AbbVie Inc ABBV (XNYS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Trailing Dividend Yield %	Forward Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★★ 26 Jan 2017 22:34, UTC	61.27 USD 26 Jan 2017	73.00 USD 10 Jun 2016 20:32, UTC	0.84	3.84 26 Jan 2017	4.18 26 Jan 2017	99.57 26 Jan 2017	Drug Manufacturers - Major	Standard

Morningstar Pillars	Analyst	Quantitative
Economic Moat	Narrow	Wide
Valuation	★★★★	Undervalued
Uncertainty	Medium	Medium
Financial Health	—	Moderate

Source: Morningstar Equity Research

Quantitative Valuation

ABBV

Undervalued | Fairly Valued | Overvalued

	Current	5-Yr Avg	Sector	Country
Price/Quant Fair Value	0.88	0.99	0.89	1.04
Price/Earnings	16.6	—	26.6	22.8
Forward P/E	11.1	—	12.0	17.1
Price/Cash Flow	13.4	—	17.1	13.0
Price/Free Cash Flow	14.4	—	24.8	19.7
Trailing Dividend Yield%	3.84	—	1.47	1.88

Source: Morningstar

Bulls Say

- AbbVie supports a strong dividend yield of close to 4%, which should act as valuation support, as the cash flows to support the dividend are fairly secure over the next few years.
- AbbVie's increasing entrenchment in blood cancers should bode well for growth as pricing power remains particularly strong in this area of the healthcare market.
- AbbVie's next generation immunology drugs targeting IL23 and JAK pathways will help mitigate the competitive headwinds facing Humira.

Bears Say

- Several of AbbVie's pipeline products are partnered with other drug companies, which partly limits the profit potential of the new drugs.
- The side effects emerging on hepatitis C drug Viekira could weigh on the company's ability to penetrate the important market.
- AbbVie's pipeline prospects are not strong enough to offset the eventual sales erosion from Humira following the increased biosimilar competition.

AbbVie Posts in Line Fourth Quarter; Shares Look Undervalued Despite Likely Humira Fall in 2018

Investment Thesis

Damien Conover, CFA, Sector Director, 10 June 2016

Armed with a best-in-class immunology drug Humira, AbbVie is well-positioned to drive strong cash flows to support the company's next generation of pipeline drugs. At over 50% of total sales and a higher portion of earnings (due to higher margin revenue), Humira is well positioned to drive the majority of AbbVie's performance over the next three years. With approvals in rheumatoid arthritis, psoriasis, and Crohn's disease, Humira should continue to grow in these markets as penetration rates are below 25% on average. With leading efficacy and a favorable side-effect profile, we expect Humira to continue to post double-digit growth over the next couple of years.

Despite a strong near-term outlook for Humira, uncertainty around encroaching competition will likely weigh on investor sentiment toward the company. In particular, new JAK inhibitors and IL-17 antibodies represent major drug advancements in rheumatoid arthritis and psoriasis, which will likely lead to some market share losses for Humira. Also, while Humira's biologic composition may deter generic completion following the late-2016 patent loss in the U.S. and the 2018 patent loss in Europe, we model close to 20% annual revenue declines for Humira by 2019.

Beyond Humira, cancer drug Imbruvica is poised to become the next biggest sales contributor. Imbruvica's strong clinical data in several forms of blood cancer should lead to peak sales above $6 billion. AbbVie's remaining drugs are largely mature with patent expirations long past, but have manufacturing or specific dosing complexities which make generic competition less likely.

Looking ahead, AbbVie's pipeline is weighted heavily toward new cancer drugs. In particular, AbbVie's pipeline should lead to an increasingly strong position in blood cancer. The company should be able to leverage its solid entrenchment with Imbruvica to launch the new drugs.

Analyst Note

Damien Conover, CFA, Sector Director, 27 January 2017

AbbVie reported fourth-quarter results largely in line with both our and consensus expectations, and we don't expect any changes to our $73 fair value estimate. Further, the 10% operational sales growth expected in 2017, driven by Humira gains, is in line with our expectations. We continue to view the stock as undervalued despite our significantly below consensus sales expectations for immunology drug Humira by year 2020 ($11 billion versus consensus of $19 billion). Despite the likely biosimilar headwinds facing Humira over the next few years, we believe the combination of the well-positioned currently marketed drugs along with a strong pipeline secures a narrow moat rating for the firm.

Strong sales once again from Humira (up 16% operationally mainly from volume gains in rheumatoid arthritis) and cancer drug Imbruvica helped offset weakness in the virology group, leading to total sales growth of 7%, but a new hepatitis C drug launch should help stabilize the infectious disease segment in late 2017. While AbbVie continues to lose share in the fast-moving hepatitis C market, we expect the launch of its doublet will be much more competitive than Merck's Zepatier and more on par with Gilead's offerings, allowing AbbVie to gain close to a quarter of the market with $3 billion in annual sales.

Despite the expected gains from hepatitis C drugs in the pipeline and several new immunology and oncology drugs, we expect total sales growth to flatten by 2019 as biosimilars to Humira take share from AbbVie's leading drug (63% of total sales). While the exact timing of the launches is uncertain, close to 10 Humira biosimilars are in Phase III development, filed or approved, and we expect multiple competitors by 2018. In particular, Amgen's approved Humira biosimilar will likely lead the launches in the U.S. following an uncertain litigation time frame.

Economic Moat

Damien Conover, Sector Director, 10 June 2016

We believe AbbVie supports a narrow moat based on patent-protected drugs, intellectual intangibles and a powerful salesforce. As is the case for most drug firms, the core of AbbVie's moat lies in its portfolio of patent-protected drugs. However, unlike AbbVie's Big

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Operating Margin	TTM/PE
Johnson & Johnson JNJ	USD	304,264	71,595	27.52	19.61
Pfizer Inc PFE	USD	189,818	53,243	23.45	31.25
Merck & Co Inc MRK	USD	168,737	39,907	19.60	31.25
Eli Lilly and Co LLY	USD	82,332	20,837	16.14	32.47

Pharma peers, which tend to carry wide moats, one drug (Humira) represents the majority of AbbVie's sales (more than 50%) and profits (greater than 70%). As a result of both emerging branded competition to Humira in the immediate term and a potential generic biosimilar threat in the 2017-18 time frame, we believe excess returns are likely to persist for 10 years, but we cannot be as certain of this for our 20-year outlook, which would be needed for a wide moat rating. Further supporting our narrow moat rating, AbbVie needs to improve its pipeline to be more ready for the eventual biosimilar competition to Humira.

Nevertheless, AbbVie derives enormous cash flows from its current product portfolio to fund ongoing discovery and development of the next generation of drugs. The large cash flows create an economy of scale that enables AbbVie to fund the average $800 million required for a new drug. While not as strong as other Big Pharma firms, AbbVie's R&D has created a database of intellectual insights that should help increase the odds of successful drug development. Finally, AbbVie's entrenched salesforce in one of the most sought-after therapeutic areas of immunology should help the firm launch its next generation of drugs and make the company a leading candidate for smaller drug firms needing help to develop and commercialize innovative new drugs.

Valuation

Damien Conover, Sector Director, 10 June 2016

We are increasing our AbbVie fair value estimate to $73 from $65 largely due to increased expectations for the company's next generation immunology drugs targeting the IL23 and JAK pathways as these next pathways seem to offer better efficacy and an improved side effect profile. However, our $28 billion 2020 total sales projection remains well below management's guidance of $37 billion, with the primary difference regarding immunology drug Humira. While management is projecting 2020 Humira sales at more than $18 billion, we project Humira sales at $10 billion. We anticipate quicker launches of biosimilar versions of Humira after the December 2016 patent loss in the U.S. However, AbbVie believes other less-powerful patents will keep biosimilars off the market much longer. Helping offset the likely eventual Humira sales declines, cancer drug Imbruvica holds strong blockbuster potential in blood cancers. Also, the company has several other late-stage cancer drugs that should further help mitigate the eventual Humira sales declines. On the bottom line, over the next three years we expect improving margins, largely driven by the higher contribution to total sales by specialty drugs, which carry very high margins. For the weighted average cost of capital, we use a 7.5% cost of equity and market rates for the cost of debt.

Risk

Damien Conover, Sector Director, 10 June 2016

Similar to other drug companies, AbbVie faces the risks of new product failures, reimbursement challenges for new drugs, and drug pricing cuts by large payer groups that are growing increasingly price-sensitive. Further, AbbVie's high concentration of Humira sales makes the company significantly exposed to any new competitive threats to Humira, both from biosimilars and new branded competition.

Management

Damien Conover, Sector Director, 10 June 2016

We believe AbbVie's management team has demonstrated Standard stewardship, as the key leaders haven't had much of a track record yet. While the failed acquisition attempt for Shire is concerning, we believe the new abrupt U.S. Treasury laws largely caused the acquisition to collapse, somewhat giving management a pass. Nevertheless, the $1.6 billion breakup fee related to the failed Shire deal does show that management didn't gauge the political landscape correctly. Further, the $21 billion Pharmacyclics acquisition appears to be a fair use of capital if Imbruvica reaches our $6 billion peak sales projection.

Turning to management specifically, AbbVie is led by Rick Gonzalez, who joined Abbott in 1977 and held many managerial posts throughout his career there. However, he only recently led the drug group starting in July 2010 after a brief retirement. His relatively short tenure in the key field of drug commercialization and development is a concern, but execution has been going well under his leadership. Backing up Gonzalez, CFO Bill Chase has been with Abbott for more than 20 years. Chase's background in licensing and acquisitions will be helpful, as AbbVie will need to redeploy the strong cash flows from Humira

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into acquisitions and partnering to augment the company's developing pipeline.

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Analyst Notes Archive

Clinton's Proposed Drug Plan Doesn't Change the Pricing Power for Innovative Drugs

Damien Conover, Sector Director, 02 September 2016

We don't expect any significant fair value estimate changes in the drug group based on Democratic presidential candidate Hillary Clinton's disclosed drug pricing plan targeting unjustified price increases for older drugs. While passage of the plan in Congress would be very uncertain, if the plan were to take shape, we expect less innovative generic drugs and older branded drugs to be the focus of price controls. Further, we believe the core element of patent protection supporting drug prices is still intact, supporting our moat ratings in the pharmaceutical and biotechnology industries. Our moat ratings and valuations reflect our skeptical outlook on less innovative companies and their weaker prospects for pricing power, including our no-moat and negative trend ratings for Endo and Mallinckrodt, for example.

Parts of Clinton's proposed plan would face low chances of passage in Congress or tough implementation. In response to unjustifiable price increases for older drugs, Clinton proposes increasing supply of competitive drugs and issuing penalties, which generally go against Republican support of market driven forces. Further, if drug prices increase too much, Clinton also supports drug importation, which is generally supported by Republicans but difficult to implement through the FDA.

Less innovative drugs would face the brunt of Clinton's proposed plan. We believe smaller generic drugs with less natural competition and old branded drugs pushing for gains through pricing before generic competition would feel the most price pressure under this plan. However, most drug companies don't derive much valuation from these drugs, and most large diversified generic drug manufacturers continue to face significant competition and pricing pressure.

On a broader note, the recently introduced drug plan reinforces Clinton's message of lowering healthcare costs, but we don't expect major changes in drug pricing power, especially for innovative drugs.

AbbVie Posts In-Line Q3 and Shares Look Undervalued, Despite Looming Humira Biosimilar Competition

Damien Conover, Sector Director, 28 October 2016

AbbVie reported third-quarter results largely in line with both our and consensus expectations, and we don't expect any major changes to our $73 fair value estimate. We still see the stock as undervalued, supported by a solid pipeline, despite aggressive projected declines for immunology drug Humira following biosimilar competition. Quarterly sales of Humira represented over 60% of total revenue, and this high concentration of profits and expected declines drives our narrow moat rating, a rarity in the Big Pharma industry.

In the quarter, total sales increased 8% as steady operational Humira growth of 12% helped offset hepatitis C drug declines of 20%, but dynamics in both areas are poised for rapid changes. Starting in 2018, we expect faster deterioration of Humira sales than management guidance and consensus, based on likely aggressive pharmacy benefit managers forcing pricing concessions and switches to biosimilars. For hepatitis C, we expect AbbVie's next-generation drug to drive strong growth and capture close to 20% of the market by 2020, based on strong efficacy across genotypes and lower duration of therapy (eight weeks) for some patients.AbbVie holds several drugs that will partly stabilize cash flows over the next three years.

Cancer drug Imbruvica is critical for growth, and new indications in first-line chronic lymphocytic leukemia, combined with likely expansion into non-Hodgkin lymphoma, will open up significant new patient populations. Also, several of AbbVie's current drugs have already lost patent protection but due to drug complexities (Lupron, Synthroid, Sevoflurane) are unlikely to face significant competitive threats. Also, likely spurred by concerns over Humira declines, AbbVie has gathered a strong pipeline focused on cancer and immunology, two areas with strong pricing power, which should strengthen its moat.

U.S. Elections Add Uncertainty to Healthcare Stocks, but Unlikely to Cause Major Fair Value Changes

Damien Conover, Sector Director, 09 November 2016

The presidential election of Donald Trump combined with the Republicans retaining majorities in Congress leads to greater uncertainty for healthcare stocks. While Trump and the Republicans have been clear on the desire to

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repeal the Affordable Care Act (ACA), there is less clarity on their healthcare policies, except for the focus on reducing regulations. We suspect as plans take shape to repeal the ACA, the likely outcome will be more of a modification than a complete repeal as several groups have benefited from the legislation.

If the ACA were repealed, the outcome will likely mean a lower demand for healthcare combined with less industry fees and profit restrictions. The passage of ACA was largely a compromise with industry stakeholders, mandating increased insurance coverage in return for lower costs. Reversing this mandate is largely a net neutral to the healthcare sector, with the drug, biotech, and insurance industries slightly benefiting, hospitals and drug supply chain firms negatively impacted, and the remaining industries less influenced.

On stock valuations, a repeal of the ACA would create some changes to healthcare fair values, but without clarity on the Republican plans, we have not made any changes to our fair value estimates. The drug industry would likely lose some volume gains as the close to 20 million newly insured patients from the ACA will likely lose some insurance coverage and spend less, but the mandated costs of ACA would likely more than offset the lost revenue. Similarly, for managed care organizations, the increased profitability without ACA restrictions would likely more than offset lost volumes. However, hospitals would face challenges due to the likely reversal of the declines in uncompensated care and higher volumes from the newly insured patients. Also, drug supply chain firms from Pharmacy Benefit Managers to drug distributors would face headwinds due to the lost benefit of drug demands from the newly insured patients.

AbbVie Posts in Line Fourth Quarter; Shares Look Undervalued Despite Likely Humira Fall in 2018

Damien Conover, Sector Director, 27 January 2017

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Quantitative Equity Report | Release: 27 Jan 2017, 11:01, GMT-06:00 | Reporting Currency: USD | Trading Currency: USD | Exchange:XNYS Page 6 of 13

AbbVie Inc ABBV ★★★★[Q] 27 Jan 2017 02:00 UTC

Last Close	Fair Value[Q]	Market Cap	Sector	Industry	Country of Domicile
26 Jan 2017	27 Jan 2017 02:00 UTC	26 Jan 2017			
61.27	69.29	99,569.8 Mil	Healthcare	Drug Manufacturers - Major	USA United States

There is no one analyst in which a Quantitative Fair Value Estimate and Quantitative Star Rating are attributed to; however, Mr. Lee Davidson, Head of Quantitative Research for Morningstar, Inc., is responsible for overseeing the methodology that supports the quantitative fair value. As an employee of Morningstar, Inc., Mr. Davidson is guided by Morningstar, Inc.'s Code of Ethics and Personal Securities Trading Policy in carrying out his responsibilities. For information regarding Conflicts of Interests, visit http://global.morningstar.com/equitydisclosures

Company Profile

AbbVie Inc is a research-based biopharmaceutical company. The Company is engaged in the discovery, development, manufacture and sale of a broad line of pharmaceutical products for treating chronic autoimmune diseases, virology and neurological disorders.

Quantitative Scores

		Scores All	Rel Sector	Rel Country
Quantitative Moat	Wide	100	99	99
Valuation	Undervalued	89	51	86
Quantitative Uncertainty	Medium	98	97	95
Financial Health	Moderate	68	59	68

Source: Morningstar Equity Research

Valuation

	Current	5-Yr Avg	Sector Median	Country Median
Price/Quant Fair Value	0.88	0.99	0.89	1.04
Price/Earnings	16.6	—	26.6	22.8
Forward P/E	11.1	—	12.0	17.1
Price/Cash Flow	13.4	—	17.1	13.0
Price/Free Cash Flow	14.4	—	24.8	19.7
Trailing Dividend Yield %	3.84	—	1.47	1.88
Price/Book	15.4	—	3.2	2.5
Price/Sales	4.0	—	3.9	2.2

Profitability

	Current	5-Yr Avg	Sector Median	Country Median
Return on Equity %	107.3	110.6	12.3	11.9
Return on Assets %	10.0	14.7	6.2	4.6
Revenue/Employee (K)	901.5	—	308.8	305.5

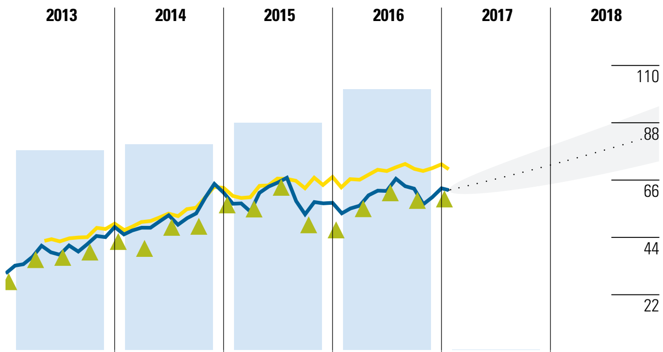
Financial Health

	Current	5-Yr Avg	Sector Median	Country Median
Distance to Default	0.6	0.7	0.6	0.5
Solvency Score	424.8	—	522.1	585.0
Assets/Equity	13.4	10.9	1.4	1.7
Long-Term Debt/Equity	—	—	0.1	0.3

Growth Per Share

	1-Year	3-Year	5-Year	10-Year
Revenue %	14.5	7.5	7.9	—
Operating Income %	121.0	9.0	9.8	—
Earnings %	184.6	-2.2	3.4	—
Dividends %	21.7	—	—	—
Book Value %	123.9	—	—	—
Stock Total Return %	9.2	12.2	—	—

Price vs. Quantitative Fair Value



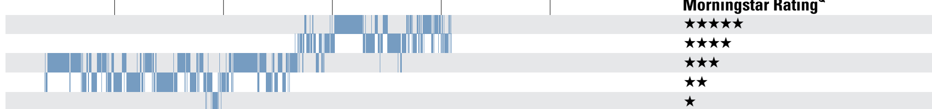
- Quantitative Fair Value Estimate
- Total Return
- Sales/Share
- Forecast Range
- Forcasted Price
- Dividend
- Split

Momentum:	Neutral
Standard Deviation:	21.97
Liquidity:	High

51.60 52-Wk 68.12

2013	2014	2015	2016	2017	2018	
59.3	27.1	-6.4	9.6	-1.1		Total Return %
26.1	14.2	-7.1	-2.9	-3.9		+/– Market (Morningstar US Index)
3.03	2.54	3.41	3.64	—		Trailing Dividend Yield %
—	—	—	—	3.84		Forward Dividend Yield %
18.6	28.5	34.6	16.9	16.6		Price/Earnings
4.5	5.4	4.4	4.1	4.0		Price/Revenue

Morningstar Rating[Q]



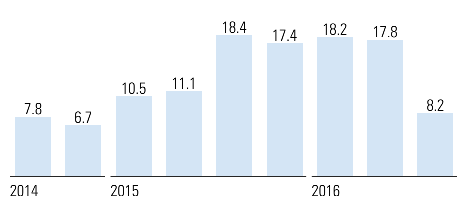
2011	2012	2013	2014	2015	TTM	**Financials** (Fiscal Year in Mil)
17,444	18,380	18,790	19,960	22,859	25,242	Revenue
11.5	5.4	2.2	6.2	14.5	10.4	% Change
3,621	5,817	5,664	3,411	7,537	9,139	Operating Income
-23.2	60.7	-2.6	-39.8	121.0	21.3	% Change
3,433	5,275	4,128	1,774	5,144	6,079	Net Income
6,247	6,345	6,267	3,549	7,535	7,463	Operating Cash Flow
-356	-333	-491	-612	-532	-510	Capital Spending
5,891	6,012	5,776	2,937	7,003	6,953	Free Cash Flow
33.8	32.7	30.7	14.7	30.6	27.5	% Sales
—	3.35	2.56	1.10	3.13	3.70	EPS
—	—	-23.6	-57.0	184.5	18.2	% Change
—	3.81	3.46	2.96	2.73	4.25	Free Cash Flow/Share
—	—	1.60	1.66	2.02	2.22	Dividends/Share
—	—	2.25	2.92	3.02	3.98	Book Value/Share
1,587	1,591	1,610	1,625	—	1,625	Shares Outstanding (Mil)

2011	2012	2013	2014	2015	TTM	**Profitability**
24.6	67.7	105.1	56.9	180.9	107.3	Return on Equity %
16.8	22.6	14.7	6.3	12.8	10.0	Return on Assets %
19.7	28.7	22.0	8.9	22.5	24.1	Net Margin %
0.86	0.79	0.67	0.70	0.57	0.42	Asset Turnover
1.6	8.0	6.5	15.8	13.4	10.3	Financial Leverage
73.4	75.5	75.6	77.8	80.3	77.2	Gross Margin %
20.8	31.7	30.1	17.1	33.0	36.2	Operating Margin %
—	—	—	—	—	—	Long-Term Debt
12,224	3,363	4,492	1,742	3,945	6,469	Total Equity
7.7	8.4	8.3	8.3	9.1	9.7	Fixed Asset Turns

Quarterly Revenue & EPS

Revenue (Mil)	Mar	Jun	Sep	Dec	Total
2016	5,958.0	6,452.0	6,432.0	—	—
2015	5,040.0	5,475.0	5,944.0	6,400.0	22,859.0
2014	4,563.0	4,926.0	5,019.0	5,452.0	19,960.0
2013	4,329.0	4,692.0	4,658.0	5,111.0	18,790.0
Earnings Per Share ()					
2016	0.83	0.98	0.97	—	—
2015	0.63	0.83	0.74	0.92	3.13
2014	0.61	0.68	0.31	-0.50	1.10
2013	0.60	0.66	0.60	0.70	2.56

Revenue Growth Year On Year %



Research Methodology for Valuing Companies

Qualitative Equity Research Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market-price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we", "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate and (4) the current market price. This process ultimately culminates in our single-point star rating.

1. Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

2. Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working-capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and the net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total pres-

Morningstar Research Methodology for Valuing Companies

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ent value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market-value weights.

3. Uncertainty around that fair value estimate

Morningstar's Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case, and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

- ►**Low:** margin of safety for 5-star rating is a 20% discount and for 1-star rating is 25% premium.
- ►**Medium:** margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- ►**High:** margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- ►**Very High:** margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- ►**Extreme:** Stock's uncertainty exceeds the parameters we have set for assigning the appropriate margin of safety.

4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed which we believe is a reliable source.

For more detail information about our methodology, please go to http://global.morningstar.com/equitydisclosures

Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow, and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

Five Stars ★★★★★

We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

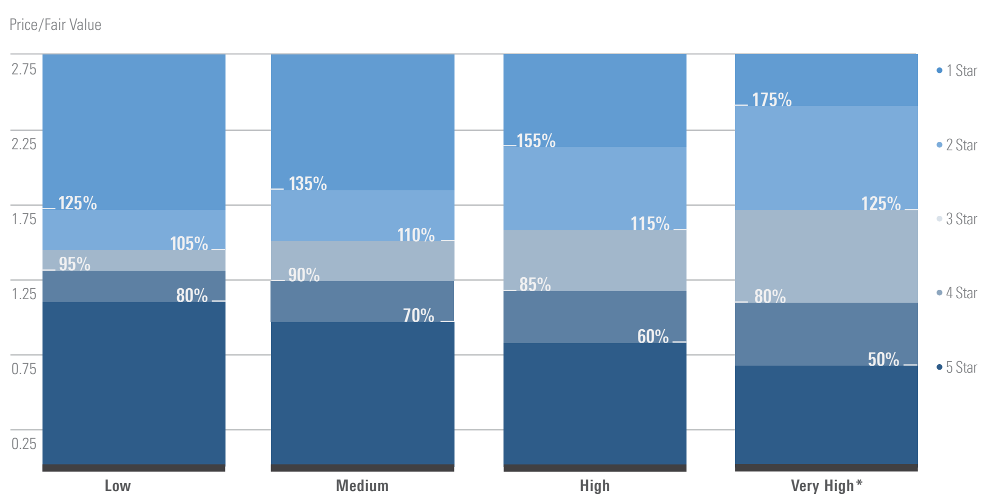
Four Stars ★★★★

We believe appreciation beyond a fair risk-adjusted return is likely.

Three Stars ★★★

Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

Morningstar Research Methodology for Valuing Companies



* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

Research Methodology for Valuing Companies

Two Stars ★★
We believe investors are likely to receive a less than fair risk-adjusted return.

One Star ★
Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

Other Definitions:

Last Price: Price of the stock as of the close of the market of the last trading day before date of the report.

Stewardship Rating: Represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

Quantitative Valuation: Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- ►**Undervalued:** Last Price is below Morningstar's quantitative fair value estimate.
- ►**Farily Valued:** Last Price is in line with Morningstar's quantitative fair value estimate.
- ►**Overvalued:** Last Price is above Morningstar's quantitative fair value estimate.

Risk Warning
Please note that investments in securities are subject to market and other risks and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's Uncertainty Rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

Quantitative Equity Reports Overview
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Quantitative Equity Ratings
Morningstar's quantitative equity ratings consist of: (i) Quantitative Fair Value Estimate, (ii) Quantitative Star Rating, (iii) Quantitative Uncertainty, (iv) Quantitative Economic Moat, and (v) Quantitative Financial Health (collectively the "Quantitative Ratings).

The Quantitative Ratings are calculated daily and derived from the analyst-driven ratings of a company's peers as determined by statistical algorithms. Morningstar, Inc. ("Morningstar", "we", "our") calculates Quantitative Ratings for companies whether or not it already provides analyst ratings and qualitative coverage. In some cases, the Quantitative Ratings may differ from the analyst ratings because a company's analyst-driven ratings can significantly differ from other companies in its peer group.

Quantitative Fair Value Estimate: Intended to represent Morningstar's estimate of the per share dollar amount that a company's equity is worth today. Morningstar calculates the Quantitative Fair Value Estimate using a statistical model derived from the Fair Value Estimate Morningstar's equity analysts assign to companies. Please go to http://global.morningstar.com/equitydisclosures for information about Fair Value Estimate Morningstar's equity analysts assign to companies.

Quantitative Economic Moat: Intended to describe the strength of a firm's competitive position. It is calculated using an algorithm designed to predict the Economic Moat rating a Morningstar analyst would assign to the stock. The rating is expressed as Narrow, Wide, or None.

- ►**Narrow:** assigned when the probability of a stock receiving a "Wide Moat" rating by an analyst is greater than 70% but less than 99%.
- ►**Wide:** assigned when the probability of a stock receiving a "Wide Moat" rating by an analyst is greater than 99%.
- ►**None:** assigned when the probability of an analyst receiving a "Wide Moat" rating by an analyst is less than 70%.

Quantitative Star Rating: Intended to be the summary rating based on the combination of our Quantitative Fair Value Estimate, current market price, and the Quantitative Uncertainty Rating. The rating is expressed as One-Star, Two-Star, Three-Star, Four-Star, and Five-Star.

- ►**One-Star:** the stock is overvalued with a reasonable margin of safety.
  *Log (Quant FVE/Price) < -1*Quantitative Uncertainty*
- ►**Two-Star:** the stock is somewhat overvalued.
  *Log (Quant FVE/Price) between (-1*Quantitative Uncertainty, -0.5*Quantitative Uncertainty)*
- ►**Three-Star:** the stock is approximately fairly valued.
  *Log (Quant FVE/Price) between (-0.5*Quantitative Uncertainty, 0.5*Quantitative Uncertainty)*
- ►**Four-Star:** the stock is somewhat undervalued.
  *Log (Quant FVE/Price) between (0.5*Quantitative Uncertainty, 1*Quantitative Uncertainty)*
- ►**Five-Star:** the stock is undervalued with a reasonable margin of safety.
  *Log (Quant FVE/Price) > 1*Quantitative Uncertainty*

Quantitative Uncertainty: Intended to represent Morningstar's level of uncertainty about the accuracy of the Quantitative Fair Value Estimate. Generally, the lower the Quantitative Uncertainty, the narrower the potential range of outcomes for that particular company. The rat-

Research Methodology for Valuing Companies

ing is expressed as Low, Medium, High, Very High, and Extreme.

- ►**Low:** the interquartile range for possible fair values is less than 10%.
- ►**Medium:** the interquartile range for possible fair values is less than 15% but greater than 10%.
- ►**High:** the interquartile range for possible fair values is less than 35% but greater than 15%.
- ►**Very High:** the interquartile range for possible fair values is less than 80% but greater than 35%.
- ►**Extreme:** the interquartile range for possible fair values is greater than 80%.

Quantitative Financial Health: Intended to reflect the probability that a firm will face financial distress in the near future. The calculation uses a predictive model designed to anticipate when a company may default on its financial obligations. The rating is expressed as Weak, Moderate, and Strong.

- ►**Weak:** assigned when Quantitative Financial Health < 0.2
- ►**Moderate:** assigned when Quantitative Financial Health is between 0.2 and 0.7
- ►**Strong:** assigned when Quantitative Financial Health > 0.7

Other Definitions:

Last Close: Price of the stock as of the close of the market of the last trading day before date of the report.

Quantitative Valuation: Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- ►**Undervalued:** Last Price is below Morningstar's quantitative fair value estimate.
- ►**Farily Valued:** Last Price is in line with Morningstar's quantitative fair value estimate.
- ►**Overvalued:** Last Price is above Morningstar's quantitative fair value estimate.

This Report has not been made available to the issuer of the security prior to publication.

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Please note that investments in securities are subject to market and other risks and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report.

The quantitative equity ratings are not statements of fact. Morningstar does not guarantee the completeness or accuracy of the assumptions or models used in determining the quantitative equity ratings. In addition, there is the risk that the price target will not be met due to such things as unforeseen changes in demand for the company's products, changes in management, technology, economic development, interest rate development, operating and/or material costs, competitive pressure, supervisory law, exchange rate, and tax rate. For investments in foreign markets there are further risks, generally based on exchange rate changes or changes in political and social conditions. A change in the fundamental factors underlying the quantitative equity ratings can mean that the valuation is subsequently no longer accurate.

For more information about Morningstar's quantitative methodology, please visit www.corporate.morningstar.com.

AbbVie Inc ABBV (XNYS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Trailing Dividend Yield %	Forward Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★★	61.27 USD	73.00 USD	0.84	3.84	4.18	99.57	Drug Manufacturers - Major	Standard
26 Jan 2017 22:34, UTC	26 Jan 2017	10 Jun 2016 20:32, UTC		26 Jan 2017	26 Jan 2017	26 Jan 2017		

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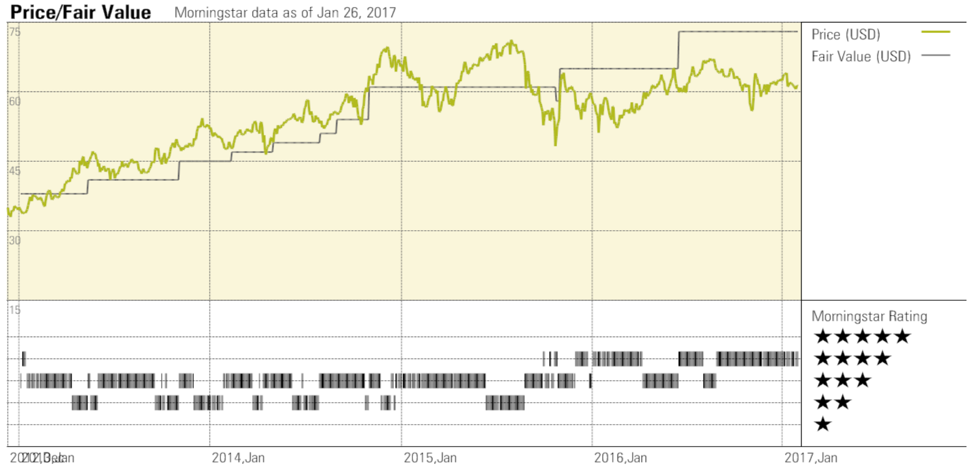
Price/Fair Value Morningstar data as of Jan 26, 2017



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AbbVie Inc ABBV (XNYS)

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