ResMed Inc. RMD [XNYS] | ★★

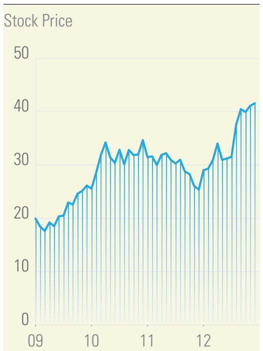
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
43.94 USD	35.00 USD	24.50 USD	47.25 USD	Medium	Narrow	NA		Medical Instruments & Supplies

Resmed's Quarterly Earnings Power Ahead

by James Cooper
Senior Equities Analyst
Analyst covering this company do not own its stock.

Pricing as of Jan 15, 2013.
Rating as of Jan 15, 2013.

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



Analyst Note Oct. 31, 2012

Resmed delivered another very strong quarterly result. Revenue rose 8% against previous corresponding period to USD 340 million while net income rose 41% to USD 71.3 million, and with fewer shares on issue, diluted earnings per share jumped 48 percent to USD 0.49. The board declared a quarterly dividend of USD 0.17 per NYSE share. Holders of Chess Depositary Instruments (CDIs) trading on the Australian Securities Exchange, will receive an equivalent amount in Australian currency, based on the exchange rate on the record date, and reflecting the 10:1 ratio between CDIs and NYSE shares.

No change to our thesis or fair value estimate of USD 35 a share or AUD 3.30 per Australian CDI. With its excellent research and development and distribution capability we expect Resmed to continue successfully to target a large market of undiagnosed sleep disordered breathing sufferers.

Over the quarter revenue grew 12% in constant currency terms. In the Americas (largely the U.S.) revenue rose 15%, while in the rest of the world (largely Europe) growth was 9%. Most noteworthy was the 260 basis points increase in gross margin to 61.4%, although without the benefit of the weaker Australian dollar we estimate the increase would have been closer to 150 basis points. The company expects such levels to be sustainable, guiding for 60% to 62%. The earnings before interest and taxes (EBIT) margin strengthened 480 basis points, benefiting from effective overhead cost control.

Both the flow generator and mask categories grew strongly. Flow generator sales were 17% stronger than the previous corresponding period, but benefited from a relatively weak first-quarter fiscal 2012. Although strong in an absolute sense, mask sales growth at 13% was some way below average growth in recent years of above 20%. This is important as masks generate higher margins along with stronger sales growth than flow generators. Unusually there were four new product launches by competitors, likely much of the reason for the lower growth. This is not a significant concern as Resmed has a rich pipeline of product under development and nearing launch. Along with 6% to 8% underlying market growth, we expect these releases to sustain gross margins and continue to drive constant currency sales growth above 10%.

The balance sheet remains cash-laden with net cash of USD 625 million. Resmed spent USD 8.1 million to buy back 216,000 shares in the quarter.

Thesis Nov. 24, 2011

ResMed remains one of the key leaders of sleep apnea treatment. With its admirable innovative capabilities, we expect ResMed to deliver solid returns in the long run, and we look forward to seeing what it develops next.

ResMed focuses on developing medical devices to treat sleep apnea and educating caregivers about therapy options. The firm's product portfolio consists of airflow generators, nasal masks, and pillows that introduce the airflow needed to prop open patients' respiratory pathways during sleep. These tools help patients breathe easier and avoid complications associated with sleep apnea, including exhaustion and hypertension. ResMed generates about half of its sales in the United States, while the other half is dispersed primarily throughout Europe, Japan, and Australia.

As a second-mover in sleep apnea devices, ResMed was initially forced to play catch-up by differentiating itself through technically superior devices. It still aims to maintain its technical edge, which has served it well so far. Patients can have a difficult time adjusting to sleep disruptions, and ResMed's advanced features can lead to greater patient comfort and compliance, which in turn leads to brand loyalty. As these patients return to ResMed's sleep lab and home health-care customers request ResMed products--especially masks and pillows--this highly profitable recurring revenue stream helps endear ResMed to its customer base.

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Covidien PLC	USD	28,365	11,852	2,414	1,905
Koninklijke Philips Electronics NV	USD	25,786	31,459	1,772	545

ResMed faces tough competition, though, particularly from Philips Electronics (formerly Respironics). Respironics pioneered the industry and possesses admirable marketing and distribution capabilities. Also, its products are synonymous with sleep apnea treatment in the U.S., so ResMed faces a difficult challenge when trying to educate physicians about its own product set. Competitors also have shown a willingness to compete on price by blanketing the market with free samples during past new product launches, so ResMed must continue to stay ahead of the pack on innovation to prevent price erosion from substantially damaging returns.

We think ResMed has proved its ability to develop new sleep apnea treatments, and we expect more of the same in the future. Considering those development capabilities and the large potential patient pool that still remains undiagnosed or untreated in the sleep apnea market, ResMed looks positioned to grow at a fast clip by filling the gaps in existing therapeutic options.

Valuation, Growth and Profitability

We've raised our fair value estimate 16% from USD 30.00 to USD 35.00 per share, reflecting slightly stronger gross margin and lower fixed cost estimates. ResMed incurs the majority of manufacturing cost in Australian dollars, while sales are mostly generated in the United States and Europe. In fiscal 2013, we expect innovation and continued market penetration to drive 11% sales growth. We expect operating margins to increase from 21.5% to around 23% reflecting strong overhead cost control. During the next five years, we expect key demographic trends (especially aging and obesity) and increased penetration of the potential patient pool (through greater awareness and more convenient testing options) to drive 9% compound annual sales growth at the firm. We expect the weaker economic environment in Europe and the United States to somewhat subdue sales growth. We assume a more competitive environment during the five-year period to result in limited scale economies as the firm increases marketing spend. We assume a relatively flat U.S. dollar/Australian dollar exchange rate. We use an 11% cost of equity to discount our assumptions.

Risk

Like most medical-device firms, ResMed must innovate or face significant pricing pressure. The company may not be able to stay at the head of the innovation class in future years, which would create an opening for competitors. The company also faces foreign exchange risk, as substantial development and manufacturing operations remain in Australia where the firm was founded, while more than 95% of its sales are dispersed throughout the rest of the world. The U.S. accounts for about half of ResMed's sales.

Bulls Say

- ResMed pursues the large, underpenetrated sleep-disordered breathing market. Growth should continue on a high trajectory as more patients incorporate ResMed's noninvasive treatments into their sleeping patterns.
- With focus now shifted toward compliance rather than low-cost systems, ResMed should thrive given its history of introducing innovative products that improve sleep apnea therapy.
- A significant boost of at-home sleep apnea testing could open up the market to patients who had balked at costly, uncomfortable testing in a sleep lab.

Bears Say

- ResMed's ability to sell products depends largely on the willingness of third parties to pay for treatment. Lower reimbursement rates for ResMed's products would hurt revenue and margin potential.
- ResMed invests significantly in research and development. If it is unable to introduce new products in

the marketplace successfully, sales and margins may suffer.

- Competitive sampling hurt ResMed's growth in recent years. If those practices return, the attractiveness of the sleep apnea device market could diminish and ResMed's returns could suffer.

Financial Overview

Financial Health:With more than USD 470 million in net cash after debt is considered at 31 March 2012, ResMed remains in excellent financial health. Given its ability to generate significant free cash flow, we expect that position to strengthen in future years.

Company Overview

Profile: ResMed develops, manufactures, and distributes medical devices--such as airflow generators and masks--to treat breathing disorders. It recently acquired a ventilation firm, but the primary focus remains sleep apnea. ResMed's reach is truly global, with distribution capabilities in more than 70 countries through wholly owned and independent firms. Most of its manufacturing capacity remains in Australia, where it was founded.

Management: We give ResMed a C Stewardship Grade and frown upon the ongoing perks and compensation doled out to chairman Peter Farrell and other executives. Current disclosure requirements shed clear light on those practices, which include personal use of company aircraft and club memberships. We do not think shareholders should have to foot those bills. We also don't like how much overall compensation Farrell continues to receive ($2.8 million in salary, incentives, and options last year) after stepping down as CEO. Even though Farrell founded and ran ResMed very well for nearly two decades, we don't think shareholders should have to continue paying such generous compensation to him during his retirement. We also don't like the staggered terms and clubby feel of the board of directors, which could make stewardship changes difficult at ResMed.

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Analyst Notes

Another Strong Quarter Aug. 06, 2012

Resmed reported another strong quarter. Revenue grew nine percent (13% on constant currency basis) to USD 372 million, net income increased 31 percent to USD 77 million and earnings per share rose 43% to USD 0.53 boosted by the share buyback. Resmed's 13% constant currency growth for the quarter was well ahead of the company's 6% to 8% estimate of overall market growth, implying market share gains. Net operating cash flow was USD 97 million. The board declared an unfranked maiden quarterly dividend of USD 0.17 per share, equating to 1.7 Australian cents per CDI.

Over the full year to 30 June 2012, revenue increased 10% (11% in constant currency) to USD 1.37 billion, net income rose 12% to USD 254.9 million, and diluted earnings per share increased 19% to USD 1.71. This equates to an 18.1% increase in earnings per Australian CDI to 16.3 Australian cents. A fall in the effective tax rate from 25% to 23% boosted the bottom line. The buyback reduced the average number of shares on issue by 9.3 percent at a cost of USD 391 million. The full-year gross margin increased from 59.6% to 60.0%. EBIT margin was flat, impacted by a 19% increase in research and development to USD 110 million.

Our valuation rises from AUD 2.95 to AUD 3.30 reflecting slightly stronger gross margin and lower fixed cost estimates. After adjusting for excess cash, Resmed trades on a P/E near 16 times at our valuation of AUD 3.30. This is an appropriate level considering the defensive and growth characteristics of the business.

Resmed's Quarterly Earnings Power Ahead Oct. 31, 2012

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Analyst Notes (continued)

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ResMed Inc.(USD) RMD

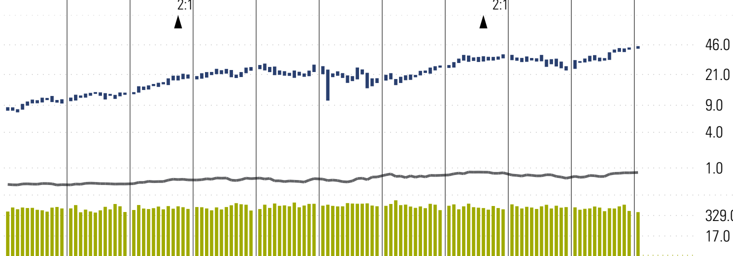
Last Close $	Sales $Mil	Mkt Cap $Mil	Industry	Currency
$43.75	$1,393	$6,260	Medical Instruments & Supplies	USD

ResMed Inc. is a developer, manufacturer and distributor of medical equipment for treating, diagnosing, and managing sleep-disordered breathing and other respiratory disorders.

Morningstar Rating	Fair Value Uncertainty	Fair Value	Economic Moat	Style	Sector
★★ As of 01-14-2013	Medium	$35.00	Narrow	Mid Growth	

9001 Spectrum Center Boulevard
San Diego, CA 92123
Phone: +1 858 836-5000
Website: http://www.resmed.com.au

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD	
Annual Price High	11.68	13.00	21.41	25.59	28.08	26.21	26.69	35.90	35.36	42.94	44.47	
Low	7.33	10.09	12.26	18.40	19.17	10.26	15.75	25.04	23.37	24.41	41.57	
Recent Splits			2:1					2:1				



Price Volatility
- Monthly High/Low
- Rel Strength to S&P 500

52 week High/Low $
44.47-25.69

10 Year High/Low $
44.47-7.33

Trading Volume Thousand

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	10.1	14.1	13.8	21.0
Operating Income %	10.3	15.7	26.7	—
Earnings/Share %	18.8	21.6	32.1	20.1
Dividends %	—	—	—	—
Book Value/Share %	-0.8	15.2	13.5	22.4
Stock Total Return	70.9	18.8	12.3	17.9
+/- Industry	42.7	10.2	9.2	9.8
+/- Market	54.2	7.9	9.2	11.1

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	17.0	14.1	13.4	20.7
Return on Assets %	13.2	11.0	7.0	8.5
Revenue/Employee $K	376.6	339.7	—	1090.4
Fixed Asset Turns	3.2	2.8	3.9	7.0
Inventory Turns	2.9	2.5*	3.5	13.4
Gross Margin %	60.6	59.8	51.0	43.8
Operating Margin %	22.5	20.6	15.9	19.3
Net Margin %	19.8	16.7	11.7	13.3
Free Cash Flow/Rev %	22.8	14.6	12.4	12.0
R&D/Rev %	8.0	7.3	5.6	—

Financial Position (USD)

Grade: A	06-12 $Mil	09-12 $Mil
Cash	810	891
Inventories	174	193
Receivables	285	270
Current Assets	1361	1450
Fixed Assets	434	438
Intangibles	311	333
Total Assets	2138	2245
Payables	98	77
Short-Term Debt	0	0
Current Liabilities	253	253
Long-Term Debt	251	266
Total Liabilities	530	546
Total Equity	1608	1699

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	23.4	22.4	22.6	15.0
Forward P/E	37.2	—	—	13.1
Price/Cash Flow	17.3	17.0	14.4	9.2
Price/Free Cash Flow	20.3	25.3	19.8	75.1
Dividend Yield %	0.8	—	1.0	2.3
Price/Book	3.7	3.1	3.2	2.1
Price/Sales	4.6	3.9	2.7	2.5
PEG Ratio	3.7	—	—	1.7

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

Stock Performance

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD
Total Return %	36.9	20.6	49.9	28.5	6.7	-28.7	39.5	32.5	-26.7	65.0	5.2
+/- Market	8.2	9.8	45.0	12.7	1.2	8.3	13.0	17.5	-28.8	49.0	2.1
+/- Industry	-2.8	1.8	59.5	22.7	-13.9	3.8	9.2	25.8	-21.8	38.0	1.6
Dividend Yield %	—	—	—	—	—	—	—	—	—	0.8	0.8
Market Cap $Mil	1411	1734	2714	3743	4061	2837	3931	5316	3736	5948	6260

Financials (USD)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM
Revenue $Mil	274	339	426	607	716	835	921	1092	1243	1369	1393
Gross Margin %	63.3	63.9	64.6	62.1	53.7	59.1	60.2	60.0	59.6	60.0	60.6
Oper Income $Mil	-3	-2	-1	1	6	143	190	240	267	294	314
Operating Margin %	24.6	25.2	22.9	21.6	12.6	17.1	20.7	22.0	21.5	21.5	22.5
Net Income $Mil	46	57	65	88	66	110	146	190	227	255	276
Earnings Per Share $	0.33	0.41	0.46	0.58	0.43	0.70	0.95	1.23	1.44	1.71	1.87
Dividends $	—	—	—	—	—	—	—	—	—	—	0.17
Shares Mil	138	141	150	154	157	157	154	155	157	149	147
Book Value Per Share $	2.45	3.15	3.71	5.59	6.56	6.37	8.36	10.50	10.61	11.87	11.87
Oper Cash Flow $Mil	59	77	71	99	91	138	239	188	283	383	372
Cap Spending $Mil	-26	-57	-40	-103	-78	-76	-114	-62	-73	-61	-54
Free Cash Flow $Mil	34	19	31	-4	14	62	125	127	210	322	317

Profitability	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM
Return on Assets %	10.9	11.4	9.8	9.9	5.9	8.3	10.1	12.1	12.3	12.1	13.2
Return on Equity %	19.1	17.7	15.5	14.6	7.9	11.0	13.3	15.8	15.0	15.3	17.0
Asset Turnover	0.65	0.67	0.64	0.68	0.63	0.63	0.63	0.70	0.67	0.65	0.67
Net Margin %	16.7	16.9	15.2	14.5	9.3	13.2	15.9	17.4	18.3	18.6	19.8
Financial Leverage	1.6	1.5	1.6	1.4	1.3	1.3	1.4	1.3	1.2	1.3	1.3

Financial Health (USD)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	09-12
Long-Term Debt $Mil	113	113	59	116	87	94	94	0	100	251	266
Total Equity $Mil	286	361	474	738	931	1082	1115	1288	1731	1608	1699
Debt/Equity	0.40	0.31	0.12	0.16	0.09	0.09	0.08	—	0.06	0.16	0.16
Working Capital $Mil	191	222	142	381	466	547	584	673	1084	1108	1197

Valuation	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM
Price/Earnings	28.3	29.7	40.5	37.0	65.4	24.1	23.3	25.0	17.4	22.2	23.4
P/E vs. Market	0.0	0.0	—	—	0.0	0.0	0.0	0.0	—	0.0	1.6
Price/Sales	4.8	4.9	5.8	5.7	5.4	3.3	4.0	4.7	3.1	4.4	4.6
Price/Book	4.3	4.1	5.2	4.4	4.0	2.9	3.1	3.3	2.4	3.5	3.7
Price/Cash Flow	22.7	20.7	46.5	34.1	43.7	13.6	21.1	22.6	11.2	16.5	17.3

Quarterly Results (USD)

Revenue $Mil	Dec	Mar	Jun	Sep
Most Recent	332.0	349.0	371.0	339.0
Previous	305.0	313.0	341.0	314.0

Rev Growth %	Dec	Mar	Jun	Sep
Most Recent	8.7	11.4	8.8	7.9
Previous	11.2	12.4	17.3	11.6

Earnings Per Share $	Dec	Mar	Jun	Sep
Most Recent	0.42	0.44	0.53	0.49
Previous	0.37	0.34	0.37	0.33

Close Competitors

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
Covidien PLC	28328	11852	15.3	18.7
Koninklijke Philips Electronics NV ADR	25740	24339	27.0	3.4

Major Fund Holders

	% of shares
Vanguard Total Stock Mkt Idx Inv	1.29
Vanguard Mid Cap Index I	1.29
Fidelity Series International Growth	0.93

MORNINGSTAR®

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 → **Economic Moat™ Rating** → Company Valuation → **Fair Value Estimate** → Uncertainty Assessment → ★★★★★

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.