Coach, Inc. COH [XNYS] | ★★★★

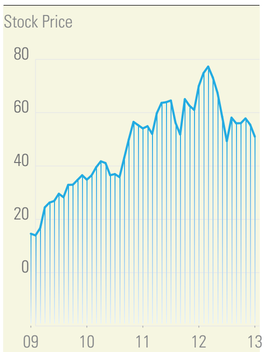
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
49.02 USD	63.00 USD	37.80 USD	97.65 USD	High	Narrow	Exemplary		Luxury Goods

Coach's Choice for New CEO Shows Board Believes in International Growth; Key to Long Term

by Paul Swinand
Stock Analyst
Analyst covering this company do not own its stock.

Pricing as of Feb 19, 2013.
Rating as of Feb 19, 2013.

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



Analyst Note Feb. 14, 2013

Coach COH announced that CEO Lew Frankfort will transition to an executive chairman role over the next year, with the current president of the international group, Victor Luis, becoming CEO in January 2014. We read little negative innuendo into the announcement; the choice suggests to us that the North American business is not broken, but also that international growth will continue to be an important driver over the long run. Luis' record in Asia and international is good, and although we'd guess swiftly addressing the operational needs of growing international operations is one of his top strengths, ultimately the long-run desirability of the products and the Coach brand is the firm's long-run competitive advantage, in our opinion, and the reason we give Coach a narrow economic moat rating.

The board of directors has long shared our view. While the board isn't afraid to share the wealth of Coach's success across executives, the actions of its compensation committee speak loudest, since Reed Krakoff (age 48), with the title of president, executive creative director, usually earns 60%-70% more than CEO Frankfort. Krakoff's total compensation ranged between $19 million and $21 million over the last three fiscal years, while Frankfort's total compensation ranged from $12 million to $14 million, indicating to us the board's willingness to retain and compensate the chief product person and one of the key stewards of the brand. There is some risk that an executive like Michael Tucci, president, North American group, could depart having not been given the CEO post, but considering that he received long-term stock awards of $4.5 million last year and total compensation of more than $9 million, up from $4 million the prior year, he appears to have good reason to stay.

Thesis Apr. 27, 2012

With such historically strong financial metrics, investors may worry how sustainable Coach's record is. Fashion-driven companies can often seem like high-return companies when products and styles are popular, and fade quickly when tastes and preferences change. In our view, Coach has developed a narrow economic moat through a brand that commands pricing power, sourcing and distribution advantages, and attention on capital efficiency. We believe these competitive advantages are sustainable over our explicit forecast period, resulting in excess economic profits.

Even during the challenges of the recession, Coach's fundamentals were excellent, with three-year historical operating margins above 30% and returns on capital around 40%. Free cash flow generation has been also quite high, historically greater than 20% of revenue. Management's attention on capital efficiency and strong brand loyalty have been the key drivers of Coach's strong financial results. We judge brand to be more important than other softgoods categories--in bags and leather accessories, consumers tend to be more brand loyal, repurchasing the same brand of bag or matching the bag with accessories purchases. We liken this brand loyalty to be part fit, part style, and part product performance.

Coach has created sourcing and distribution advantages that contribute to our view of the sustainability of its competitive advantages. Recent hard work on sourcing due to cost pressures lengthens that advantage, in our view. Although some aspects such as quality control are process advantages that can be copied in the medium term, others, such as being one of the largest high-quality leather buyers on the planet, are more structural.

The current distribution footprint is still relatively small, and can be expanded without diluting the brand. Coach has more than 500 stores in the U.S., fewer than 200 stores in Japan, and should soon reach 100 stores in China. In the domestic market, roughly one third of the stores are factory outlets, which have a different customer mix and do a greater proportion of men's and tourist business. Coach has been improving its men's business domestically, and, although we

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Oper Income	Net Income
LVMH Moet Hennessy Louis Vuitton SA	EUR	66,771	26,333	5,514	3,436
Compagnie Financiere Richemont SA	CHF	41,918	12,525	3,010	2,465
Hermès International	EUR	26,751	3,127	978	639
Tiffany & Co.	USD	8,323	3,746	693	415
Vera Bradley, Inc.	USD	1,074	513	103	64

believe it will always be smaller than women's, we believe there is some upside in this category. The men's business is also potentially bigger in China and Asia compared to western economies, as men in Asia give leather goods as gifts and tend to have more personal leather accessories compared to Coach's home markets; and we believe men's growth could show some upside from current trends.

Coach's international business is still underdeveloped and represents an opportunity if growth and margins continue on current trajectories. Many investors assume that Coach is too wed to the fortunes of the American consumer, but if the long-run success in Japan is taken as a guide, there is plenty of room for Coach to take share from European leather and accessories makers in other markets. In Japan, Coach has had flat to low single-digit growth rates for the past 10 years while other competitors generally have experienced declines. The company only just entered Europe last year through department store boutique partnerships. Again, many investors assume Coach will never compete with European bag makers, but it is our belief that there is room for new brands offering unique styles, makes, and price points. In China, Coach lags other luxury brands with respect to sales, but also has greater growth potential. The company doubled the business in 2010 to over $100 million and projects that by 2012 it will reach $300 million, and in 2014 it will attain $500 million in sales. Coach could also see higher operating margins in China as it expands due to lower operating costs. Similar estimates can be made for Europe, where Coach has just a small number of boutiques being tested in department stores. We estimate that the company could attain $500 million in sales in Europe over our forecast period.

Investors seem quick to punish Coach for any dip in margins or in average price points, pointing out that the brand is "aspirational" for consumers that can't afford the highest priced luxury brands. We agree that Coach products are aspirational, but also point out the resiliency of its operating results during the 2008-09 economic downturn. Coach did adjust price and product mix to represent more value to the consumer, which we think was a winning strategy despite the investor angst it created, and the sales rebound is proof that management did not dilute the brand. Coach has also showed more recently that it can raise average price points and deal with input costs fairly well. Our view is that the brand and distribution system that Coach has created is more bulletproof than a small change in price or mix would suggest, and we point to the still high margins and returns on capital, which we think will only improve during the next phases of recovery and expansion.

Valuation, Growth and Profitability

Our fair value estimate is $63 per share, based on the time value of money. Gross margins are now over 72%, given that cost pressures should subside as the calendar year continues, and currently we are modeling roughly 20 basis points of gross margin improvement, year over year, in fiscal 2013. Our updated fair value estimate implies 18 times fiscal 2012 earnings per share and 15 times fiscal 2013 earnings. On an enterprise value/EBITDA basis, our valuation implies 11 times fiscal 2012 and 9 times fiscal 2013. On a cash flow yield basis, our fair value suggests approximately 6% yield in fiscal 2013, in line with a five-year historical range of 4%-6%.

For fiscal 2012 (year ended June 2012), we project overall growth of nearly 16%, driven by high-single-digit comparable store sales growth in North America and around 14% square footage growth globally). We also anticipate gross margins holding an even performance, year over year, at 72.7% as the second half of 2012 improves. Some additional selling, general, and administrative spending will produce operating margins of 32.1% (compared with 31.4% in the fiscal year ended June 2011, and 32.2% expected for June 2013).

Over the next five years, we model annual average revenue growth around 12%. We expect net store openings to grow to 90 next year and to average 75 over the next five years, before fading to 45 at the end of our 10-year forecast period. We expect Coach to surpass $500 million in sales in China in 2014, faster than we previously expected, and 9% wholesale growth for five years based on European and new market development. Our five-year assumptions also include operating margins averaging over 32%. We project cash flows as a percentage of revenue to remain in the 20% range, dipping slightly below that in years five through 10, even with growth initiatives, dividends, and share buybacks.

Risk

Remaining fashionable and extending the brand are constant risks at Coach. If Coach extends the brand beyond what consumers understand it to be, the company could damage its core business. For example, Coach has produced some leather footwear and is also experimenting with some men's stores. Footwear does leverage some competitive advantages in leather sourcing, but in our opinion is an entirely different category than bags and accessories. Men's accessories have lower risk, in our opinion, but we cannot be sure that the extension will not dilute the women's business.

While Coach has established a niche in the fashion world, and customers are very brand-loyal in the handbag and accessories category, Coach runs the risk that changes in tastes and preferences will eventually lead to consumers turning elsewhere.

Coach also has been successful thus far extending the brand into new geographies, and a portion of our fair value is based on that continued expansion. Today, sales growth prospects appear strong, but there is a risk that new entrants or other market forces could derail the international projects that today look promising for Coach.

Bulls Say

- Coach's history, high-end positioning, and brand loyalty to its products give it the ability to price at levels above lesser brands but where consumers still see value. Its position is hard to copy and has led to high returns on capital.
- Coach's success abroad has only just begun, with growth and share gains to be had in China and other developing markets where the revenue base is small but growing. Coach has also just taken its first steps into Europe. The company's success in Japan proves it can compete effectively with European leather goods makers and gain share.
- With operating margins in the 30% range, Coach ranks as one of the best cash-generating consumer companies an investor can find.
- Coach continues to drive demand through its innovation in styles, colors, and materials. The company does extensive primary market research and picks attractive competitive spaces where it knows it can compete.
- Coach has been underestimated because it has focused efforts on the domestic market. New markets such as China and men's accessories in Asia offer unexplored opportunities.

Bears Say

- Since Coach's prices are lower, its customers tend to be more aspirational and thus more sensitive to the economy in general.
- Coach's growth strategy relies heavily on strong international markets, particularly Japan and China. Any change in demand or the inability to follow fashion trends there would affect Coach's earnings and future growth forecasts.

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- Coach continues to extend into new product areas such as shoes and men's accessories. This could eventually dilute the core business or distract management attention.
- Coach appears to have incredible brand loyalty, but new entrants will eventually replace it as a midprice aspirational brand, as fashion brands don't last forever.
- Coach will always trail its European leather goods competitors, particularly in fast-growing Asian markets where consumers want only the number one brand and Coach has poor name recognition.

Financial Overview

Financial Health:With little debt on the balance sheet and its ability to turn roughly 20% of sales into free cash flow, Coach is in excellent financial health and well-positioned to fund growth. Coach has also increased its dividend to $0.90 per share and is in good shape to continue to raise dividends through existing and growing operating cash flows.

Company Overview

Profile: Coach is a manufacturer, distributor, and retailer focused on handbags and leather accessories in an assortment of styles. Its products offer the quality of higher luxury brands but at more attractive price points. Although about 60% of sales come from its more than 345 North American retail stores and more than 120 outlet stores, Coach also sells its products through department stores, international shops, the Internet, its catalog, and Coach stores in Japan and China. Coach recently opened European distribution through department stores.

Management: Lew Frankfort has served as chairman and CEO since 1995 and helped lead the firm through its initial public offering in October 2000. He has more than 25 years of experience at Coach. In recent years, he has revitalized the Coach brand and assembled a top-notch management team to lead this effort. In 2011, his total compensation was $12 million, down by $1 million, due to a lower stock grant and nonequity incentive compensation. Although Frankfort's compensation is generous, particularly in terms of equity compensation, we think his 1.7% stake in the company helps align his interests with those of other shareholders. President and executive creative director Reed Krakoff's total compensation of $21 million in 2011 does strike us as excessive despite his unquestionable contribution to the company's success. He owns less than 1% of the shares outstanding, and we would prefer to see him have a greater equity stake in the company.

A majority of Coach's board is independent, and officers and directors own nearly 5% of the shares outstanding. Although we would prefer to see the roles of chairman and CEO split, we like that the company has appointed a lead director who can challenge the CEO if necessary. We believe management does a good job of providing transparency around the business. Overall, corporate governance is good, in our opinion, and we rate Coach's stewardship of shareholder capital as exemplary given its long record of above average returns and recent actions to return cash to shareholders.

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Analyst Notes

Coach NA Comps Hold Up, China Still Double Digit; Long-Run Men's Initiative and Sourcing Encouraging

Oct. 23, 2012

Coach COH shares have rebounded following the company's fiscal 2013 first-quarter earnings announcement this morning (September ended). Although the stock was 3 stars prior to the announcement, and remains so with the rise today, shares are still trading at a discount to our estimated $63 fair value estimate of cash flows. We'd underline to investors that firms with similar high returns and double-digit growth are typically difficult to buy at large discounts to fair value. We remain attracted to the firm's high returns on capital (over 40%). We also like its long-run prospects in emerging markets (Coach still has two thirds of revenue in North America and roughly one eighth of stores are in China) and ability to buy back shares with free cash flow (over $1 billion) or cash on the balance sheet (nearly $800 million).

Quarterly results were mostly in line with market expectations, with revenue rising 11% to $1.1 billion. More importantly, North American comparable-store sales were 5.5% and in China comparable-store sales remained at double digits on 40% total growth. Earnings per share came in at $0.77, compared with an average analyst's expectation of $0.76 and up from $0.73 last year, as the company had already forecast some SG&A impact on operating margins from the acquisition of several of its Asian distributors in the first half of fiscal year 2013. The 1 penny beat was due to share buybacks ahead of our internal model. We highlight that management has been aggressively buying back shares at average prices in the $55 range, and announced an additional authorization program of $1.5 billion.

Coach's positive stock performance today, following an earnings announcement where results largely met expectations, and where the outlook for the remaining three fiscal quarters was largely unchanged, underlines the market's expectation that last quarter's weak 1.7% comparable-store sales performance was the first sign of worse things to come. Management also underlined during the conference call that some financial community discussions about Coach's online promotions and coupons during the quarter had overestimated the impact of any one visible promotion, and that the promotional environment during the quarter was normal. Although coupons were resumed in the factory channel, the cause for the slump in comparable-store sales in the prior quarter, total promotions by the company were actually down and gross margins were even with last year at 72.8%. Worries about a slowing China also eased some as growth in China remained over 40% and same-store sales were disclosed as double digits. The company still plans to open 25 stores in China by year-end, bring the total number of China stores to 125 on a base of 150. We maintain our stance that Coach stands to gain if the environment in China and emerging markets mimics the slowdown in Japan, where Coach has gained market share over the last 15-20 years.

Looking ahead, we continue to believe that the recent launch of the new Legacy dual gender line and the men's initiatives will be long-run successes. Sourcing strengths and new initiatives started two years ago also enabled gross margins to hold even in the quarter at 72.8%. In our view, gross margins have the potential to go higher in the long run given a 10-year average gross margin of 74% and a high of 77%, and despite what we view as management's conservative outlook for flat operating margins at around 31% for the fiscal year ending in June 2013. We believe in the future that both the higher sales base can be leveraged, and that as cost headwinds such as commodity inputs (60% cost of goods) continue to subside, gross margins should continue to benefit.

Analyst Notes (continued)

Coach Misses Fiscal 2Q and Announces Lifestyle Strategy: Long Term Still Dependent on International. Jan. 23, 2013

Despite Coach's COH fiscal second-quarter sales and earnings miss, which included a 2% decline in North American same-store sales, and despite our view that the new "lifestyle" strategy has risks that could make the next year choppy, we believe the longer term is still dependent on international growth and market share, and that core advantages in leather goods will continue to be maintained. Our fair value estimate of $63 remains in place, and despite our worries about the near term, with the stock trading in 4-star territory, historically investors with longer time horizons have been rewarded by investing at current valuation levels.

In the quarter, sales rose only 4% to $1.5 billion, missing the mean analyst's expectation of just over $1.6 billion, with the North American retail comparable store sales creating the drag (a 2% comp-store decline). International sales grew 12%, and while exact figures aren't disclosed in filings, management said China sales grew over 40%, with comparable store sales up "double digits." Earnings per share came in at $1.23, compared to the mean expectation of $1.28, and our own internal model of $1.31. Management also explained that despite some promotional pressures on sales, they held the line on discounts, protecting gross margins, which held steady at 72.2%. SG&A was up 100 bps to 37.2% excluding a one-time charitable contribution in 2011, but was in line with expectations due to distributor acquisition overhead cost absorption (previously announced). Also in the quarter, higher-priced bags and higher-end retail partners did better than average, as the Legacy line sold bags priced above $400, and as retailers such as Bloomingdales performed well in the wholesale channel. Traffic in both outlets and regular malls was a driver of the sales decline, and Hurricane Sandy also accounted for about 1% of the 2% sales downturn.

More importantly for the future, management announced plans to transform Coach from a handbag and accessory brand, into a "lifestyle" brand. Management believes that, while the company previously tried to fit a "functional" need, in the future, Coach will focus on a more "emotional" connection.

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Coach, Inc.(USD) COH

Last Close $	Sales $Mil	Mkt Cap $Mil	Industry	Currency
$48.40	$4,929	$13,590	Luxury Goods	USD

Morningstar Rating	Fair Value Uncertainty	Fair Value	Economic Moat	Style	Sector
★★★★ As of 02-15-2013	High	$63.00	Narrow	Large Growth	

Coach, Inc. is a marketer of fine accessories and gifts for women and men. Its product offerings include women's and men's bags, accessories, business cases, footwear, wearables, jewelry, sunwear, travel bags, watches and fragrance.

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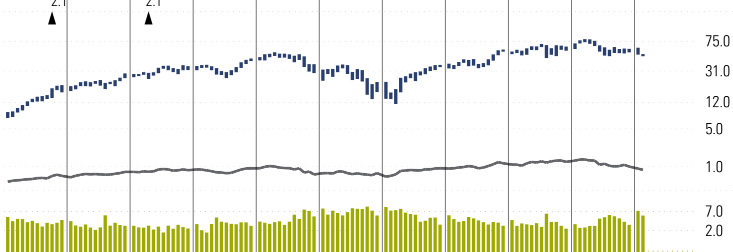
2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD	
20.27	28.85	36.84	44.99	54.00	37.64	37.36	58.55	69.20	79.70	61.94	Annual Price High
7.26	16.96	24.51	25.18	29.22	13.19	11.41	32.96	45.70	48.24	48.05	Low
2:1		2:1									Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low $
79.70-48.05
10 Year High/Low $
79.70-7.26
Trading Volume Million

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	14.5	13.8	12.8	20.8
Operating Income %	15.9	15.9	8.8	27.5
Earnings/Share %	20.9	22.7	15.9	14.2
Dividends %	—	—	—	—
Book Value/Share %	25.1	9.4	6.4	25.3
Stock Total Return	-34.1	12.8	10.5	20.5
+/- Industry	-37.6	-16.4	-7.3	3.7
+/- Market	-49.8	-1.9	5.8	12.1

Profitability Analysis

Grade: A	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	53.2	49.0	25.0	20.4
Return on Assets %	32.9	31.8	14.2	8.3
Revenue/Employee $K	273.8	270.7	—	1080.9
Fixed Asset Turns	7.6	7.0	7.9	7.0
Inventory Turns	2.9	2.8*	1.4	11.6
Gross Margin %	72.8	73.2	55.8	43.3
Operating Margin %	31.4	32.2	8.3	18.7
Net Margin %	21.3	21.5	11.8	13.3
Free Cash Flow/Rev %	20.0	21.9	9.4	11.7
R&D/Rev %	—	—	0.0	—

Financial Position (USD)

Grade: B	06-12 $Mil	12-12 $Mil
Cash	917	859
Inventories	504	494
Receivables	174	223
Current Assets	1805	1848
Fixed Assets	644	701
Intangibles	386	387
Total Assets	3104	3279
Payables	241	153
Short-Term Debt	22	22
Current Liabilities	718	769
Long-Term Debt	1	0
Total Liabilities	1111	1197
Total Equity	1993	2082

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	13.4	16.5	24.1	15.6
Forward P/E	11.4	—	—	12.7
Price/Cash Flow	11.5	13.1	15.8	9.5
Price/Free Cash Flow	14.3	15.8	24.5	80.6
Dividend Yield %	2.3	—	1.2	2.1
Price/Book	6.5	7.4	4.7	2.2
Price/Sales	2.8	3.5	2.0	2.6
PEG Ratio	1.5	—	—	2.2

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

Stock Performance

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD	Stock Performance
130.0	49.0	18.2	28.9	-28.8	-32.1	77.0	52.8	11.9	-7.2	-12.8	Total Return %
101.3	38.1	13.3	13.1	-34.3	4.9	50.5	37.8	9.7	-23.2	-19.7	+/- Market
39.9	35.2	11.6	5.5	-5.8	14.4	-10.7	-0.4	0.4	-23.3	-19.7	+/- Industry
—	—	—	—	—	—	0.6	1.0	1.4	2.0	2.3	Dividend Yield %
7005	10655	12671	15787	11258	6790	11470	16393	17813	15578	13590	Market Cap $Mil

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Financials (USD)
953	1321	1652	2035	2612	3181	3230	3608	4159	4763	4929	Revenue $Mil
71.1	74.9	76.7	77.7	77.4	75.7	71.9	73.0	72.7	72.8	72.8	Gross Margin %
244	405	536	715	993	1147	972	1150	1305	1512	1547	Oper Income $Mil
25.6	30.7	32.4	35.1	38.0	36.1	30.1	31.9	31.4	31.7	31.4	Operating Margin %
147	238	359	494	664	783	623	735	881	1039	1051	Net Income $Mil
1.58	1.36	1.00	1.27	1.69	2.17	1.91	2.33	2.92	3.53	3.62	Earnings Per Share $
—	—	—	—	—	—	—	—	—	—	—	Dividends $
93	193	390	388	377	360	326	316	302	294	290	Shares Mil
1.59	2.61	3.58	4.04	4.30	4.48	5.94	5.87	6.40	7.42	7.42	Book Value Per Share $
222	359	476	597	779	923	809	991	1033	1222	1216	Oper Cash Flow $Mil
-57	-74	-95	-134	-141	-175	-240	-81	-148	-184	-231	Cap Spending $Mil
165	286	381	463	638	749	569	910	886	1037	984	Free Cash Flow $Mil

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Profitability
27.7	28.6	29.7	33.0	32.6	33.3	25.9	29.2	34.5	36.2	32.9	Return on Assets %
42.7	39.4	39.0	44.0	42.8	46.1	39.1	45.9	56.5	57.6	53.2	Return on Equity %
1.80	1.59	1.37	1.36	1.28	1.35	1.34	1.43	1.63	1.66	1.55	Asset Turnover
15.4	18.0	21.7	24.3	25.4	24.6	19.3	20.4	21.2	21.8	21.3	Net Margin %
1.4	1.3	1.3	1.4	1.3	1.5	1.5	1.6	1.6	1.6	1.6	Financial Leverage

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-12	Financial Health (USD)
4	3	3	3	3	3	25	24	23	1	0	Long-Term Debt $Mil
427	782	1056	1189	1910	1490	1696	1505	1613	1993	2082	Total Equity $Mil
0.01	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.01	0.00	0.00	Debt/Equity
287	535	444	633	1332	908	937	774	859	1086	1079	Working Capital $Mil

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Valuation
0.4	16.8	27.8	28.2	16.1	9.5	18.3	20.1	19.1	15.3	13.4	Price/Earnings
0.0	0.0	—	—	0.0	0.0	0.0	0.0	—	0.0	0.9	P/E vs. Market
0.1	3.6	6.7	6.9	3.9	2.2	3.5	4.3	4.1	3.3	2.8	Price/Sales
11.9	10.8	9.3	10.6	7.1	4.6	6.2	9.4	9.5	7.5	6.5	Price/Book
0.3	10.2	21.5	23.0	13.2	9.5	10.9	17.5	14.3	13.2	11.5	Price/Cash Flow

Quarterly Results (USD)

Revenue $Mil	Mar	Jun	Sep	Dec
Most Recent	1108.0	1155.0	1161.0	1503.0
Previous	950.0	1031.0	1050.0	1448.0
Rev Growth %	**Mar**	**Jun**	**Sep**	**Dec**
Most Recent	16.7	12.0	10.6	3.8
Previous	14.5	8.5	15.2	14.6
Earnings Per Share $	**Mar**	**Jun**	**Sep**	**Dec**
Most Recent	0.77	0.86	0.77	1.23
Previous	0.62	0.68	0.73	1.18

Close Competitors

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
LVMH Moet Hennessy Louis Vuitton SA	66372	26333	19.4	15.0
Hermès International	26640	3127	41.3	30.6

Major Fund Holders

	% of shares
Harbor Capital Appreciation Instl	1.47
Vanguard Total Stock Mkt Idx	1.34
Vanguard 500 Index Inv	0.93

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- 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.

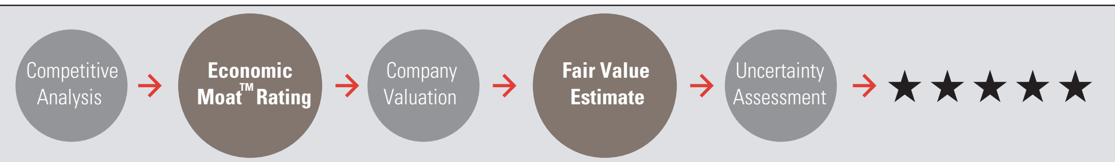
Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely 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

Morningstar Research Methodology for Valuing Companies



Competitive Analysis: Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade-show visits
- Competitor, supplier, distributor, and customer interviews

Economic Moat™ Rating: The depth of the firm's competitive advantage is rated:

- None
- Narrow
- Wide

Company Valuation: Analyst considers company financial statements and competitive position to forecast future cash flows.

Assumptions are input into a discounted cash-flow model.

Fair Value Estimate: DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework.

Uncertainty Assessment: An uncertainty assessment establishes the margin of safety required for the stock rating.

★ / ★★ / ★★★ / ★★★★ / ★★★★★: The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

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.