Abbott Laboratories ABT [XNYS] | ★★★

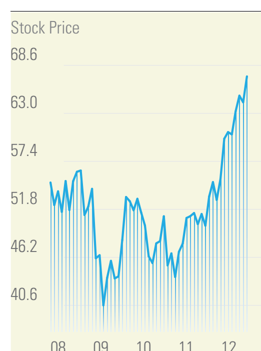
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
72.05 USD	70.00 USD	56.00 USD	87.50 USD	Low	Wide	Standard	UR-	Drug Manufacturers - Major

Abbott's breakup into two pieces should draw more attention to the company's undervalued assets.

by Damien Conover, CFA
Director
Analyst covering this company do not own its stock.

Pricing as of Oct 15, 2012.
Rating as of Oct 16, 2012.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.



Thesis Aug. 22, 2012

On the foundation of a wide lineup of patent-protected drugs, a leading diagnostics business, a strong nutritional division, and a top-tier vascular group, Abbott Laboratories has dug a wide economic moat. We expect these operating lines will continue to generate strong returns and drive growth. Further, the company's decision to split itself into two is likely to result in two well-positioned companies (a drug company and a diversified health-care company) with strong competitive advantages.

Existing drugs and new pipeline products should propel long-term growth. Abbott's pharmaceutical division contains a diverse set of growing blockbusters across many therapy groups. Autoimmune agent Humira, HIV/AIDS drug Kaletra, and cardiovascular treatments Tricor and Trilipix lead the group with more than $10 billion in annual sales (28% of total sales). Humira continues to be the workhorse of the group with 21% growth in 2011, as new indications help propel the drug. The company's active research and development efforts are creating the next potential blockbusters, with several hepatitis C drugs and kidney disease drug bardoxolone showing particularly strong clinical data.

Outside the pharmaceutical group, Abbott runs top-tier diagnostic and nutritional segments that generate more than 25% of total sales, helping to insulate the company from patent losses in the drug group. The diagnostic group is well positioned as disease therapy becomes more patient-specific.

Complementing the pharmaceutical, diagnostic, and nutritional segments, the firm's vascular line is poised for steady growth. Favorable clinical data on the company's drug-coated stent Xience versus entrenched Boston Scientific BSX stent Taxus have resulted in fast market uptake.

In addition to strong internal operating lines, Abbott has a successful record of acquisitions and partnerships. The favorable acquisitions of Knoll and Kos Pharmaceuticals brought in Humira and Niaspan along with pipeline products. The acquisition of Guidant's vascular business opened the door to a new operating segment and Xience, a drug-eluting stent superior to an in-house stent. Additionally, the acquisitions of Advanced Medical Optics and the drug units from Solvay and Piramal should add value over the long term. The strong record and ample cash flow raise our confidence that external growth opportunities will probably augment internal growth.

Valuation, Growth and Profitability

We are maintaining our fair value estimate of $70 per share based on our increased projections for the company's hepatitis C drugs. Our fair value estimate implies a 2012 price/earnings multiple of 14 times. The current forward-year industry price/earnings multiple is 12 times, and we believe Abbott's industry-leading growth continues to warrant a premium multiple valuation for the company. Humira represents the most important driver in Abbott's valuation--we project it contributes more than 20% to our estimate of the firm's total value. While competing drugs lurk in the near future, we expect Humira to post double-digit annual growth during the next several years. Overall, during the next five years, we project 5% average annual sales growth, led by Humira, Xience, and acquisitions. During the same period, we project slightly increasing operating margins, as cost-containment initiatives offset patent losses on high-margin drugs.

Risk

While Abbott maintains diverse operations, it depends heavily on Humira and Xience for future growth. Further, the company's pipeline isn't as large as those of rivals, making any failures with late-stage candidates very costly. Also, the company faces typical industry risks including drug delays or nonapprovals, as well as an increasingly aggressive generic and managed-care industry.

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Pfizer Inc	USD	192,713	64,858	16,618	10,224
Johnson & Johnson	USD	191,752	64,874	15,960	8,738
Baxter International Inc.	USD	33,671	14,033	2,840	2,288

Bulls Say

- Strong clinical data on safety and efficacy give Abbott's stent Xience a leg up in the drug-eluting stent market.
- Aggressive cost-cutting plans should propel Abbott's bottom-line growth much quicker than top-line growth.
- International markets and indications in Crohn's disease and psoriasis for Humira should further propel sales growth for the company's leading pharmaceutical product.
- The acquisition of Piramal's drug unit increases Abbott's exposure to the rapidly growing Indian market.
- The decision to split the company into two could increase the transparency of each unit, which could help investors see the value in the different operations.

Bears Say

- Splitting the company into two could create distractions for management as well as reverse cost synergies such as increasing duplicative areas of operations.
- Lack of robust internal development casts a shadow on the company's ability to create blockbusters in-house.
- Clinical data on drug-eluting stents have recently presented unclear benefits versus bare-metal stents and other treatments. Stent operations and use of drug-eluting stents could fall without supportive new data.
- To prepare for more tuck-in acquisitions, Abbott is probably going to add cash to its balance sheet rather than pursue aggressive share buybacks. The investment community could react negatively toward decisions in favor of acquisitions over returning cash to shareholders via share repurchases.
- Pfizer's JAK inhibitor for rheumatoid arthritis has shown strong efficacy in Phase III trials relative to Humira, which could enable the drug to take significant market share from Humira based on the drug's oral dosing. Also, Roche's RA drug Actemra reported positive head-to-head data versus Humira, which could translate into Humira market share losses.

Financial Overview

Financial Health:Thanks to its acquisitions, Abbott holds less cash than its peers. However, Abbott's robust and relatively stable cash flows should easily meet interest expenses with ample reserves left for share repurchases, increases to dividends, and small acquisitions.

Company Overview

Profile: Abbott manufactures and markets pharmaceuticals, medical devices, blood glucose monitoring kits, and nutritional health-care products. Products include prescription drugs, coronary and carotid stents, and nutritional liquids for infants and adults. Following the Advanced Medical Optics acquisition, Abbott also markets eye-care products. Abbott generates close to half of its revenue from pharmaceuticals.

Management: Overall, we rate Abbott's stewardship as standard. While the company has made some impressive acquisitions over the past decade including Knoll, which was purchased for $6.9 billion in 2001 and brought in Humira, several of the more recent acquisitions, such as Advanced Medical Optics and Piramal, remain promising but have yet to fully match up to the purchase prices. Despite the uncertainty surrounding these more recent acquisitions and whether the decision to break up into two pieces will bring more value to shareholders, the company has been a better steward of capital than many of its peers in the drug industry.

Miles White took the helm as CEO in 1998 and chairman of the board the following year. His tenure with Abbott dating back to 1984 provides the experience needed in handling the many operating lines of the company. After the split, White will continue as the CEO of the diversified company, and longtime Abbott executive Richard Gonzalez will take the CEO spot at the pharmaceutical-focused firm. Gonzalez brings many years of experience to the post, having joined

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Abbott in 1977 and serving in many manager roles across the company, including pharmaceuticals, medical products, and Abbott's medical technology investment arm, Abbott Ventures.

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Analyst Notes

Abbott Reports In Line 2Q Buoyed by Robust Humira Growth; Company Breakup Remains on Track Jul. 18, 2012

Abbott ABT reported second-quarter results that largely matched our expectations as well as consensus expectations and we don't expect any significant changes to our fair value estimate of $70 per share. On the top line, total sales increased 7% operationally versus the prior-year period as strong sales from nutritionals and immunology drug Humira posted solid gains. On the bottom line, earnings per share increased 10% year over year, outpacing sales growth as we believe cost-cutting drove higher gross margins. Also, Abbott reiterated its full-year 2012 earnings-per-share guidance range of $5.00-$5.10, which we expect the company to easily meet.

Sales growth in the quarter largely came in as expected with continued strong growth from nutritionals, Humira, and testosterone gel AndroGel. We continue to believe Humira will post double-digit growth over the next two years based on the drug's leading efficacy and safety profile, despite new competition likely from Pfizer's PFE tofacitinib in August. We expect Pfizer's competing drug will initially target patients who don't respond to Humira or another anti-TNF alpha therapy.

Turning to earnings, Abbott continues to make solid strides in increasing its efficiency. Gross margins increased more than 300 basis points year over year, largely driven by improvements in the nutritional, diagnostic, and vascular businesses as well as changes in currency. However, we don't expect this trend to continue through 2013 because the near-term patent losses on high-margin cardiovascular drugs Tricor and Niaspan will likely weigh on profitability for the company. Offsetting some of the expected gross margin impact from the loss of these drugs is the likely cuts in variable spending around supporting the marketing of the drugs.

Regarding the split of the company into two separate firms, everything looks on track for the completion of the split by the end of the year. We expect more details on the structure of the balance sheet and in particular debt holdings of each of the new companies in the third quarter. With these expected disclosures, a more complete valuation perspective of the two new companies should be possible.

The Supreme Court Upholds Health-Care Reform; Valuation Impact on the Sector's Stocks Is Minimal Jun. 28, 2012

The U.S. Supreme Court upheld the individual mandate in a narrow ruling Thursday, clearing the main hurdle for health-care reform known as the Patient Protection and Affordable Care Act (PPACA). While it is possible that the battle over the fate of the health-care law will now shift to the legislature, given the low probability of Republicans gaining a filibuster-proof majority in the Senate, we now believe the PPACA isn't likely to be repealed. We've incorporated the anticipated effects of the PPACA in all of our projections, and as a result, the effect of the ruling on our valuations and recommendations across the health-care sector is immaterial.

For the managed-care sector, the ruling is largely a positive, as alternatives were a lot more punitive, particularly for firms operating in the individual marketplace. We factor into our models the more than 30 million individuals that are expected to gain insurance coverage as a result of the law through a combination of expansions to the Medicaid program (although the Court's ruling on this issue may limit the magnitude of this expansion) as well as new subsidies that can be used to buy insurance in the state-based

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Analyst Notes (continued)

exchanges. Medicaid MCOs like Amerigroup AGP are best positioned to benefit from broader Medicaid eligibility, adding to the already robust growth story from increased outsourcing of Medicaid. We expect most commercial insurers to compete for new individual members in the exchanges, but those with a strong historical position in the individual market and well-known brands, such as WellPoint WLP, seem particularly well positioned. On the other hand, MCOs will continue to face margin pressure from regulatory scrutiny of premium increases, minimum medical cost ratios, and cuts to Medicare Advantage reimbursements. However, we expected most of these headwinds to remain in place even without the PPACA, and we have incorporated deteriorating margins in our valuations.

The other group most affected by Thursday's ruling is health-service providers, such as hospitals, but our valuations already properly account for the anticipated effects from the law's provisions, particularly the expanded insured population. We consider the law's reduction of uncompensated care combined with an influx of newly insured patients into the health-care system as a positive for the health-services industry, while other components of the law, including lower Medicare payments and greater oversight of insurance premium increases, mostly mitigate such benefits. Overall, hospitals may breathe a sigh of relief as without the mandate, the environment for providers would have been rather dire. Regardless of this ruling, we think reimbursement pressure is here to stay thanks to government incentives to curb health-care spending growth and an industry shift to quality-of-care-based payment methods, and health providers still will face an uphill battle to maintain profitability amid the ongoing uncertainty of reimbursements.

For the Big Pharma group, we expect the increased demand for drugs as a direct result of the mandate largely will offset the increased fees and rebates associated with health-care reform. Our valuations are unchanged. However, since the costs related to health-care reform are front-end loaded (which started in 2010) and the increased demand will not likely begin until 2014 (when the mandate goes into effect), we believe investors' sentiment toward the drug group should improve as the tailwind of increased demand for drugs begins to materialize in 2014.

The generic drug manufacturers are largely unaffected, in our view. Most of the generic manufacturers have broad geographic operations and generic drug pricing was relatively unaffected by the law. We think additional drug volumes from newly insured patients are relatively immaterial to our fair value estimates for the generic firms. The biosimilars approval pathway should remain intact.

The device side was viewed largely as a relative loser when the reform was passed, and the ruling doesn't change much in terms of our assessments of the industry's prospects going forward. We anticipate the additional insureds in 2014 will not significantly contribute to volume because many devices are concentrated among Medicare recipients. For example, an estimated 90%-95% of pacemakers in the U.S. are implanted in Medicare patients. However, there are some particular product lines that do skew somewhat younger, such as spine devices, which are split more evenly between Medicare and non-Medicare patients. Firms that are not highly tied to Medicare reimbursement should see the volume boost in some magnitude, but likely not to the extent of other health-care industries. With the law upheld, it also appears that the 2.3% medical device excise tax will stand. We already baked that tax into our valuations two years ago, and at the time we said it would cut into the long-term earnings power of medical device firms by 4%-10%, hardly a devastating impact. We believe the marketplace already

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Analyst Notes (continued)

baked this into assumptions as well and thus most device firms are currently trading in line with the market. The effect of the tax is being mitigated by several factors, particularly the sales mix by geography, which has generally been shifting away from the U.S. Medical device companies also have been preparing for this tax and additional pricing pressure (not necessarily only because of the ACA), which led to the restructuring of operations and investments in more manufacturing facilities in tax-advantaged locations outside of the U.S. Overall, we think a number of larger regulatory and customer issues--such as changes in the pathway to market and fiscal budget pressures in the developed world--are changing the competitive landscape for medical device firms, and these changing dynamics should have a more substantial effect on this industry than the ACA in the foreseeable future.

For other sectors, the impact is also fairly muted. With regards to biotech, we are maintaining our view that health reform has an overall net neutral impact on our valuations as expanded coverage offsets new fees and drug rebates. However, within the spectrum of our biotech coverage, some firms have fared better than others under reform. Companies like Gilead GILD, Amgen AMGN, and Roche RHHBY have seen the largest hits to their businesses due to larger rebates through Medicaid and industry fees from the higher share of drugs reimbursed by Medicare. Conversely, reform has had little impact on companies like Celgene CELG and BioMarin BMRN with heavy exposure to orphan drugs that are exempt from the industry fee.

We expect drug supply-chain companies, including retail pharmacies, pharmacy benefit managers, and distributors, to experience a modest revenue boost due to increased consumption of health care by the newly insured population. But any positive impact isn't likely to be material to our valuations.

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Abbott Laboratories ABT

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
39,458	113,071	Drug Manufacturers - Major	Healthcare

Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship
—	72.05	—	—	—	—

per share prices in USD

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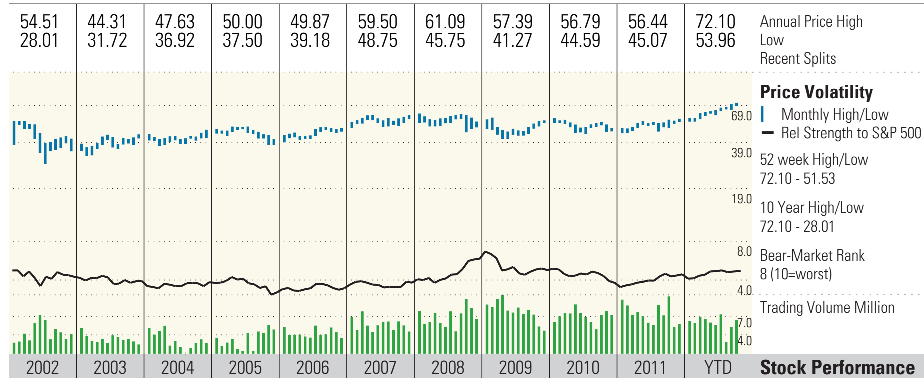
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD
Annual Price High	54.51	44.31	47.63	50.00	49.87	59.50	61.09	57.39	56.79	56.44	72.10
Low	28.01	31.72	36.92	37.50	39.18	48.75	45.75	41.27	44.59	45.07	53.96
Recent Splits											



Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	10.5	9.6	11.6	9.1
Operating Income %	-5.5	0.3	23.0	11.8
Earnings/Share %	1.7	-0.2	21.9	11.8
Dividends %	9.3	10.2	10.1	8.7
Book Value/Share %	7.5	11.4	11.2	10.3
Stock Total Return %	40.5	14.4	9.2	8.0
+/- Industry	15.6	0.9	3.5	1.8
+/- Market	22.2	4.5	11.0	3.8

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	19.2	23.9	17.6	22.8
Return on Assets %	7.9	9.9	8.1	9.3
Fixed Asset Turns	4.9	4.2	3.8	7.7
Inventory Turns	4.3	4.4	2.6	17.0
Revenue/Employee USD K	433.6	413.0*	—	1055.7
Gross Margin %	61.5	57.7	71.3	39.7
Operating Margin %	16.1	17.9	22.6	16.6
Net Margin %	12.4	14.9	16.0	11.1
Free Cash Flow/Rev %	18.1	19.1	20.8	0.1
R&D/Rev %	10.6	0.1	—	9.5

Financial Position

Grade: A	12-11 USD Mil	06-12 USD Mil
Cash	6813	7053
Inventories	3284	3518
Receivables	7684	6768
Current Assets	23769	26257
Fixed Assets	7874	7831
Intangibles	25695	24340
Total Assets	60277	61860
Payables	2990	2797
Short-Term Debt	3375	6083
Current Liabilities	15480	17120
Long-Term Debt	12040	12004
Total Liabilities	35837	37373
Total Equity	24440	24487

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	23.3	18.3	17.2	—
Forward P/E	13.1	—	—	13.2
Price/Cash Flow	13.0	11.6	11.2	—
Price/Free Cash Flow	15.9	14.7	13.2	—
Dividend Yield %	2.8	—	3.8	2.0
Price/Book	4.6	4.0	2.9	—
Price/Sales	2.9	2.7	2.8	—
PEG Ratio	1.7	—	—	0.3

*3Yr Avg data is displayed in place of 5Yr Avg

Stock Performance

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
-26.6	18.9	8.8	-13.2	26.5	17.9	-2.5	4.1	-8.1	21.3	31.7	Total Return %
-3.2	-7.5	-0.2	-16.2	12.9	14.4	36.0	-19.3	-20.9	21.3	18.1	+/- Market
-8.0	3.2	13.0	-15.5	12.3	14.5	14.9	-11.2	-11.4	5.8	14.5	+/- Industry
2.3	2.1	2.2	2.8	2.4	2.3	2.6	2.9	3.6	3.3	2.8	Dividend Yield %
58736	68459	72652	61165	74763	86767	82808	83748	74116	87595	113071	Market Cap USD Mil

Financials

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Financials
17685	19681	19680	22338	22476	25914	29528	30765	35167	38851	39458	Revenue USD Mil
51.9	51.9	54.9	52.4	56.3	55.9	57.3	57.1	58.3	60.0	61.5	Gross Margin %
3530	3323	3898	4362	2042	4579	5694	6236	6088	5752	6357	Oper Income USD Mil
20.0	16.9	19.8	19.5	9.1	17.7	19.3	20.3	17.3	14.8	16.1	Operating Margin %
2794	2753	3236	3372	1717	3606	4881	5746	4626	4728	4889	Net Income USD Mil
1.78	1.75	2.06	2.16	1.12	2.31	3.12	3.69	2.96	3.01	3.09	Earnings Per Share USD
0.92	0.97	1.03	1.09	1.16	1.27	1.41	1.56	1.72	1.88	1.95	Dividends USD
1573	1572	1571	1564	1537	1560	1561	1547	1556	1567	1581	Shares Mil
6.83	8.36	9.20	9.29	9.16	11.51	11.27	14.73	14.66	15.69	15.60	Book Value Per Share USD
4183	3746	4408	5174	5329	5184	7344	7275	8736	8970	8748	Oper Cash Flow USD Mil
-1296	-1247	-1292	-1207	-1338	-1656	-1288	-1089	-1015	-1492	-1605	Cap Spending USD Mil
2887	2500	3116	3967	3991	3528	6056	6186	7721	7479	7142	Free Cash Flow USD Mil

Profitability

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Profitability
11.8	10.8	11.7	11.7	5.3	9.5	11.9	12.1	8.3	7.9	7.9	Return on Assets %
28.3	23.2	23.6	23.5	12.1	22.7	27.7	28.5	20.4	20.2	19.2	Return on Equity %
15.8	14.0	16.4	15.1	7.6	13.9	16.5	18.7	13.2	12.2	12.4	Net Margin %
0.74	0.77	0.71	0.77	0.69	0.68	0.72	0.65	0.63	0.65	0.64	Asset Turnover
2.3	2.0	2.0	2.0	2.6	2.2	2.4	2.3	2.7	2.5	2.5	Financial Leverage

Financial Health

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	06-12	Financial Health
2120	2651	3909	3971	-669	4939	5451	10264	5055	8289	9137	Working Capital USD Mil
4274	3452	4788	4572	7010	9488	8713	11266	12524	12040	12004	Long-Term Debt USD Mil
10665	13072	14326	14415	14054	17779	17480	22856	22388	24440	24487	Total Equity USD Mil
0.40	0.26	0.33	0.32	0.50	0.53	0.50	0.49	0.56	0.49	0.49	Debt/Equity

Valuation

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
22.6	26.7	23.1	18.3	43.5	24.3	17.6	14.6	16.2	18.7	23.3	Price/Earnings
—	—	—	—	—	—	—	—	—	1.1	—	P/E vs. Market
3.6	3.7	3.7	2.8	3.3	3.4	2.8	2.7	2.1	2.3	2.9	Price/Sales
5.9	5.6	5.1	4.2	5.3	4.9	4.7	3.7	3.3	3.6	4.6	Price/Book
15.1	19.6	16.6	11.9	14.1	16.9	11.3	11.5	8.5	9.8	13.0	Price/Cash Flow

Quarterly Results

Revenue USD Mil	Sep 11	Dec 11	Mar 12	Jun 12
Most Recent Period	9816.7	10377.5	9456.6	9807.1
Prior Year Period	8674.5	9967.9	9040.9	9616.3

Rev Growth %	Sep 11	Dec 11	Mar 12	Jun 12
Most Recent Period	13.2	4.1	4.6	2.0
Prior Year Period	11.8	13.4	17.4	8.9

Earnings Per Share USD	Sep 11	Dec 11	Mar 12	Jun 12
Most Recent Period	0.19	1.03	0.78	1.08
Prior Year Period	0.57	0.93	0.55	1.23

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Abbott Laboratories	113071	39458	23.3	19.2
Pfizer Inc	190995	64858	21.9	12.2
Johnson & Johnson	189133	64874	21.8	14.3

Major Fund Holders

	% of shares
	—
	—
	—

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

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- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

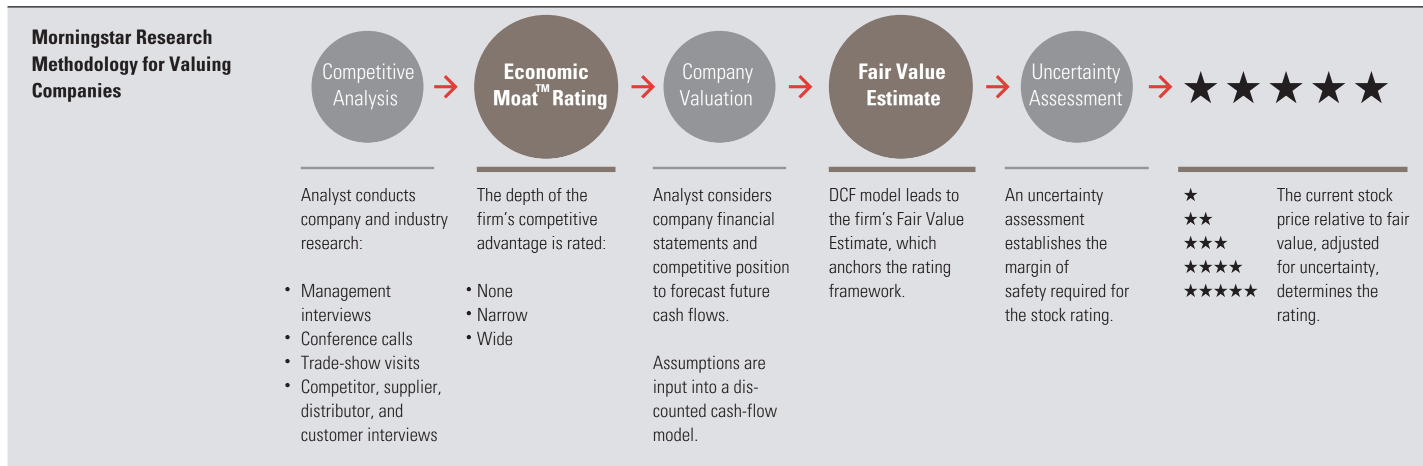
Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such



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economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate
We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value
This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty
To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety
This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling
The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades
Our corporate 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.

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