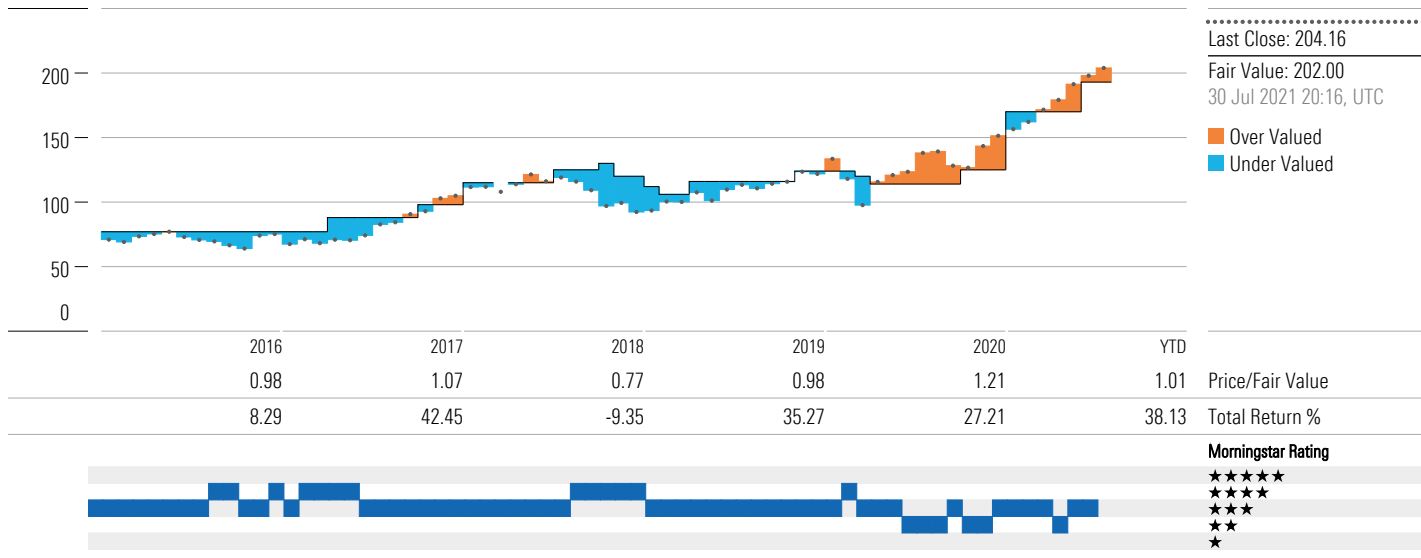


# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

|  |  |                          |   |                               |                              |                              |  |  |
|--|--|--------------------------|---|-------------------------------|------------------------------|------------------------------|--|--|
| <b>Last Price</b><br>204.16 USD<br>30 Jul 2021 | <b>Fair Value Estimate</b><br>202.00 USD<br>30 Jul 2021 20:16, UTC | <b>Price/FVE</b><br>1.01 | <b>Market Cap</b><br>46.28 USD Bil<br>29 Jul 2021 | <b>Economic Moat™</b><br>Wide | <b>Moat Trend™</b><br>Stable | <b>Uncertainty</b><br>Medium | <b>Capital Allocation</b><br>Exemplary | <b>ESG Risk Rating Assessment<sup>1</sup></b><br>7 Jul 2021 05:00, UTC |
|--|--|--------------------------|---|-------------------------------|------------------------------|------------------------------|--|--|

## Price vs. Fair Value



Total Return % as of 29 Jul 2021. Last Close as of 30 Jul 2021. Fair Value as of 30 Jul 2021 20:16, UTC.

### Contents

- Business Description
- Business Strategy & Outlook (30 Jul 2021)
- Bulls Say / Bears Say (30 Jul 2021)
- Economic Moat (30 Jul 2021)
- Fair Value and Profit Drivers (30 Jul 2021)
- Risk and Uncertainty (30 Jul 2021)
- Capital Allocation (30 Jul 2021)
- Analyst Notes Archive
- Financials
- Research Methodology for Valuing Companies

### Important Disclosure

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The primary analyst covering this company does not own its stock.

<sup>1</sup>The ESG Risk Rating Assessment is a representation of Sustainalytics' ESG Risk Rating.

## Market Gains Continue to Offset Weaker Flows to Drive T. Rowe Price's AUM Higher

**Business Strategy & Outlook** Gregory Warren, CFA, Sector Strategist, 30 Jul 2021

In an environment where active fund managers are under assault for poor relative performance and high fees, we believe wide-moat-rated T. Rowe Price is the best positioned of the U.S.-based active asset managers we cover. The biggest differentiators for the firm are the size and scale of its operations, the strength of its brands, its consistent record of active fund outperformance, and reasonable fees. T. Rowe Price has historically had a stickier set of clients than its peers as well, with two thirds of its assets under management derived from retirement-based accounts. At the end of 2020, 83%, 79%, and 77% of the company's fund AUM were beating peers on a 3-, 5-, and 10-year basis, respectively, with 77% of AUM in the funds closing out the year with an overall rating of 4 or 5 stars, better than just about every other U.S.-based asset manager. T. Rowe Price also has a much stronger Morningstar Success Ratio--which evaluates whether a firm's open-end funds deliver sustainable, peer-beating returns over longer periods--giving it an additional leg up.

While T. Rowe Price will face headwinds in the near to medium term as baby boomer rollovers affect organic growth in the defined-contribution channel, we think the firm and defined-contribution plans in general have a compelling cost and service argument to make to pending retirees, which should mitigate some of the impact. We also believe T. Rowe Price is uniquely positioned among the firms we cover (as well as the broader universe of active asset managers) to pick up business in the retail-advised

# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

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| Sector   | Industry         |
|--|------------------|
|  Financial Services | Asset Management |

## Business Description

T. Rowe Price provides asset-management services for individual and institutional investors. It offers a broad range of no-load U.S. and international stock, hybrid, bond, and money market funds. At the end of May 2021, the firm had \$1.593 trillion in managed assets, composed of equity (60%), balanced (28%), and fixed-income (12%) offerings. Approximately two thirds of the company's managed assets are held in retirement-based accounts, which provides T. Rowe Price with a somewhat stickier client base than most of its peers. The firm also manages private accounts, provides retirement planning advice, and offers discount brokerage and trust services. The company is primarily a U.S.-based asset manager, deriving just 9% of its AUM from overseas.

channel, given the solid long-term performance of its funds and reasonableness of its fees, exemplified by deals the past few years with Fidelity Investments' FundsNetwork and Schwab's Mutual Fund OneSource platform. With the company likely to generate mid- to high-single-digit AUM growth on average going forward (aided by 0%-3% annual organic growth), we see top-line growth expanding at a positive 7.7% CAGR during 2021-25, with operating margins of 47%-49% on average.

### Bulls Say Gregory Warren, CFA, Sector Strategist, 30 Jul 2021

- ▶ With \$1.623 trillion in AUM at the end of June 2021, T. Rowe Price is one of the larger U.S.-based asset managers. Retirement accounts and variable-annuity investment portfolios account for two thirds of assets.
- ▶ At the end of the second quarter of 2021, 91%, 84%, and 86% of T. Rowe Price's multi-asset AUM was beating passive peers on a 3-, 5-, and 10-year basis, respectively.
- ▶ Target-date retirement portfolios have been a significant source of organic growth, generating just under \$100 billion in net inflows (equivalent to an 8% rate of annual growth) for the firm the past 10 years.

### Bears Say Gregory Warren, CFA, Sector Strategist, 30 Jul 2021

- ▶ The company's equity performance has weakened, with just 59%, 64%, and 71% of assets beating passive peers on a 3-, 5-, and 10-year basis, respectively, at the end of June 2021.
- ▶ Fixed-income performance has stumbled as well, with just 66%, 57%, and 61% of bond fund AUM beating passive peers on a 3-, 5-, and 10-year basis, respectively, at the end of the second quarter of 2021.
- ▶ With a large portion of the firm's assets generating fees based on daily AUM levels rather than monthly or quarterly averages, revenue will be more heavily affected during periods of extreme market volatility.

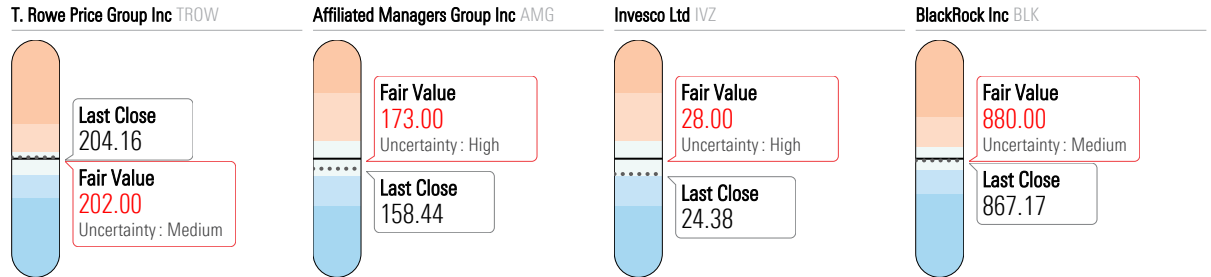
### Economic Moat Gregory Warren, CFA, Sector Strategist, 30 Jul 2021

In our view, the asset-management business can be conducive to economic moats, with switching costs and intangible assets the most durable sources of competitive advantage for firms operating in the industry. Although the switching costs might not be explicitly large, inertia and the uncertainty of achieving better results by moving from one asset manager to another tend to keep many investors invested with the same funds for extended periods of time. As a result, money that flows into asset-management firms tends to stay there. For the industry as a whole, the average narrow redemption (retention) rate, which does not include exchange redemptions, has been 25% or less (75% or greater) annually during the past 5-, 10-, 15-, 20-, 25-, and 30-year time frames. Including exchange redemptions, the rate has been less than 30% (greater than 70%). Because T. Rowe Price does not break out its net flows (which are gross sales less investor redemptions) we assume that, based on its historical record of positive organic growth, the company's average annual redemption rate has been at

# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

| Last Price                | Fair Value Estimate                  | Price/FVE | Market Cap                   | Economic Moat™ | Moat Trend™ | Uncertainty | Capital Allocation | ESG Risk Rating Assessment¹ |
|---------------------------|--------------------------------------|-----------|------------------------------|----------------|-------------|-------------|--------------------|-----------------------------|
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## Competitors



|                    | T. Rowe Price Group Inc TROW       | Affiliated Managers Group Inc AMG  | Invesco Ltd IVZ                    | BlackRock Inc BLK                  |
|--------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| Economic Moat      | Wide                               | Narrow                             | Narrow                             | Wide                               |
| Moat Trend         | Stable                             | Negative                           | Negative                           | Stable                             |
| Currency           | USD                                | USD                                | USD                                | USD                                |
| Fair Value         | 202.00 30 Jul 2021 20:16, UTC      | 173.00 28 Jul 2021 18:03, UTC      | 28.00 27 Jul 2021 17:19, UTC       | 880.00 15 Jun 2021 21:34, UTC      |
| 1-Star Price       | 272.70                             | 268.15                             | 43.40                              | 1,188.00                           |
| 5-Star Price       | 141.40                             | 103.80                             | 16.80                              | 616.00                             |
| Assessment         | Fairly Valued 29 Jul 2021          | Fairly Valued 29 Jul 2021          | Fairly Valued 29 Jul 2021          | Fairly Valued 29 Jul 2021          |
| Morningstar Rating | ★★★ 30 Jul 2021 20:27, UTC         | ★★★ 29 Jul 2021 21:24, UTC         | ★★★ 29 Jul 2021 21:24, UTC         | ★★★ 29 Jul 2021 21:24, UTC         |
| Analyst            | Greggory Warren, Sector Strategist | Greggory Warren, Sector Strategist | Greggory Warren, Sector Strategist | Greggory Warren, Sector Strategist |
| Capital Allocation | Exemplary                          | Exemplary                          | Standard                           | Exemplary                          |
| Price/Fair Value   | 1.01                               | 0.92                               | 0.87                               | 0.99                               |
| Price/Sales        | 6.61                               | 3.29                               | 1.74                               | 7.42                               |
| Price/Book         | 5.86                               | 2.53                               | 0.75                               | 3.74                               |
| Price/Earning      | 16.11                              | 15.93                              | 10.87                              | 24.46                              |
| Dividend Yield     | 1.94%                              | 0.03%                              | 2.61%                              | 1.79%                              |
| Market Cap         | 46.28 Bil                          | 6.61 Bil                           | 11.24 Bil                          | 132.41 Bil                         |
| 52-Week Range      | 121.58—212.41                      | 62.19—180.97                       | 9.72—29.71                         | 531.39—920.31                      |
| Investment Style   | Large Core                         | Small Value                        | Mid Value                          | Large Core                         |

its worst no worse than the industrywide rate, especially given the tailwinds that have been provided at times by defined contribution plans the past couple of decades--noting that redemptions have outpaced inflows into 401(k) plans since the baby boomer retirement phase started in 2011. During the past 5 (10) calendar years, T. Rowe Price's organic growth rate has averaged positive 0.9% (0.9%) with a standard deviation of 0.8% (1.6%), which meant that the firm was in most years compensating for investor redemptions with new flows into its products. We expect T. Rowe Price will generate at least 0.5% average annual organic growth during 2021-25, with a standard deviation of 1.7%, and closer to 2.0% on average during 2021-30, with a standard deviation of 1.8%, driven by recent large investments in retail distribution, enhanced product/vehicles and technology. As a result, T. Rowe Price should continue to have a better-than-average switching cost profile than its peers despite continuing to see redemption rates at or above the industry average due to the continuation of the baby boomer retirement cycle.

We believe traditional asset managers like T. Rowe Price can improve on the switching cost advantage

# T. Rowe Price Group Inc TROW ★★★

30 Jul 2021 20:27, UTC

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inherent in their business models with organizational attributes (such as product mix, distribution channel concentration, and geographic reach) and intangible assets (such as strong and respected brands and manager reputations derived from successful, sustainable track records of investment performance), which can provide them with a degree of differentiation from their peers. While the barriers to entry are not all that significant for the industry, the barriers to success are extremely high, as it not only takes time and skill to put together a long enough record of investment performance to gather assets but even more time to build the scale necessary to remain competitive in the industry. This has generally provided larger, more established asset managers with an advantage over smaller players in the industry, especially when it comes to gaining cost-effective access to distribution platforms. Competition for investor inflows can be stiff and has traditionally centered on investment performance, especially in the retail channel. Although institutional investors and retail gatekeepers are exerting pressure on pricing, competition based on price has been rare, aside from what we've seen in the U.S. market for exchange-traded funds. While compensation remains the single-largest expense for most asset managers, supplier power has been manageable as many firms have reduced their reliance on star managers and have tied manager and analyst pay to both portfolio and overall firm performance.

Asset stickiness (the degree to which assets remain with a manager over time) tends to be a differentiator between wide- and narrow-moat firms, as those asset managers that have demonstrated an ability to gather and retain investor assets during different market cycles have tended to produce more stable levels of profitability, with returns exceeding their cost of capital for longer periods. While the more broadly diversified asset managers are structurally set up to hold on to assets regardless of market conditions, it has been firms with solid product sets across asset classes (built on repeatable investment processes), charging reasonable fees, and with singular corporate cultures dedicated to a common purpose that have done a better job of gathering and retaining assets. Firms offering niche products with significantly higher switching costs--such as retirement accounts, funds with lockup periods, and tax-managed strategies--have tended to hold on to assets longer.

T. Rowe Price, in our view, has a wide economic moat around its operations. We think the company's size and scale, the strength of its brands, and its consistent record of active fund outperformance provides the firm with a leg up over competitors. While T. Rowe Price's product mix is not overly diverse, with 89% of its \$1.623 trillion in AUM at the end of June 2021 dedicated to equity (61%) and multi-asset/balanced (28%) strategies, the company derives a significant portion (just over two thirds) of its AUM from defined contribution retirement assets and deferred annuity and direct retail retirement assets. With the switching costs for these tax-deferred products being significantly higher than those for most other accounts (the majority of which are non-tax-deferred), T. Rowe Price has traditionally had a much stickier set of assets than its peers. Benefiting from a steady stream in investor inflows into defined contribution and other retirement plans, the firm has recorded net long-term outflows in only 16

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calendar quarters the past two decades. Furthermore, the firm's cost-conscious culture and stable AUM and revenue levels have allowed it to consistently generate operating margins of 40% or more (the highest among the traditional U.S.-based asset managers we cover). T. Rowe Price's ability to generate more stable revenue, profitability, and cash flows than its peers has, in our view, provided the company with more than enough excess capital to continue building on the competitive advantages that it already possesses. The firm has been fairly effective managing its scale, with adjusted operating margins of 43.0% (44.5%) on average during 2016-20 (2011-20), allowing it to generate around \$1.9 billion (\$1.6 billion) in annual free cash flow on average, with adjusted ROICs exceeding 60% (and ROICs with goodwill exceeding 45%).

T. Rowe Price has withstood the headwinds facing active managers with its rigorous research process, strong performance across asset classes, and continued investment in its research team. At the end of 2020, the firm had 77% of its rated U.S. mutual funds (across primary share classes) rated 4 or 5 stars by Morningstar, with 72% receiving gold, silver, or bronze medal ratings. As most broker/dealer and advisory platforms tend to give deferential treatment to 4- and 5-star funds, T. Rowe Price is well positioned. With solid three- and five-year relative investment performance generated on a consistent basis also tending to be an important benchmark for the gatekeepers of retail-advised and institutional platforms, T. Rowe Price continues to hold its own, with 83%, 79%, and 77% of T. Rowe Price's sponsored U.S. mutual funds beating their passively managed peers on a 3-, 5-, and 10-year basis, respectively, at the end of 2020. Another measure that demonstrates the strength of T. Rowe Price's investment acumen is the Morningstar Success Ratio, which measures the potential for a firm's funds to generate sustainable, peer-beating returns over the long run. Morningstar calculates two different success ratios--the Morningstar Success Ratio and the Morningstar Risk-Adjusted Success Ratio--over 3-, 5-, and 10-year time frames, with the former considering each fund's category rank based on total return and the latter looking at a fund's category rank based on Morningstar Risk-Adjusted Return. The higher the Success Ratio, the greater chance that investors will see sustainable, peer-beating returns. By this measure, T. Rowe Price is the only winner among the U.S.-based asset managers we cover, with a five-year Risk-Adjusted Success Ratio of 72.0 compared with a group average (median) of 41.1 (37.0). Compared with the broader universe of fund families, T. Rowe also scores well, with its five-year Risk-Adjusted Success Ratio beating the industry average (median) of 47.6 (45.5).

Much of the success T. Rowe Price has had historically has been built on the firm having a single corporate culture dedicated to a common purpose, which has been reflected in the level and consistency of its investment performance, the rate of organic growth the company has been able to generate, and the relatively small amount of employee turnover through the years. Morningstar views the management team at T. Rowe Price as being highly insular and very protective of the culture that the firm has built--one that has cultivated a disciplined, risk-conscious investment process that has

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consistently produced successful results across its fund lineup, often with less volatility than peers. As part of ongoing efforts to enhance the company's competitive positioning, management has been willing to evolve, though, focusing for much of the past several years on building additional scale through new investment products, expanding the reach of its investment advisory business by further penetrating domestic distribution channels (like the retail-advised channel) and moving into non-U.S. markets (especially emerging and developing economies in the Asia-Pacific region), and bolstering technology in an effort to improve performance outcomes, drive down incremental costs, and improve product distribution. The company maintains an investment focus while recognizing that the business must evolve to flourish in an industry that continues to gravitate toward passive investing. All of this explains why T. Rowe Price receives some of the highest marks for corporate culture among the U.S.-based asset managers we cover. Our manager research group has also consistently awarded it a Positive Parent rating, owing not only to its ability to produce repeatable investment strategies but to prudently adapt to the changing competitive landscape all while attracting and retaining quality investment talent. We continue to believe that T. Rowe Price is well positioned to navigate the headwinds that the U.S.-based asset managers will face during the next decade and expect it to be one of the rare organic growth generators in the group.

## Fair Value and Profit Drivers Greggory Warren, CFA, Sector Strategist, 30 Jul 2021

We've increased our fair value estimate for T. Rowe Price to \$202 per share from \$193 to account for marked improvements in the company's AUM, as well as our own near-to-medium term forecasts for the firm, since our last update. Our new fair value estimate implies a price/earnings multiple of 15.6 times our 2021 earnings estimate, 15.1 times our 2022 earnings estimate and 15.5 times our 2023 earnings estimate. For some perspective, during the past five (10) years, the company's shares have traded at an average of 16.0 (17.5) times trailing earnings. We use a 26% U.S. statutory corporate tax rate and a 9% cost of equity in our valuation.

T. Rowe Price closed out June 2021 with a record \$1.623 trillion in managed assets, up 33.0% on a year-over-year basis. Net outflows of \$600 million during the quarter were slightly worse than our expectations, which we had expected to be more and on par with the \$1.9 billion quarterly run rate for inflows we've seen from the firm the past five years. It also marks only the sixteenth time that T. Rowe Price has reported quarterly outflows in the past two decades. Even so, we still see the firm generating flattish organic AUM growth this year. Going forward, we expect to see more improvements in T. Rowe Price's annual organic growth profile, which we envision in a 0% to positive 3% range over the next five years, with flows likely picking up after 2025, when fewer baby boomers retiring and millennials starting to hit their peak earnings years puts less of a drag on flows. Our five-year CAGR for overall AUM growth is 5%-7% annually during 2021-25.

Despite management fees continuing to be pressured by industry dynamics, we expect T. Rowe Price,

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which is somewhat insulated due to its channel mix and already low-cost offerings, to generate a 7.7% CAGR for revenue over our five-year forecast period (up from 7.3% previously). As for profitability, we expect to see adjusted operating margins of 47%-49% (up from 46%-48% previously), even as the firm invests in key regions and channels to drive additional growth. As such, T. Rowe Price should be able to generate around \$3.5 billion in free cash flow annually on average, with about one third of that amount returned to shareholders as dividends and 25%-30% devoted to share repurchases.

### Risk and Uncertainty Gregory Warren, CFA, Sector Strategist, 30 Jul 2021

Our uncertainty rating for T. Rowe Price is medium. We don't consider any environmental, social, or governance issues to be material enough to affect our uncertainty rating or fair value estimate. With more than 80% of annual revenue derived from management fees levied on AUM, dramatic market movements, shifts in product mix, and/or changes in fund flows can have a significant impact on operating income and cash flows. T. Rowe Price's investment offerings are overwhelmingly tied to U.S. equity markets, with close to 90% of its AUM invested in equity (60%) and balanced (28%) strategies. Additionally, 10 T. Rowe Price funds--Blue-Chip Growth, Growth Stock, Capital Appreciation, Mid-Cap Growth, New Horizons, Value, Emerging Markets Stock, Overseas Stock, Equity Income, and Institutional Large-Cap Growth--accounted for just over 20% of the firm's AUM at the end of 2020, as well as 30% of the company's investment advisory revenue during the year. As T. Rowe Price increases its investment in overseas asset managers, especially in emerging and developing economies like China and India, it is exposing itself to myriad cultural, economic, political, and currency risks that exist in the markets these managers serve. The company is, however, at a lower risk of experiencing material financial impacts from ESG factors, due to its low exposure to risks that are inherent to the industry, as well as its own operations, offset by the firm's strong management of its material ESG issues (considered to be an industry leader in the area of corporate governance).


### Capital Allocation Gregory Warren, CFA, Sector Strategist, 30 Jul 2021

T. Rowe Price is unique among the publicly traded U.S.-based asset managers in that it has traditionally been run by a group of top officers (the management committee) who consult one another before making major decisions. The firm recently announced that current chairman and CEO Bill Stromberg will be stepping down from his chief executive role at the end of 2021, with current president and CIO Rob Sharps becoming president and CEO, as well as chairman of the management committee. Stromberg, who will continue to serve on T. Rowe Price's board as non-executive chairman, has been with the firm for 35 years (rising from an initial role as an analyst to chairman and CEO) and is sticking to a fairly typical retirement time frame for the firm's executives. Sharps, meanwhile, is following a similar career track, having started with T. Rowe Price as an analyst some 24 years ago before going on to become a well-regarded portfolio manager and eventually president and CIO. His responsibilities and influence have broadened significantly in recent years as he has taken a more active role in corporate strategy,



# T. Rowe Price Group Inc TROW ★★★

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product development, and other enterprise initiatives, basically prepping him for the top job at the firm.

Our capital allocation rating for T. Rowe Price is exemplary. This rating focuses on the three key areas we look at to assess management efficacy: balance sheet health, investment efficacy, and shareholder distributions. Given that a firm's financial health directly affects its ability to invest in future growth opportunities, return cash to shareholders, or even remain a going concern, it is important to pay attention to its balance sheet strength. Asset managers, in particular, have a high degree of revenue cyclical and operating leverage (with results tending to be impacted by the vagaries of the equity and credit markets) and are generally asset light. As such, they should not maintain more than low to moderate levels of financial leverage. T. Rowe Price, in our view, has maintained a very sound balance sheet, exemplified by \$3.5 billion in cash and equivalents, \$3.5 billion in investments, and no debt on its books at the end of the second quarter of 2021. The firm has historically maintained extremely low debt to total capital and debt to EBITDA levels (due primarily to the fact that it has had no debt on its books since 2002). Going forward, we expect net debt to adjusted EBITDA (as well as to enterprise value) to remain extremely low.

We feel that the company's management committee, which is responsible for guiding, implementing, and reviewing major policy and operating initiatives, has done an exemplary job over the years. Capital allocation has been prudent, with the company carrying little to no debt on its books, engaging in very little acquisition activity, and tending to return cash to shareholders as share repurchases and dividends. Compensation, which tends to be the biggest cost center for asset managers, has tended to be reasonable at T. Rowe Price, with executive pay being in line with most of the larger asset managers we cover. The only issue we have with the firm is that it has been a heavy user of stock options over the years, which dilutes existing shareholders and blunts the impact of share repurchases.

As part of ongoing efforts to enhance the company's competitive positioning, management has been focused on building additional scale through new investment products, expanding the reach of its investment advisory business by further penetrating domestic distribution channels and moving into non-U.S. markets (especially in emerging and developing economies), and investing in technology and business transformation aimed at improving client experiences and delivering operating efficiencies across the enterprise.

On the distribution front, T. Rowe Price has generally returned excess capital to shareholders as share repurchases and dividends. During the past 10 years, the firm repurchased (net of share issuances) \$5.3 billion of common stock and paid out \$6.2 billion as dividends. Management remains committed to repurchasing shares opportunistically when they are trading at a significant discount to intrinsic value (as well as on a more regular basis to offset dilution from stock-based compensation). The company remains comfortable with the 35%-40% payout ratio we've seen for the dividend over the past five years.



# T. Rowe Price Group Inc TROW ★★★

30 Jul 2021 20:27, UTC

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## Analyst Notes Archive

### Market Gains Offset Outflows to Lift T. Rowe Price's AUM to Record \$1.623 Trillion in June Quarter

Greggory Warren, CFA, Sector Strategist, 29 Jul 2021

While there was little in wide-moat-rated T. Rowe Price's second-quarter results that would alter our long-term view of the firm, we expect to raise our fair value estimate to \$202 per share from \$193 to account for continued improvements in the company's assets under management, as well as adjustments to our own near- to medium-term forecasts since our last update.

T. Rowe Price closed the June quarter with a record \$1.623 trillion in managed assets, up 6.9% sequentially and 33.0% year over year. Net outflows of \$600 million during the quarter were slightly worse than our expectations of being more on par with the \$1.9 billion quarterly run rate for inflows we've seen from the firm the past five years. It also marks only the 16th time that T. Rowe Price has reported quarterly outflows in the past two decades. Even so, we still see the firm generating flattish organic AUM growth this year as it moves closer to the period when retiring baby boomers are less of a drag on flows.

With average AUM up 39.0% year over year during the June quarter, T. Rowe Price reported a 36.3% increase in net revenue when compared with the prior-year period (owing to product mix shift and a slight decline in the firm's effective fee rate). First-half top-line growth of 30.5% was stronger than our full-year forecast, and while we do expect revenue growth to come down to more normal levels in the back half of the year, we have revised our full-year forecast to around 25% (from 22.5%).

Adjusted operating margins of 49.3% during the first half of 2021 were 560 basis points higher than the year-ago period. Much as with revenue, we see operating profits normalizing more in the back half of the year, with full-year profitability looking to be 47%-48% (compared with the 44.2% that the firm put up in 2020), which represents a slight increase in our operating margin projection for 2021.

### Solid Flows and Market Gains Continue to Lift T. Rowe Price's AUM; Raising FVE to \$193 Per Share

Greggory Warren, CFA, Sector Strategist, 28 Jun 2021

We've increased our fair value estimate for wide-moat rated T. Rowe Price to \$193 per share from \$170 to account for ongoing improvements in the company's AUM, as well as our own near-to-medium term forecasts for the firm, since our last update. T. Rowe Price closed out May 2021 with a record \$1.593 trillion in managed assets and will likely close out the June quarter with an equivalent amount of AUM, which would be reflective of a 6% sequential (and 31% year over year) increase in the company's total AUM.

Estimated net inflows of more than \$10 billion during the June quarter were driven primarily by the firm's multi-asset and fixed-income offerings, with equities seeing modest flows during the period. We

# T. Rowe Price Group Inc TROW ★★★

30 Jul 2021 20:27, UTC

| Last Price                | Fair Value Estimate                  | Price/FVE | Market Cap                   | Economic Moat™ | Moat Trend™ | Uncertainty | Capital Allocation | ESG Risk Rating Assessment <sup>1</sup>  |
|---------------------------|--------------------------------------|-----------|------------------------------|----------------|-------------|-------------|--------------------|--|
| 204.16 USD<br>30 Jul 2021 | 202.00 USD<br>30 Jul 2021 20:16, UTC | 1.01      | 46.28 USD Bil<br>29 Jul 2021 | Wide           | Stable      | Medium      | Exemplary          | <br>7 Jul 2021 05:00, UTC |

expect to see continued stability in T. Rowe Price's annual organic growth profile, which we envision in a 0% to positive 3% range over the next five years (compared with 0% to positive 2% during fiscal 2016-20), with flows likely picking up after 2025, when millennials start to hit their peak earnings years.

Our five-year CAGR for overall AUM growth is 5%-7% annually during 2021-25 (compared with 4%-6% previously). Despite management fees being pressured by industry dynamics, we expect T. Rowe Price, which is somewhat insulated due to its channel mix and already low-cost offerings, to generate a 7.3% CAGR for revenue over our five-year forecast period (up from 5.1% previously). As for profitability, we expect adjusted operating margins of 46%-48% (up from 44%-46% previously), even as the firm invests in key regions and channels to help drive growth. As such, T. Rowe Price should be able to generate around \$3.2 billion in free cash flow annually on average, with about one third of that amount returned to shareholders as dividends and 25%-30% devoted to share repurchases.

## Positive Flows and Market Gains Lift T. Rowe Price's AUM to Record \$1.518 Trillion in First Quarter

Greggory Warren, CFA, Sector Strategist, 29 Apr 2021

There was little in wide-moat rated T. Rowe Price's first-quarter results that would alter our long-term view of the firm. We are leaving our \$170 per share fair value estimate in place. T. Rowe Price closed out the March quarter with a record \$1.518 trillion in managed assets, up 3.2% sequentially and 52.6% on a year-over-year basis. Net inflows of \$1.2 billion during the first quarter were slightly worse than our expectations, which we had expected to be more on par with the \$2.1 billion quarterly run rate we've seen from the firm the past five years. Even so, we still see the firm generating low-single-digit organic AUM growth this year as the company moves closer to the time when retiring baby boomers are less of a drag on its flows.

While average AUM was up 29.8% year over year during the March quarter, T. Rowe Price reported a 24.9% increase in revenue when compared with the prior-year's period, due to product mix shift and a slight decline in the firm's effective fee rate. We still envision full-year top-line growth coming in at a low-double-digit rate this year, with revenue expanding at a mid-single-digit rate during 2021-25. As for profitability, adjusted GAAP operating margins of 48.9% during 2021 were 50 basis points higher than the year-ago period, as expenses rose at a slightly slower rate than revenue. Full-year profitability still looks on course to end up the year at around 45% (compared with the adjusted GAAP operating margin of 44.2% that T. Rowe Price put up in 2020). Our five-year forecast calls for operating margins in a 44% to 46% range, as the firm continues to invest in key regions and channels to help drive growth.

T. Rowe price increased its quarterly dividend 20% to \$1.08 during the first quarter, which implies a yield of 2.4% based on today's trading price on the shares. The company also repurchased 1.6 million shares for \$268 million during the March quarter.

# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

| Last Price                | Fair Value Estimate                  | Price/FVE | Market Cap                   | Economic Moat™ | Moat Trend™ | Uncertainty | Capital Allocation | ESG Risk Rating Assessment <sup>1</sup>  |
|---------------------------|--------------------------------------|-----------|------------------------------|----------------|-------------|-------------|--------------------|--|
| 204.16 USD<br>30 Jul 2021 | 202.00 USD<br>30 Jul 2021 20:16, UTC | 1.01      | 46.28 USD Bil<br>29 Jul 2021 | Wide           | Stable      | Medium      | Exemplary          | <br>7 Jul 2021 05:00, UTC |

## T. Rowe Price Enters 2021 With Record \$1.470 Trillion in AUM; Increased FVE to \$170

Greggory Warren, CFA, Sector Strategist, 28 Jan 2021

We've increased our fair value estimate for T. Rowe Price to \$170 per share from \$125 to account for the continued recovery in the equity, credit, and currency markets following the steep COVID-19-induced sell-off in the March quarter of 2020. Roughly half the change comes from our belief that T. Rowe Price will have more in assets under management during 2021-25 than we previously forecast (especially after adjusting for the timing and severity of near-term market corrections), with the remainder coming from a slightly better fee and margin outlook as well as a slightly lower statutory tax rate (we had expected to see a greater push to increase the U.S. corporate tax rate in the near term). Our fair value estimate implies a P/E multiple of 15.0 times our 2021 earnings estimate and 14.8 times our 2022 earnings estimate, which on a multiple basis is in line with our previous fair value estimate.

T. Rowe Price closed out 2020 with a record \$1.470 trillion in managed assets, up 12.2% sequentially and 21.9% year over year. Net inflows of \$2.2 billion during the fourth quarter were better than our expectations and on par with the \$2.3 billion quarterly run rate we've seen from the firm since the end of the 2008-09 financial crisis. While average AUM was up 20.0% year over year during the December quarter, T. Rowe Price reported an 18.0% increase in fourth-quarter revenue compared with the prior-year period due to product mix shift and a slight decline in the firm's effective fee rate. Full-year top-line growth of 10.5% was better than our forecast of mid- to high-single-digit growth. Adjusted GAAP operating margins of 44.2% during 2020 were 170 basis points higher than the year-ago period, as expenses rose at a slower rate than revenue. Our new five-year forecast calls for margins of 44%-46% even as the firm invests in key regions and channels to help drive growth.

## T. Rowe Price's New Entity Brings Opportunities and Trade-Offs; No Change to Moat or FVE


Greggory Warren, CFA, Sector Strategist, 19 Nov 2020

We do not anticipate making any meaningful changes to our moat rating or fair value estimate for wide-moat-rated T. Rowe Price following the company's announcement that it will be splitting its investment-research organization in two--leading to the launch of T. Rowe Price Investment Management in the second quarter of 2022. Six constrained or closed investment strategies and their supporting analytical resources will be moving over to the new entity. T. Rowe Price Investment Management is expected to be completely separate from legacy T. Rowe Price Associates, with the two teams expected to no longer share research and investment resources and corporate not providing much in the way of assets under management, flow, or fee data for the new entity.

Our initial thoughts here are that the move adheres to our longstanding argument about increased size/scale not necessarily being a benefit for active managers (exemplified by T. Rowe Price's long-running

# T. Rowe Price Group Inc TROW ★★★

30 Jul 2021 20:27, UTC

| Last Price                | Fair Value Estimate                  | Price/FVE | Market Cap                   | Economic Moat™ | Moat Trend™ | Uncertainty | Capital Allocation | ESG Risk Rating Assessment <sup>1</sup>  |
|---------------------------|--------------------------------------|-----------|------------------------------|----------------|-------------|-------------|--------------------|--|
| 204.16 USD<br>30 Jul 2021 | 202.00 USD<br>30 Jul 2021 20:16, UTC | 1.01      | 46.28 USD Bil<br>29 Jul 2021 | Wide           | Stable      | Medium      | Exemplary          | <br>7 Jul 2021 05:00, UTC |

practice of closing funds once they get too large). Those attributes are great for index fund or exchange-traded fund shops where increased size/scale doesn't affect performance and allows those firms to drive down costs/fees but can be detrimental for active performance. Where increased size/scale works for active managers is where they've decided to run certain funds for cash, expecting to continue to lose AUM at a low- to mid-single-digit range annually to outflows and need the added AUM from consolidation to offset fee/margin pressure.

This move will create additional costs for T. Rowe Price, primarily over the next couple of years as things get set up. However, the firm has enough leeway with its operating margins (which we had expected to be 40%-44% during 2020-24 before this announcement) relative to peers (expected to post margins below 30% longer term) to sacrifice some in the pursuit of organic growth, especially in strategies where it may have been capacity-constrained in the past.

## Outflows Mar T. Rowe Price's 3Q Results; No Change to FVE at \$125 per Share

Greggory Warren, CFA, Sector Strategist, 29 Oct 2020

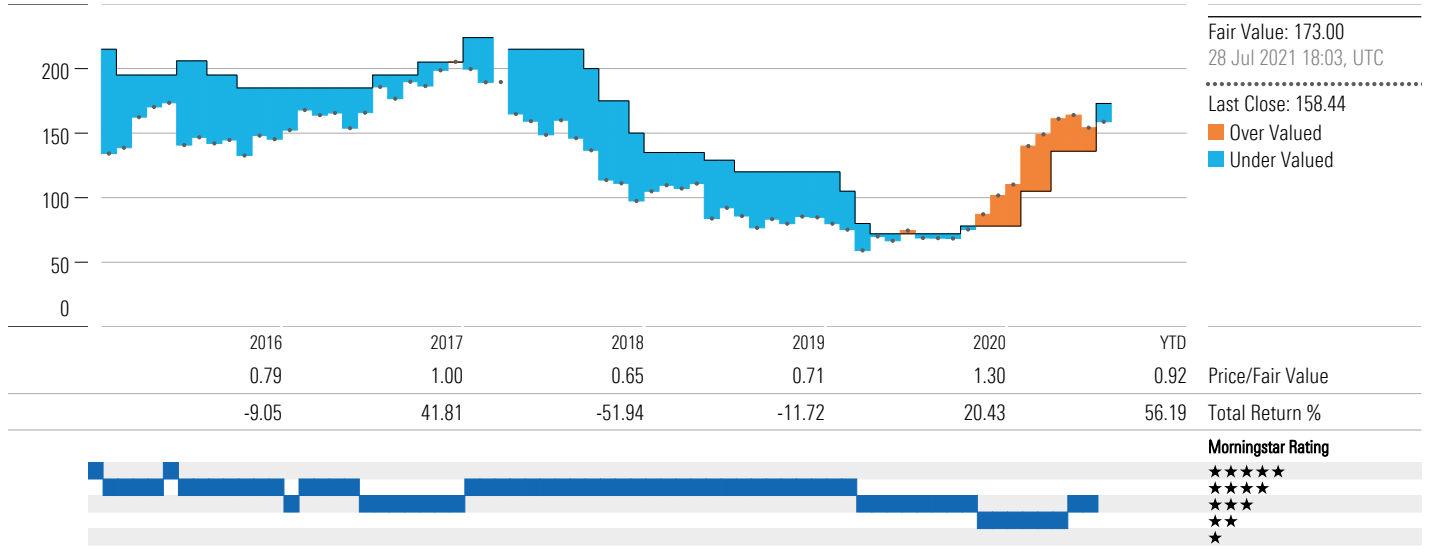
There was little in wide-moat T. Rowe Price's third-quarter results that would alter our long-term view of the firm. We are leaving our \$125 per share fair value estimate in place. The company closed out the September quarter with a near-record \$1.310 trillion in managed assets, up 7.4% sequentially and 16.3% on a year-over-year basis. Net outflows of \$5.3 billion during the quarter were worse than our expectations, as well as the positive \$2.4 billion quarterly run rate we've seen for net flows from the firm since the end of the 2008-09 financial crisis. Target-date funds saw an uncharacteristic \$5.5 billion in outflows during the third quarter (which is likely why the stock is trading down hard today), marking the second straight quarter of outflows from what has been a reliable growth vehicle for the firm over the past decade. This could be a sign, in our view, that the firm is losing share to lower-cost passively managed target date offerings in the retirement market.

While average AUM was up 14.4% year over year during the September quarter, T. Rowe Price reported an 11.9% increase in third-quarter revenue when compared with the prior year's period, due to product mix shift and a slight decline in the firm's effective fee rate to 0.455% (from 0.461% during the year-ago period). Year-to-date top-line growth of 7.8% was in line with our full-year forecast calling for a mid- to high-single-digit revenue increase. As for profitability, adjusted GAAP operating margins of 44.5% during the first three quarter of 2020 were about 90 basis points higher than the year-ago period, as expenses rose at a slower rate than revenues. Our current five-year forecast calls for operating margins in a 40% to 44% range, as the firm continues to make upfront investments in key regions and channels to help drive growth (and is likely to continue to take advantage of its better margin profile relative to peers to make additional investments that will help spur organic growth). ■■

# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

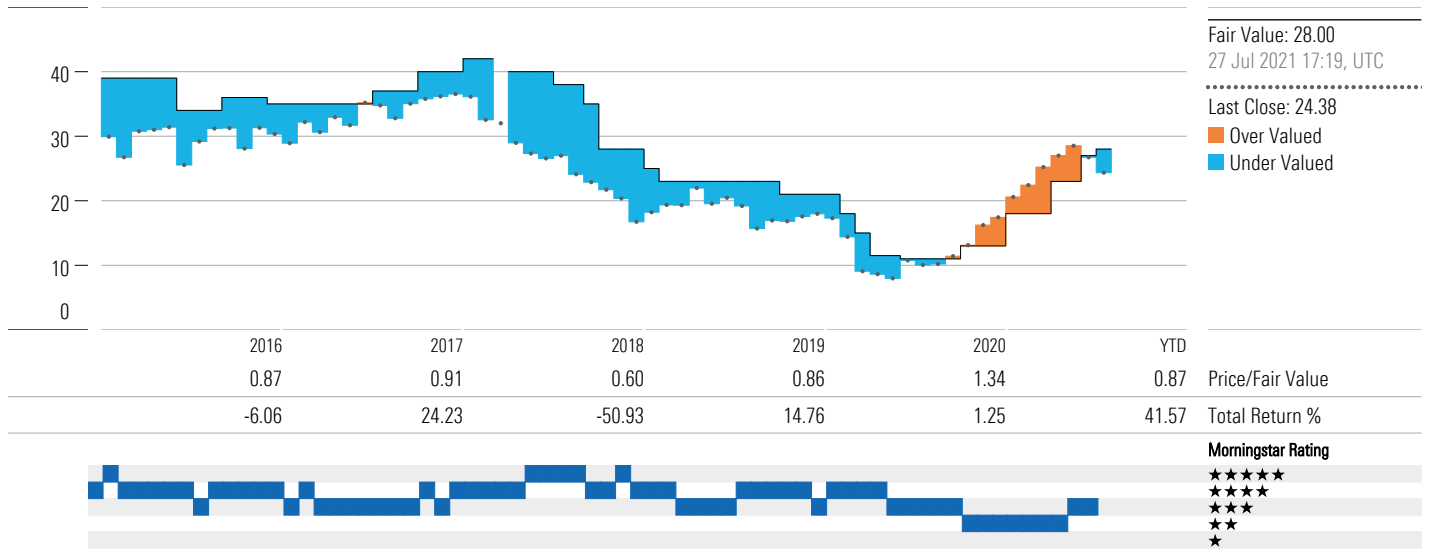
## Competitors Price vs. Fair Value

### Affiliated Managers Group Inc AMG



Total Return % as of 29 Jul 2021. Last Close as of 30 Jul 2021. Fair Value as of 28 Jul 2021 18:03, UTC.

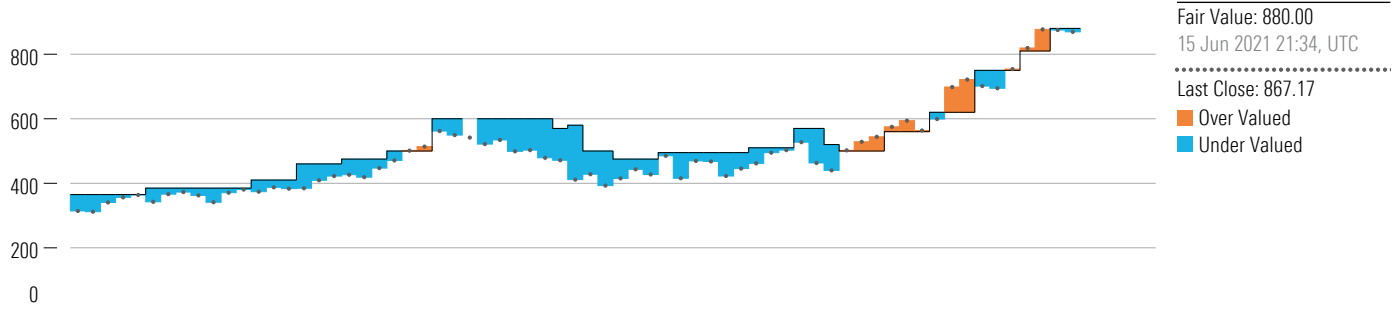
### Invesco Ltd IVZ



Total Return % as of 29 Jul 2021. Last Close as of 30 Jul 2021. Fair Value as of 27 Jul 2021 17:19, UTC.

# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

## BlackRock Inc BLK



Fair Value: 880.00  
 15 Jun 2021 21:34, UTC  
 Last Close: 867.17  
 Over Valued  
 Under Valued

|  | 2016  | 2017  | 2018   | 2019  | 2020  | YTD   |                  |
|--|-------|-------|--------|-------|-------|-------|------------------|
|  | 0.99  | 1.03  | 0.79   | 0.99  | 1.16  | 0.99  | Price/Fair Value |
|  | 14.44 | 37.62 | -21.19 | 31.33 | 46.42 | 21.64 | Total Return %   |

**Morningstar Rating**  
 ★★★★★  
 ★★★★  
 ★★★  
 ★★  
 ★

Total Return % as of 29 Jul 2021. Last Close as of 30 Jul 2021. Fair Value as of 15 Jun 2021 21:34, UTC.

# T. Rowe Price Group Inc TROW ★★★ 30 Jul 2021 20:27, UTC

| Last Price  | Fair Value Estimate    | Price/FVE | Market Cap    | Economic Moat™ | Moat Trend™ | Uncertainty | Capital Allocation | ESG Risk Rating Assessment <sup>1</sup>   |
|-------------|------------------------|-----------|---------------|----------------|-------------|-------------|--------------------|---|
| 204.16 USD  | 202.00 USD             | 1.01      | 46.28 USD Bil | Wide           | Stable      | Medium      | Exemplary          |  7 Jul 2021 05:00, UTC |
| 30 Jul 2021 | 30 Jul 2021 20:16, UTC |           | 29 Jul 2021   |                |             |             |                    |   |

## Morningstar Historical Summary

### Financials as of 30 Jun 2021

| Fiscal Year, ends 31 Dec         | 2011  | 2012  | 2013  | 2014  | 2015  | 2016  | 2017  | 2018  | 2019  | 2020  | YTD   | TTM   |
|----------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Revenue (USD Mil)                | 2,747 | 3,023 | 3,484 | 3,982 | 4,201 | 4,285 | 4,855 | 5,373 | 5,618 | 6,207 | 3,756 | 7,085 |
| Revenue Growth %                 | 16.1  | 10.0  | 15.3  | 14.3  | 5.5   | 2.0   | 13.3  | 10.7  | 4.6   | 10.5  | 30.5  | 22.7  |
| EBITDA (USD Mil)                 | 1,299 | 1,445 | 1,728 | 2,003 | 2,025 | 1,933 | 2,202 | 2,506 | 2,578 | 2,935 | 1,951 | 3,531 |
| EBITDA Margin %                  | 47.3  | 47.8  | 49.6  | 50.3  | 48.2  | 45.1  | 45.4  | 46.6  | 45.9  | 47.3  | 51.9  | 49.8  |
| Operating Income (USD Mil)       | 1,227 | 1,364 | 1,637 | 1,891 | 1,899 | 1,800 | 2,059 | 2,346 | 2,387 | 2,746 | 1,851 | 3,336 |
| Operating Margin %               | 44.7  | 45.1  | 47.0  | 47.5  | 45.2  | 42.0  | 42.4  | 43.7  | 42.5  | 44.2  | 49.3  | 47.1  |
| Net Income (USD Mil)             | 773   | 884   | 1,048 | 1,230 | 1,223 | 1,215 | 1,498 | 1,838 | 2,131 | 2,373 | 1,565 | 2,992 |
| Net Margin %                     | 28.2  | 29.2  | 30.1  | 30.9  | 29.1  | 28.4  | 30.2  | 33.4  | 37.0  | 37.2  | 40.6  | 41.1  |
| Diluted Shares Outstanding (Mil) | 263   | 261   | 266   | 267   | 261   | 250   | 245   | 247   | 239   | 231   | 230   | 229   |
| Diluted Earnings Per Share (USD) | 2.92  | 3.36  | 3.90  | 4.55  | 4.63  | 4.75  | 5.97  | 7.27  | 8.70  | 9.98  | 6.63  | 12.66 |
| Dividends Per Share (USD)        | 1.24  | 1.36  | 1.52  | 1.76  | 2.08  | 2.16  | 2.28  | 2.80  | 3.04  | 3.60  | 2.16  | 3.96  |

### Valuation as of 30 Jun 2021

|                  | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017  | 2018 | 2019 | 2020 | Recent Qtr | TTM  |
|------------------|------|------|------|------|------|------|-------|------|------|------|------------|------|
| Price/Sales      | 5.5  | 5.6  | 6.6  | 5.9  | 4.5  | 4.5  | 5.6   | 4.3  | 5.4  | 5.9  | 6.9        | 6.9  |
| Price/Earnings   | 19.5 | 19.4 | 22.6 | 19.3 | 15.4 | 17.0 | 17.2  | 12.8 | 15.4 | 17.0 | 16.9       | 16.9 |
| Price/Cash Flow  | 15.7 | 18.8 | 18.5 | 17.8 | 13.0 | 49.8 | 101.0 | 16.8 | 17.9 | 18.2 | 21.4       | 21.4 |
| Dividend Yield % | 2.18 | 2.09 | 1.81 | 2.05 | 2.91 | 2.87 | 2.17  | 3.03 | 2.5  | 2.38 | 2.0        | 2.0  |
| Price/Book       | 4.4  | 4.4  | 4.8  | 4.3  | 3.8  | 3.8  | 4.7   | 3.4  | 4.2  | 4.8  | 5.6        | 5.6  |
| EV/EBITDA        | 10.3 | 11.0 | 11.7 | 10.4 | 8.3  | 8.8  | 10.7  | 7.9  | 10.3 | 11.1 | 0.0        | 0.0  |

### Operating Performance / Profitability as of 30 Jun 2021

| Fiscal Year, ends 31 Dec | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | YTD  | TTM  |
|--------------------------|------|------|------|------|------|------|------|------|------|------|------|------|
| ROA %                    | 20.9 | 22.2 | 22.7 | 23.0 | 22.8 | 21.4 | 21.3 | 23.6 | 24.4 | 23.1 | 13.9 | 28.0 |
| ROE %                    | 23.0 | 24.3 | 24.2 | 24.1 | 24.1 | 24.9 | 27.0 | 30.0 | 31.4 | 31.2 | 19.5 | 39.8 |
| ROIC %                   | 23.0 | 24.3 | 24.2 | 24.1 | 24.1 | 24.9 | 27.0 | 30.0 | 31.1 | 30.5 | 19.2 | 38.9 |
| Asset Turnover           | 0.7  | 0.8  | 0.8  | 0.7  | 0.8  | 0.8  | 0.7  | 0.7  | 0.7  | 0.6  | 0.3  | 0.7  |

### Financial Leverage

| Fiscal Year, ends 31 Dec | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Recent Qtr | TTM |
|--------------------------|------|------|------|------|------|------|------|------|------|------|------------|-----|
| Debt/Capital %           | —    | —    | —    | —    | —    | —    | —    | —    | 2.0  | 2.0  | 1.7        | —   |
| Equity/Assets %          | 90.7 | 91.5 | 95.7 | 95.6 | 93.2 | 80.5 | 77.3 | 79.6 | 76.1 | 72.3 | 70.0       | —   |
| Total Debt/EBITDA        | —    | —    | —    | —    | —    | —    | —    | 0.0  | 0.1  | 0.1  | 0.1        | —   |
| EBITDA/Interest Expense  | —    | —    | —    | —    | —    | —    | —    | —    | —    | —    | —          | —   |

## Morningstar Analyst Historical/Forecast Summary as of 30 Jul 2021

| Financials                       | Estimates |       |       |       |       | Forward Valuation | Estimates |      |      |      |      |  |
|----------------------------------|-----------|-------|-------|-------|-------|-------------------|-----------|------|------|------|------|--|
|                                  | 2019      | 2020  | 2021  | 2022  | 2023  |                   | 2019      | 2020 | 2021 | 2022 | 2023 |  |
| Fiscal Year, ends 31 Dec         |           |       |       |       |       |                   |           |      |      |      |      |  |
| Revenue (USD Mil)                | 5,618     | 6,207 | 7,726 | 8,231 | 8,132 | Price/Sales       | 5.1       | 5.6  | 6.0  | 5.6  | 5.7  |  |
| Revenue Growth %                 | 4.6       | 10.5  | 24.5  | 6.5   | -1.2  | Price/Earnings    | 15.1      | 15.8 | 15.7 | 15.3 | 15.6 |  |
| EBITDA (USD Mil)                 | 2,578     | 2,935 | 3,917 | 4,220 | 4,138 | Price/Cash Flow   | 12.7      | 13.8 | 10.6 | 14.2 | 14.6 |  |
| EBITDA Margin %                  | 45.9      | 47.3  | 50.7  | 51.3  | 50.9  | Dividend Yield %  | 2.50      | 2.38 | 3.59 | 2.28 | 2.45 |  |
| Operating Income (USD Mil)       | 2,387     | 2,746 | 3,671 | 3,973 | 3,873 | Price/Book        | —         | —    | —    | —    | —    |  |
| Operating Margin %               | 42.5      | 44.2  | 47.5  | 48.3  | 47.6  | EV/EBITDA         | 10.3      | 11.1 | 11.0 | 10.2 | 10.4 |  |
| Net Income (USD Mil)             | 1,927     | 2,216 | 2,953 | 3,013 | 2,910 |                   |           |      |      |      |      |  |
| Net Margin %                     | 34.3      | 35.7  | 38.2  | 36.6  | 35.8  |                   |           |      |      |      |      |  |
| Diluted Shares Outstanding (Mil) | 239       | 231   | 228   | 225   | 223   |                   |           |      |      |      |      |  |
| Diluted Earnings Per Share(USD)  | 8.07      | 9.58  | 12.97 | 13.37 | 13.05 |                   |           |      |      |      |      |  |
| Dividends Per Share(USD)         | 3.04      | 3.60  | 7.32  | 4.64  | 4.99  |                   |           |      |      |      |      |  |



# Research Methodology for Valuing Companies

## 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 es-

timate 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.

When considering a company's moat, we also assess whether there is a substantial threat of value destruction, stemming from risks related to ESG, industry disruption, financial health, or other idiosyncratic issues. In this context, a risk is considered potentially value destructive if its occurrence would eliminate a firm's economic profit on a cumulative or mid-cycle basis. If we deem the probability of occurrence sufficiently high, we would not characterize the company as possessing an economic moat.

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

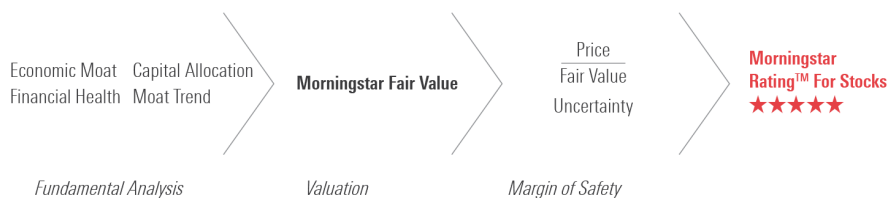
Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with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

## Morningstar Equity Research Star Rating Methodology



# Research Methodology for Valuing Companies

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, exposure to material ESG risks, 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. In cases where there is less than a 25% probability of an event, but where the event could result in a material decline in value, analysts may adjust the uncertainty rating to reflect the increased risk. Analysts may also make a fair value adjustment to reflect the impact of this event.

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.

|                      | Margin of Safety |              |
|----------------------|------------------|--------------|
| Qualitative Analysis | ★★★★★ Rating     | ★ Rating     |
| Uncertainty Ratings  | ★★★★★ Rating     | ★ Rating     |
| Low                  | 20% Discount     | 25% Premium  |
| Medium               | 30% Discount     | 35% Premium  |
| High                 | 40% Discount     | 55% Premium  |
| Very High            | 50% Discount     | 75% Premium  |
| Extreme              | 75% Discount     | 300% Premium |

## 4. Market Price

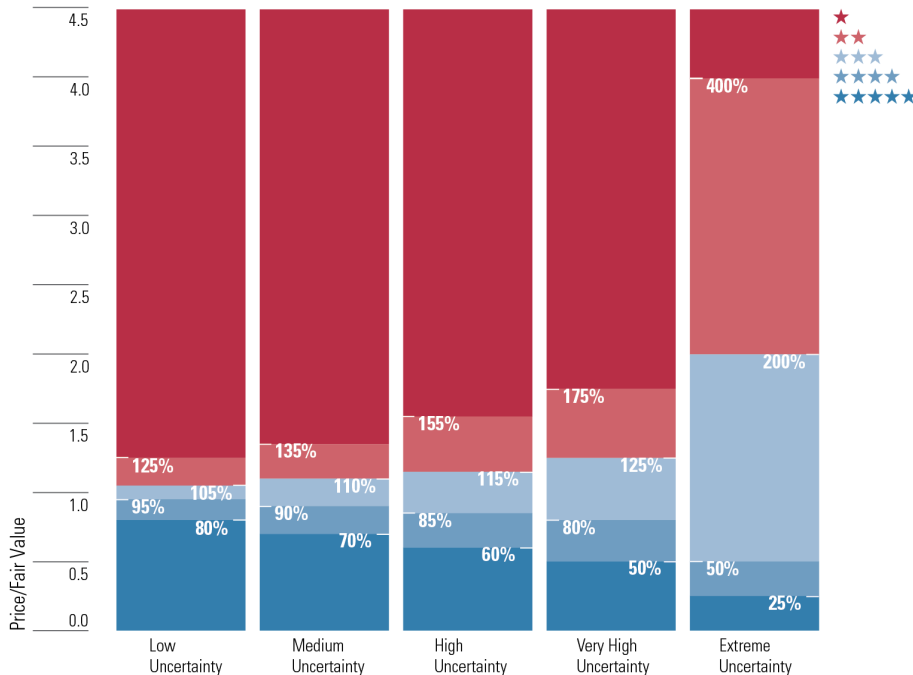
The market prices used in this analysis and noted in the report come from exchange on which the stock is listed which we believe is a reliable source.

For more details about our methodology, please go to <https://shareholders.morningstar.com>.

### 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

**Morningstar Equity Research Star Rating Methodology**



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:

★★★★★ 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.

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

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

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

★ 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.

**Capital Allocation Rating:** Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider companies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exem-

# Research Methodology for Valuing Companies

plary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

Capital Allocation (or Stewardship) analysis published prior to Dec. 9, 2020, was determined using a different process. Beyond investment strategy, financial leverage, and dividend and share buyback policies, analysts also considered execution, compensation, related party transactions, and accounting practices in the rating.

**Capital Allocation Rating:** Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider companies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

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**Sustainalytics ESG Risk Rating Assessment:** The ESG Risk Rating Assessment is provided by Sustainalytics; a Morningstar company.

Sustainalytics' ESG Risk Ratings measure the degree to which company's economic value at risk is driven by environment, social and governance (ESG) factors.

Sustainalytics analyzes over 1,300 data points to assess a company's exposure to and management of ESG risks. In other words, ESG Risk Ratings measures a company's unmanaged ESG Risks represented as a quantitative score. Unmanaged Risk is measured on an open-ended scale starting at zero (no risk) with lower scores representing less unmanaged risk and, for 95% of cases, the unmanaged ESG Risk score is below 50.

Based on their quantitative scores, companies are grouped into one of five Risk Categories (negligible, low,

medium, high, severe). These risk categories are absolute, meaning that a 'high risk' assessment reflects a comparable degree of unmanaged ESG risk across all subindustries covered.

The ESG Risk Rating Assessment is a visual representation of Sustainalytics ESG Risk Categories on a 1 to 5 scale. Companies with Negligible Risk = 5 Globes, Low Risk = 4, Medium Risk = 3 Globes, High Risk = 2 Globes, Severe Risk = 1 Globe. For more information, please visit [sustainalytics.com/esg-ratings/](https://sustainalytics.com/esg-ratings/)

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