

# ResMed Inc. RMD [XNYS] | ★★

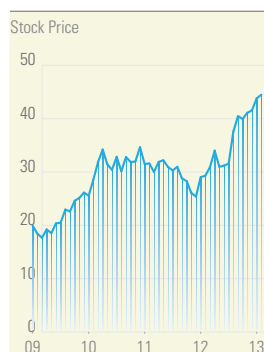
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
43.37 USD	39.00 USD	27.30 USD	52.65 USD	Medium	Narrow	Standard		Medical Instruments & Supplies

## Competitive Tender Results Fall Below Expectations, Small Impact on Valuation

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

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

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



### Analyst Note Feb. 04, 2013

We undertake a closer look following the release of the results of round two of the U.S. government medical insurance (CMS) competitive tender process for supply of durable medical equipment. Instead of the 30 percent falls seen in round one, the price decreases were significantly greater at 45-50 percent in round two.

Our revenue forecasts already factored in a view that strained public and private finances in the developed world would constrain future growth. Competitive tender is one method of reducing spending. Given the extent of the price falls we have reduced our forecasts for ResMed's RMD U.S. revenue growth to 10 percent from 12 percent in fiscal 2014 and to 8 percent from 10 percent in fiscal 2016, when round three of the tender process is likely to hit. Our calculation assumes ResMed absorbs roughly one third of the 45-50 percent price falls, the dealers bearing the remainder. These changed assumptions result in the operating margin falling from 24 percent to 23 percent in 2017 and net income falling by around 5 percent by fiscal 2017. Our fair value estimate falls to \$39 per share, from \$41.

There is no change to our thesis and underlying view of ResMed. Culturally the company is well-equipped to respond to margin pressure. ResMed consistently delivers solid sales growth, and preserves or increases gross margins despite continuous industry price deflation in the 3-5 percent range. This is a function, among other factors, of product innovation to counter commoditisation, incremental manufacturing efficiency gains, and relocation of manufacturing out of Australia to lower-cost Asia locations, such as Singapore and Malaysia. These Asian facilities are now responsible for over half of Resmed's global manufacturing task.

### Thesis Jan. 30, 2013

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 other respiratory problems, 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.

ResMed faces tough competition, though, particularly from Philips Electronics (formerly Respirationics). Respirationics 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, but ResMed continue to impress with innovation that has successfully combated price erosion, and has prevented any decline in returns on capital.

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Oper Income	Net Income
<b>Covidien PLC</b>	USD	30,881	12,010	2,436	1,904
<b>Koninklijke Philips Electronics NV</b>	USD	28,724	32,104	1,334	293

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 continuing growing at a fast clip by filling the gaps in existing therapeutic options.

### Valuation, Growth and Profitability

We've reduced our fair value estimate around 5% to USD 39 from USD 41 per share, after competitive tendering by home care dealers delivered a greater than expected 45%-50% fall in the pricing of durable medical equipment reimbursed by U.S. government health insurance (CMS).

In fiscal 2013, we expect innovation and continued market penetration to drive 13% sales growth. We expect operating margins to increase to around 24% from 21.5%, reflecting strong overhead cost control and stronger gross margins. 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 10.5% compound annual sales growth at the firm. 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 600 million in net cash after debt as of 31 December 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.

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## Company Overview

Profile: ResMed develops, manufactures, and distributes medical devices--such as airflow generators and masks--to treat breathing disorders. It also markets ventilation products, 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. An increasing proportion of manufacturing capacity is in Singapore, with some still in Australia, where the company was founded.

Management: We give ResMed a standard stewardship grade. As a very strong free cash flow generator ResMed has internally funded growth for many years. It has not issued fresh equity, and has employed little debt. Returns on invested capital are consistently well above cost of capital, and have been in an upward trend in recent years. The majority of growth follows from effectively investing in research and development that maintains a leadership position in sleep disordered breathing technology, from investing in clinical trials that demonstrate the medical benefits of treating the condition, and from distribution expertise and reach.

We applaud management's aversion to debt, but net cash levels are somewhat excessive, in our opinion, given limited large-scale acquisition opportunities.

In the past, we have questioned management's zero dividend policy. Its preference is intermittently to repurchase stock which, to management's credit, it has done at prices that have generally proved value-accretive. In 2012, we were pleased when the firm initiated a dividend.

Resmed's acquisition strategy is to buy relatively small firms

that own complementary technology or intellectual property. We have not witnessed management risk material amounts of capital on such acquisitions, nor have we found any to have been value-destructive.

Founder Peter Farrell is back in the CEO position after Kieran Gallahue resigned in January 2011, after three years in the role. Our concern is that Farrell may lack the energy and ambition of a younger CEO, but the performance of the company since his re-appointment has been highly rewarding for shareholders.

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## Analyst Notes

### Resmed's Quarterly Earnings Power Ahead 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.

### Resmed's Second Quarter: No Sign of Slowing Jan. 30, 2013

Resmed RMD delivered another very impressive quarterly result, with the top line gaining 13 percent to \$377 million, operating profit rising 37 percent to \$92.1 million, and net income rising 24 percent to \$77.9 million. Earnings per share rose 26 percent to 53 cents. Resmed will pay a 17-cent dividend in respect of the quarter. There was no dividend in the previous corresponding quarter.

We raise our fair value estimate to \$41 from \$37 per share reflecting an increase in our five-year compound average sales growth estimate from 9.3 percent to 11.4 percent, a small increase in our operating margin estimates and lower effective tax rate assumptions.

Resmed continues to impress. Revenue and earnings remain impervious to global economic headwinds, and we expect this resilience to continue. The firm is a leading innovator of technology for the treatment of sleep disordered breathing,

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## Analyst Notes (continued)

or SDB. The market remains relatively immature and system growth strong at around 6-8 percent in the US, 4-6 percent in Europe and 8-10 percent in Asia. Studies increasingly demonstrate the link between SDB and other severe diseases such as heart disease, strengthening the case for treatment. The economic case is also compelling, given the impact of the condition on worker productivity, and the cost of treating comorbidities.

growth, and preserves or increases gross margins despite continuous industry price deflation in the 3-5 percent range. This is a function, among other factors, of product innovation to counter commoditisation, incremental manufacturing efficiency gains, and relocation of manufacturing out of Australia to lower-cost Asia locations, such as Singapore and Malaysia. These Asian facilities are now responsible for over half of Resmed's global manufacturing task.

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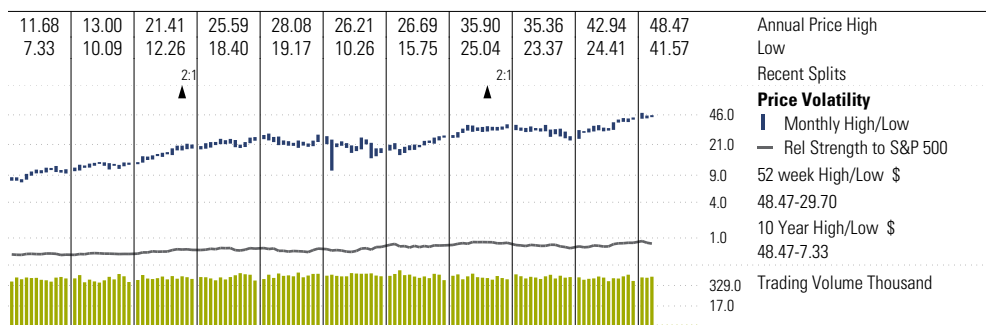
# ResMed Inc.(USD) RMD

**Last Close \$** \$43.39  
**Sales \$Mil** \$1,437  
**Mkt Cap \$Mil** \$6,226  
**Industry** Medical Instruments & Supplies  
**Currency** 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** Medium  
**Fair Value** \$39.00  
**Economic Moat** Narrow  
**Style** Mid Growth  
**Sector**

As of 03-13-2013



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 San Diego, CA 92123  
 Phone: +1 858 836-5000  
 Website: <http://www.resmed.com.au>

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	41.6	13.1	16.2	19.4	
+/- Industry	22.9	3.0	10.0	9.9	
+/- Market	27.7	0.1	10.4	10.8	

Profitability Analysis				
Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	17.6	14.1	13.4	19.7
Return on Assets %	13.3	11.0	7.0	8.2
Revenue/Employee \$K	388.5	339.7	—	1040.6
Fixed Asset Turns	3.3	2.8	3.9	7.0
Inventory Turns	2.9	2.5*	3.5	12.2
Gross Margin %	61.1	59.8	51.0	43.2
Operating Margin %	23.6	20.6	15.9	18.6
Net Margin %	20.2	16.7	11.7	13.1
Free Cash Flow/Rev %	20.7	14.6	12.4	11.7
R&D/Rev %	8.0	7.3	5.5	—

Financial Position (USD)			
Grade: A	06-12 \$Mil	12-12 \$Mil	
Cash	810	958	
Inventories	174	195	
Receivables	285	285	
Current Assets	1361	1530	
Fixed Assets	434	440	
Intangibles	311	338	
Total Assets	2138	2330	
Payables	98	71	
Short-Term Debt	0	0	
Current Liabilities	253	251	
Long-Term Debt	251	301	
Total Liabilities	530	579	
Total Equity	1608	1752	

Valuation Analysis				
	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	21.9	22.2	25.6	16.2
Forward P/E	32.5	—	—	13.6
Price/Cash Flow	17.9	17.1	14.9	9.4
Price/Free Cash Flow	21.4	25.5	21.9	27.5
Dividend Yield %	1.2	—	1.1	2.3
Price/Book	3.6	3.0	3.5	2.2
Price/Sales	4.4	3.9	2.9	2.6
PEG Ratio	2.7	—	—	2.3

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

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD	Stock Performance
Revenue \$Mil	36.9	20.6	49.9	28.5	6.7	-28.7	39.5	32.5	-26.7	65.0	4.8	Total Return %
Operating Income \$Mil	8.2	9.8	45.0	12.7	1.2	8.3	13.0	17.5	-28.8	49.0	-4.7	+/- Market
Earnings/Share \$	-2.8	1.8	59.5	22.7	-13.9	3.8	9.2	25.8	-21.8	38.0	-4.6	+/- Industry
Dividends \$	—	—	—	—	—	—	—	—	—	0.8	1.2	Dividend Yield %
Book Value/Share \$	1411	1734	2714	3743	4061	2837	3931	5316	3736	5960	6226	Market Cap \$Mil

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Financials (USD)
Revenue \$Mil	274	339	426	607	716	835	921	1092	1243	1369	1437	Revenue \$Mil
Gross Margin %	63.3	63.9	64.6	62.1	53.7	59.1	60.2	60.0	59.6	60.0	61.1	Gross Margin %
Oper Income \$Mil	67	85	97	131	90	143	190	240	267	294	339	Oper Income \$Mil
Operating Margin %	24.6	25.2	22.9	21.6	12.6	17.1	20.7	22.0	21.5	21.5	23.6	Operating Margin %
Net Income \$Mil	46	57	65	88	66	110	146	190	227	255	291	Net Income \$Mil
Earnings Per Share \$	0.33	0.41	0.46	0.58	0.43	0.70	0.95	1.23	1.44	1.71	1.98	Earnings Per Share \$
Dividends \$	—	—	—	—	—	—	—	—	—	—	0.34	Dividends \$
Shares Mil	138	141	150	154	157	154	155	155	157	149	147	Shares Mil
Book Value Per Share \$	2.45	3.15	3.71	5.59	6.56	6.37	8.36	10.50	10.61	12.22	12.21	Book Value Per Share \$
Oper Cash Flow \$Mil	59	77	71	99	91	138	239	188	283	383	355	Oper Cash Flow \$Mil
Cap Spending \$Mil	-26	-57	-40	-103	-78	-76	-114	-62	-73	-61	-58	Cap Spending \$Mil
Free Cash Flow \$Mil	34	19	31	-4	14	62	125	127	210	322	297	Free Cash Flow \$Mil

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Profitability
Return on Assets %	10.9	11.4	9.8	9.9	5.9	8.3	10.1	12.1	12.3	12.1	13.3	Return on Assets %
Return on Equity %	19.1	17.7	15.5	14.6	7.9	11.0	13.3	15.8	15.0	15.3	17.6	Return on Equity %
Asset Turnover	0.65	0.67	0.64	0.68	0.63	0.63	0.63	0.70	0.67	0.65	0.66	Asset Turnover
Net Margin %	16.7	16.9	15.2	14.5	9.3	13.2	15.9	17.4	18.3	18.6	20.2	Net Margin %
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 Leverage

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	12-12	Financial Health (USD)
Long-Term Debt \$Mil	113	113	59	116	87	94	94	0	100	251	301	Long-Term Debt \$Mil
Total Equity \$Mil	286	361	474	738	931	1082	1115	1288	1731	1608	1752	Total Equity \$Mil
Debt/Equity	0.40	0.31	0.12	0.16	0.09	0.09	0.08	—	0.06	0.16	0.17	Debt/Equity
Working Capital \$Mil	191	222	142	381	466	547	584	673	1084	1108	1279	Working Capital \$Mil

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM	Valuation
Price/Earnings	28.3	29.7	40.5	37.0	65.4	24.1	23.3	25.0	17.4	21.0	21.9	Price/Earnings
P/E vs. Market	0.0	0.0	—	—	0.0	0.0	0.0	0.0	—	0.0	1.3	P/E vs. Market
Price/Sales	4.8	4.9	5.8	5.7	5.4	3.3	4.0	4.7	3.1	4.2	4.4	Price/Sales
Price/Book	4.3	4.1	5.2	4.4	4.0	2.9	3.1	3.3	2.4	3.4	3.6	Price/Book
Price/Cash Flow	22.7	20.7	46.5	34.1	43.7	13.6	21.1	22.6	11.2	17.2	17.9	Price/Cash Flow

Quarterly Results (USD)				
	Mar	Jun	Sep	Dec
Revenue \$Mil	349.0	371.0	339.0	376.0
Most Recent	313.0	341.0	314.0	332.0
Previous	—	—	—	—
Rev Growth %	Mar	Jun	Sep	Dec
Most Recent	11.4	8.8	7.9	13.2
Previous	12.4	17.3	11.6	8.7
Earnings Per Share \$	Mar	Jun	Sep	Dec
Most Recent	0.44	0.53	0.49	0.53
Previous	0.34	0.37	0.33	0.42

Close Competitors				
	Mkt Cap \$Mil	Rev \$Mil	P/E	ROE%
Covidien PLC	31164	12010	16.8	18.1
Koninklijke Philips Electronics NV ADR	28417	24788	81.3	1.9

Major Fund Holders		% of shares
Vanguard Total Stock Mkt Idx		1.33
Vanguard Mid Cap Index I		1.30
SPDR S&P MidCap 400		0.90

## 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

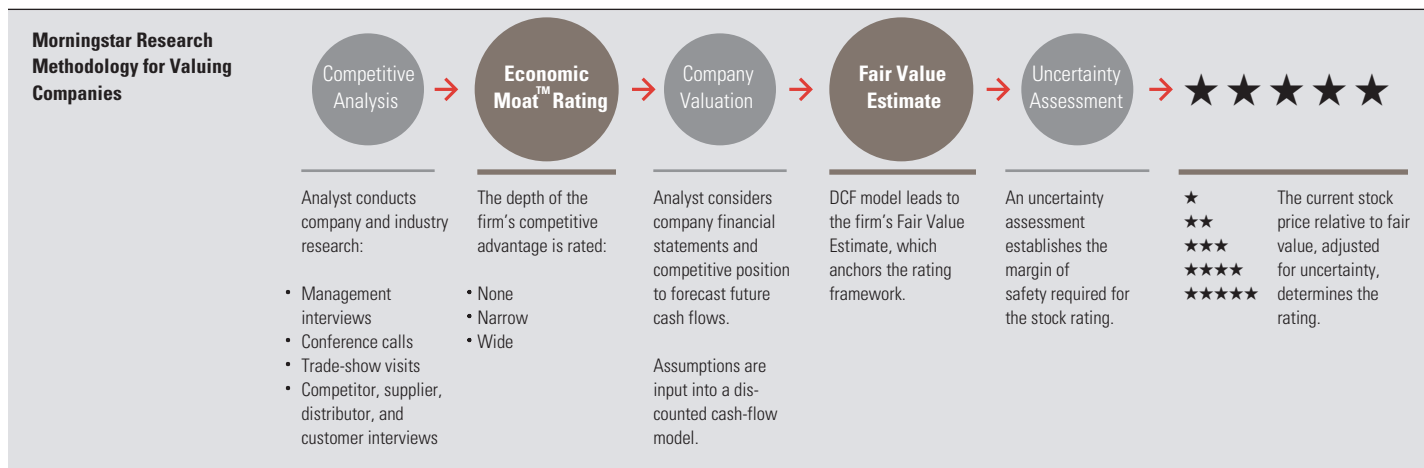
just on movement in the share price. If we think a stock's fair value is \$50, and the shares decline to \$40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at \$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's Approach to Rating Stocks (continued)

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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.

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### 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.

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### 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.

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### 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.

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### 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.

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### 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.

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### 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.

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### 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.