

December 7, 2020

DOGNESS INTERNATIONAL CORP. (NGM: DOGZ)

Dogness was born in 2003 from the belief that pet dogs and cats are important, well-loved family members. Through its smart products, leash products, hygiene products, and health and wellness products, Dogness is able to simplify pet lifestyles, make them more scientific, and enhance the relationship between pets and pet caregivers.

COMPANY HIGHLIGHTS

- * DOGZ: A leading developer, manufacturer and distributor of pet products, with a track record of innovation in the smart tech segment.
- * In our view, Dogness has continued to execute despite a challenging fiscal 2020, and is well positioned to return to profitability in fiscal 2021. We expect favorable pet market trends, accelerated by people spending more time at home as a result of COVID-19, to continue in fiscal 2021, with an abatement of headwinds, including a trade dispute between China and the United States, which has resulted in higher export tariffs and reduced sales in the United States.
- * During the first half of fiscal 2021, Dogness has leveraged its sales, marketing and distribution relationships with leading specialty, brick & mortar, mass market and online/e-commerce companies. These include Petco, Chewy, Amazon, Walmart, Costco, Target, Sam's Club, Wayfair, and JD.com, among others.
- * The Company also opened a new manufacturing factory in China, integrating key operating and management functions, along with implementing the latest in technology developments.
- * In aggregate, this should help Dogness to enhance its long-term sales and gross-margin profile. Indeed, we expect Dogness to continue its evolution into a higher-margin technology-focused pet product company with a diversified global footprint, and to capitalize on favorable long-term global trends in the pet care industry.
- * Sales of the smart pet product line, which launched in calendar 2018 and includes connected collars, harnesses, feeders, and play robots, totaled \$4.3 million in fiscal 2020, more than double prior-year results. The unit accounted for 22.6% of total sales during fiscal 2020, compared with just 8% in fiscal 2019.

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KEY STATISTICS

Key Stock Statistics

Recent price (12/3/20)	\$2.13
52 week high/low	\$3.42-\$0.77
Shares outstanding (M)	25.9
Market cap (M)	\$55.2
Dividend	Nil
Yield	Nil

Sector Overview

Sector	Consumer Discretionary
Sector % of S&P 500	11.3%

Financials (\$M)

Cash & Mkt Securities	4.8
Debt	6.6
Working Capital (\$M)	0.9
Current Ratio	1.1
Total Debt/Equity (%)	13.0%
Payout ratio	NM
Revenue (M) TTM	19.2
Net Income (M) TTM	NA
Net Margin	NA

Risk

Beta	-0.65
Inst. ownership	0%

Valuation

P/E forward EPS	9.5
Price/Sales (TTM)	2.8
Price/Book (TTM)	1.2

Top Holders

Citidel Advisors
UBS Financial Services

Management

CEO	Mr. Silong Chen
CFO	Dr. Yunhao Chen
Company website	www.dognesspet.com

PRICE CHART



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- * As of June 30, 2020, Dogness had approximately \$4.8 million in cash and short-term investments on its balance sheet. We anticipate Dogness will return to positive operational cash flow during fiscal 2021, but think the company could raise capital during the year on more favorable terms, as its recovery takes hold.
- * The DOGZ shares are trading at roughly 9-times our EPS estimate of \$0.23 for fiscal 2022. In our view, the current valuation does not reflect Dogness' recent initiatives to help drive enhanced revenue and margin expansion, and the significant accelerated growth of the pet market due to COVID-19. We view the shares as having upside and, based on our forward P/E analysis, a fair value of \$4.00.

INVESTMENT THESIS

Dogness International, founded in 2003, is a designer and manufacturer of high-quality pet products. These include leashes, harnesses and, more recently, a suite of smart products that are designed to capitalize on the migration of consumer product trends towards connectivity and remote access. The company has established an impressive track record of product innovation and seems well positioned for long-term growth due to its fully integrated manufacturing chain. It also has established commercial infrastructure in its core China as well as the United States markets, and is well positioned, in our view, to benefit from the recession-resistant nature of the pet industry.

The company's products are currently sold in about 60 markets worldwide. During fiscal 2020, sales in China accounted for 51%, down from 57.5% in the prior year. The United States remains a key export market, although sales have declined due to an ongoing trade dispute with China, which resulted in higher export tariffs and reduced sales in the U.S. In fiscal 2020, U.S. sales were 26% of total revenues, up from 21% of revenues in fiscal 2019, but still well below approximately one-third of fiscal 2018 sales. Under a new U.S. presidential administration beginning in early 2021, however, we see potential for an easing of this key overhang and a subsequent return to meaningful sales growth in this key market.

In addition to trade-related challenges with the United States, Dogness' fiscal 2020 financial results were hampered by the COVID-19 pandemic, which originated in China, forced the temporary suspension of manufacturing activities and slowed the shipping and delivery of completed goods. However, business activities had returned to a normal pace by the end of Dogness' fiscal year in June 2020. With Dogness turning its focus to product upgrades and enhancing its online and big box retail sales channels amid these challenges, we think the company should be able to meet increasing product demand in the coming years.

Despite the recent commercial challenges, we believe that Dogness' primary markets continue to show solid trends for long-term growth. According to a recent industry whitepaper published by Goumin.com, China has approximately 74 million pet owners and has seen 15% growth in annual expenses per pet. In particular, the China market for smart pet products is seeing growing demand, as younger consumers become pet owners and shop for pet products through technology platforms and online shopping sites. The market for spending on pets in China was approximately \$25 billion in 2019, according to trade organization Pet Fair Asia.

In addition, the U.S. continues to see favorable growth trends for pet ownership and spending on supplies (irrespective of macro-economic trends). The American Pet Products Association estimates that there are nearly 85 million U.S. pet-owning families (67% of all households), representing an estimated \$75 billion annual market for spending on pets in the United States.

In our view, Dogness' long-term growth prospects are supported by its reputation for innovation and product quality. It also has an established commercial infrastructure that includes a retail presence across leading pet-specialty retailers such as PetSmart and Petco, which we estimate collectively account for up to half of the U.S. retail market. In addition, the company's U.S. subsidiary has entered into agreements with large retail chains in the U.S. and Canada for the distribution of smart pet products under the company's own brand (rather than just serving as an OEM supplier). This should enhance long-term economics in the U.S. market.

Dogness also sells through mass brick-and-mortar and online retailers such as Walmart, Target and Chewy.com, and has recently reported progress in expanding distribution of its smart products online through these vendors, as well as online leader Amazon.com. In November 2020 alone, Dogness announced a new U.S. online distribution deal with Target for its smart pet products, including Smart feeders, water fountains and treat dispensers, and also announced expanded distribution pacts, both in-store and online, with Petco and Chewy.com. We view such expansion efforts favorably, given the widespread online momentum many retailers have reported during the COVID-19 pandemic. For example, in the second and third quarters of 2020, Target reported same-store digital sales growth of 195% and 155%, respectively, over the prior year, as a greater percentage of shopping moved online. Also in November 2020, Dogness announced a new U.S. sales partnership with Costco, which will feature both in-store and online special events to promote its smart product line, and introduce Dogness' products to up to 40 million members.

In China, Dogness' products are available on such sites as JD, Tmall and Taobao. We think that driving sales online should provide a tailwind for sustained commercial growth in China as well. In October 2020, Dogness entered into a strategic partnership with Huayuan Pet and Chongai Trading. The former is an established and integrated producer and marketer of pet products on an online platform in China that has 20 brands covering the toiletry, bedding, clothing, toy, staple food and snack categories. The latter is a leading pet food and supply distributor in China, and an experienced brand promoter. Dogness anticipates roughly \$6 million in increased sales during the first year of the partnership, which we see providing a key component to the company's plan to return to profitability and positive operational cash flow in fiscal 2021 and beyond.

As part of a strategic shift to diversify its global footprint, Dogness also has established new export markets in Europe, Australia, Japan, South America and other countries. During fiscal 2020, Europe, Japan and Australia accounted for 20% of total revenues, up from approximately 17.5% in fiscal 2019. In our view, continued expansion into new markets will help Dogness to diversify its customer mix, as the company's top three customers accounted for 39% of fiscal 2020 revenues, down from 47% and 46% in fiscal 2019 and fiscal 2018, respectively.

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PEER COMPARISON

Company	Ticker	Recent Price (\$)	52-Week High (\$)	52-Week Low (\$)	Mkt. Cap (\$MIL)	1-yr Price Change (%)	1-yr Rev Growth (%)	1 YR EPS Growth (%)	P/E Ratio	Beta	Yield (%)
DOGNESS INTL CORP.	DOGZ	2.13	3.42	0.77	55	35	-27	NA	NA	-0.65	NA
PETMED EXPRESS INC	PETS	29	42.9	21.2	588	33	4	1	20.0	0.73	3.8
CENTRAL GARDEN AND PET CO-A	CENTA	35.9	41.1	21.66	2000	38	8	52	16.9	0.73	NA
TDH HOLDINGS	PETZ	1.99	3.76	0.52	91	19	-47	NA	NA	1.24	NA

Dogness' product portfolio focuses on connected pet care, to link pets and pet caregivers, and aims to establish a "Smart Pet Ecosystem" into a cohesive, integrated platform that can utilize smart technology for pet owners. The Smart Pet Ecosystem, which was launched in fiscal 2018, has four major areas: smart pet technology, leashes and collars, pet care and pet health and wellness.

Smart products unveiled to date include a pet food feeder, water fountain, treat dispenser, and smart pet toys and robots. Most of the devices have high definition cameras that enable pet owners to interact with their pet remotely. Revenues for smart products totaled \$4.3 million in fiscal 2020, more than doubling results in fiscal 2019.

Legacy products include leashes, collars, harnesses, retractable dog leashes and gift suspenders. Leashes and collars accounted for 37% of fiscal 2020 revenues, down from 47.5% of fiscal 2019 and 59.1% in fiscal 2018. During fiscal 2020, Dogness strategically decreased production of its lower-margin, high raw-material-dependent legacy pet products, as it shifts focus to its smart product line. As a result, total sale volumes for fiscal 2020 declined 34% but the average selling price increased by 11%. Still, we expect that the company's reputation for high product quality and positive consumer perceptions for these legacy products will support new product launches globally.

Dogness' pet care products currently focus on high quality pet shampoos, which launched in 2018 and are focused on and tailored to Chinese market trends. These products are aimed towards dogs and cats, and feature natural plant and amino acid composition. The company has developed breed-specific formulas and a professional line of products for pet groomers.

We also view Dogness' strategy to integrate vertical production as a key competitive advantage. The company manufactures much of its products internally, which promotes better control of cost, quality and delivery time. Dogness' vertical integration and strong retail presence promotes greater efficiency and economies of scale. In 2018, the company acquired a manufacturing plant in Xiamen, China, which will be used to manufacture Dogness' line of traditional pet products, including collars, harnesses, leashes, and lanyards, using new equipment featuring advanced automation components. We expect Dogness to be able to double its annual production capabilities, and enhance the margin profile of its legacy products, which we estimate to have been about 35% prior to the COVID-19 pandemic.

In November 2018, Dogness opened its U.S. corporate headquarters in Plano, Texas. The complex includes a science-based Pet Wellness and Health unit that will research and develop pet supplements and functional pet food, in partnership with a leading U.S. company in this arena. The companies aim to develop and manufacture in the U.S. and sell through the partners' global network, sharing the advancement of the biotechnology in the U.S. with the worldwide pet population. In November 2020, Dogness opened a new China headquarters campus in Dongguan, China, which features state-of-the-art facilities for manufacturing, R&D, sales and marketing, warehousing and logistics, and a showroom to display the full range of Dogness pet products.

While products for pets may seem commoditized, Dogness has developed advanced technologies for its products. Dogness has obtained 135 patents, including 87 in China and has registered more than 160 trademarks. Through a combination of trade secret, copyright, trademark, and patent rights, Dogness appears able to protect its intellectual property and brand. As a result of its R&D efforts, Dogness became certified as a National High-Tech Enterprise by the State Intellectual Property Office in March 2015, and this certification was renewed in 2019. This certification entitles the company to tax rates of 15%, rather than the unified, uncertified rate of 25%.

RECENT DEVELOPMENTS

Year-to-date, the DOGZ shares price has increased by approximately 60%, compared with a 13% gain for the S&P 500.

In October 2020, Dogness reported results for the fiscal year ended June 30, 2020, that showed a 27% revenue decline to \$19.2 million and a net loss per share of \$0.33 compared with EPS of \$0.05 in fiscal 2019. We note that prior to the U.S. trade issues and prior to the launch of the smart product portfolio, Dogness' core business generated EPS above \$0.20 in 2016-2018. As such, we are confident in Dogness' prospects for return to positive earnings, as normalized business conditions return globally.

In November 2020, Dogness announced an expansion of its sales activities on leading online pet vendor Chewy.com.

In November 2020, Dogness announced that its smart pet products would be expanding from Petco's online store into its brick & mortar retail stores as well. The expansion is expected to commence in early 2021 and rollout fully by the middle of 2021.

In November 2020, Dogness announced a new U.S. sales partnership with Costco, which will feature both in-store and online special events to promote its smart product line and introduce Dogness' products to up to 40 million members. Dogness expects to establish an online presence with Costco during the first quarter of 2021 and expand in-store events in the first half of 2021.

In November 2020, Dogness announced a new collaboration with Target for the distribution of its smart pet products into online Target stores in the United States.

In October 2020, Dogness completed its new factory near Xiamen, China. The facility will manufacture Dogness' line of traditional pet products, including collars, harnesses, leashes, and lanyards. With new equipment featuring advanced automation components, Dogness expects to double its annual production capabilities for products manufactured at this facility.

In October 2020, Dogness entered into a strategic partnership with Hangzhou Huayuan Pet Products Co., Ltd. and Shanghai Chongai Trading Co., The company anticipates an approximately \$6 million sales opportunity during the first year of the partnership.

In September 2019, Dogness announced that U.S. distribution of its smart products had expanded through Petco.com, expanding penetration of the U.S. market. This complements the company's smart product distribution network that is led by Chewy.com and Amazon.com.

In April 2019, Dogness announced new relationships with several international distributors, including U.S. online pet product retailer Chewy.com, a prominent U.S. kennel club, and a pet product distributor in Panama that provides to 12 countries in South America.

EARNINGS & GROWTH ANALYSIS

We expect fiscal 2021 revenues to increase by 46% to \$28 million, and fiscal 2022 revenues to increase to \$42 million, which would represent 50% growth. We expect fiscal 2021 results to benefit from Dogness' recent implementation of strategic changes to its product and geographic mix, and the resumption of more normalized results following the impacts of the COVID-19 global pandemic. In addition, we see potential for results to benefit from a more favorable trade environment with the United States, with a new U.S. presidential administration taking control early in calendar 2021. We are encouraged by Dogness' penetration into new global markets, which should ease reliance on the China and U.S. markets. We believe such efforts will diversify the company's commercial footprint. Further, we view acceptance of the smart product line among leading global retailers favorably, and expect enhanced gross margins and profitability over the longer-term.

We project that gross margins will recover from the 12% level in fiscal 2020, which we view as an outlier, as fixed costs from new production and manufacturing factories compounded a challenging sales environment. Still, we are encouraged by the smart product line's gross margin profile, which we estimate to be above 40%, as well as the line's prospects to account for a higher percentage of overall revenues moving forward. As such, we expect improving sales volumes and better pricing power from the smart product portfolio to drive gross margin of 32% in fiscal 2021 and 40% in fiscal 2022.

We project EPS of \$0.03 in fiscal 2021 and EPS of \$0.23 in fiscal 2022. We expect latter period results to benefit from enhanced economies of scale from the integration of new production facilities in China and the expansion of the global commercial portfolio, to include more smart products.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Dogness is Low. As of June 30, 2020, the company had \$4.8 million in cash and short-term investments, and more than \$22 million in capital expenditure commitments from factory construction projects. As of November 2020, the company had made \$4.4 million in payments in fiscal 2021. Although Dogness has access to capital through bank loans and we anticipate the return of positive cash flow from operations, we see the potential for Dogness to raise additional capital during fiscal 2021.

During fiscal 2020, net cash used by operating activities was \$2.2 million, compared with net cash used of \$1.3 million in fiscal 2019. Current assets were \$11.6 million, and current liabilities were \$10.8 million, resulting in a current ratio of 1.1X. As of June 30, 2020, Dogness had \$5.2 million in outstanding bank loans. In the past, company debts have been guaranteed by related parties, including CEO Silong Chen and his family. We expect that Dogness will be able to repay these loans over the long-term, with positive operating cash flow.

Dogness does not pay a dividend, and we do not expect one to be initiated in the near-term, as it focuses on launching new products and investing in long-term growth initiatives -- including manufacturing and building infrastructure to support its vertically integrated model.

MANAGEMENT & RISKS

Mr. Silong Chen serves as chairman & CEO. Mr. Chen founded the Chinese subsidiary in 2003 and has more than 15 years of experience in the pet products industry. He created the Dogness brand in 2008. As the sole holder of Class B Common Shares, which hold a three-to-one voting ratio over Class A Common Shares, Mr. Chen controls a majority of the combined voting power. Overall, the company's directors, executive officers, and their affiliates, hold in aggregate approximately 62% of the voting power of the capital stock.

As of June 30, 2020, Dogness had five directors, the majority of whom are independent and non-employee in status.

Risks include the competitive nature of the pet wearable and smart pet product industries. Although we view Dogness' reputation for innovative technology products and robust sales distribution network favorably, its products are not as well known as competing products from the dozen-plus competitors to its smart collar and harness products. The competitors include well-known brands such as Whistle GPS Pet Tracker and Garmin's Delta Smart Dog Tracker. We expect the company to face intense competition over the long-term for its home-based smart products, as market trends shift towards products becoming more connected.

Lastly, the company's functional currency is the RMB. But the global sale of its products, half of which occur outside of China, subject the company to financial currency risk which can impact the results in its financial statements that are presented in U.S. dollars. The RMB depreciated against the U.S. dollar each year between 2016 and 2018, but appreciated in 2019.

COMPANY DESCRIPTION

Dogness was founded in 2003 from the belief that pet dogs and cats are important, well-loved family members. Through its smart products, leash products, hygiene products and health and wellness products, Dogness is able to simplify pet lifestyles, make them more scientific, and enhance the relationship between pets and pet caregivers. The company ensures industry-leading quality through its fully integrated vertical supply chain and world-class research and development capabilities. This has resulted in over 211 patents and patents pending. Dogness products reach families worldwide through global chain stores and distributors.

VALUATION

In our view, Dogness' current valuation does not fully reflect the robust growth, in both revenue and gross margin expected from Dogness' smart product line. We note that Dogness generated 42% total revenue growth as recently as fiscal 2018, and anticipate that its expanding global footprint will represent new sources of growth moving forward. Further, we think that Dogness' established retail network; and the vertically integrated manufacturing platform, which can drive enhanced economies of scale and superior long-term operating margins across its portfolio.

The DOGZ shares are currently trading at a forward P/E of 9-times our EPS estimate of \$0.23 for fiscal 2022, which is a steep discount to the average multiple of roughly 25 times for the S&P Small Cap 600 and the Russell 2000 benchmarks. Applying a discount to the benchmark average to account for Dogness' near-term uncertainties and sensitivity to the China and U.S. markets, we apply a 20-times multiple to our 2022 EPS estimate of \$0.23, discounted back one period at 15%, to arrive at a \$4.00 fair value estimate for the DOGZ shares. (Steve Silver, Analyst)

INCOME STATEMENT

Growth Analysis (\$MIL)	2016	2017	2018	2019	2020	1H 2021E	2H 2021E	2021E	2022E
Revenue	16.1	21.2	30.1	26.2	19.2	12.0	16.0	28.0	42.0
Gross Profit	5.6	8.3	12.1	9.4	2.4			9.1	16.8
SG&A	1.7	2.3	5.6	8.1	8.1			8.1	9.2
R&D	0.2	0.2	0.6	0.7	1.5			0.5	0.6
Operating Income	3.6	5.8	5.9	0.6	-8.7			0.7	3.1
Interest Expense	0.4	0.3	0.0	0.6	0.1			0.1	0.1
Pretax Income	4.1	5.9	5.5	1.8	0.2			0.9	3.2
Tax Rate (%)	15	16	17	21	NA			17.0	16.0
Net income	3.5	4.9	4.6	1.4	-8.4			0.8	6.0
Diluted Shares	15.0	15.0	20.8	25.9	25.9			26.0	26.0
EPS	0.23	0.33	0.22	0.05	-0.33	0.00	0.03	0.03	0.23
Dividend	NA	NA	NA	NA	NA	NA	NA	NA	NA
Growth Rates (%)									
Revenue	NA	32	42	-13	-27			46	50
Operating Income	NA	59	2	-90	NA			NA	343
Net Income	NA	42	-7	-70	NA			NA	650
EPS	NA	43	-33	-77	NA			NA	6.7
Valuation Analysis									
Price (\$): High	NA	NA	6.40	4.45	3.28			NA	NA
Price (\$): Low	NA	NA	3.55	1.77	0.78			NA	NA
PE: High	NA	NA	19.4	20.2	65.6			NA	NA
PE: Low	NA	NA	10.8	8.0	15.6			NA	NA
PS: High	NA	NA	4.5	3.1	3.2			NA	NA
PS: Low	NA	NA	2.5	1.2	0.8			NA	NA
Yield: High	NA	NA	NA	NA	NA			NA	NA
Yield: Low	NA	NA	NA	NA	NA			NA	NA
Financial & Risk Analysis (\$MIL)									
Cash	1.4	1.5	7.1	2.9	4.8			NA	NA
Working Capital	-1.2	-1.5	37.4	17.9	0.9			NA	NA
Current Ratio	0.86	0.85	5.23	3.2	1.1			NA	NA
LTDebt/Equity (%)	NA	NA	NA	5	13			NA	NA
Total Debt/Equity (%)	118	80	8	5	13			NA	NA
Ratio Analysis									
Gross Profit Margin	34.5%	39.4%	40.3%	36%	13%			33%	40%
Operating Margin	22.6%	27.4%	19.7%	2%	-45%			3%	7%
Net Margin	21.6%	23.4%	15.3%	5%	-44%			3%	14%
Return on Assets (%)	NA	32	11	NA	NA			NA	NA
Return on Equity (%)	NA	80	14	NA	NA			NA	NA
Op Inc/Int Exp	10	17	248	1	-87			7	31
Div Payout	NA	NA	NA	NA	NA			NA	NA

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