelve months of EBITDA for United Technologies' business segments. Then we found comparable publicly traded companies for each business segment. Using an average EV/EBITDA multiple we came to a total enterprise value of $176 billion. Then backing out debt, adding back cash, we get an equity value of $142 billion. With 863 million shares outstanding we arrive at **a per share value of $165**.

The Raytheon merger adds a new wrinkle. Based on the pro forma, Raytheon Technologies' 2020 EBITDA will be $15 billion. The average EV/EBITDA multiple of its peer group is 13.5x valuing Raytheon Technologies at $202.5 billion enterprise value. Backing out the pro-forma debt of $26 billion leaves an equity value of $176.5 billion.

Based on our expected enterprise value for the Remain Co, Raytheon's current enterprise value, and backing out the same $26 billion in debt, the combined equity value is $150.5 billion. If the pro-forma turns out right then we're getting the combined Raytheon Technologies at **a 15% discount**.