Oracle Corporation ORCL [Nasdaq] | ★★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
27.34 USD	41.00 USD	28.70 USD	55.40 USD	Medium	Wide	B	AA	Software - Infrastructure

Oracle's long-term hardware strategy--staked around Exadata and Exalogic--remains intact.

by Morningstar Equity Analysts

Analysts covering this company do not own its stock.

Pricing data through January 13, 2012. Rating updated as of January 13, 2012.

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

Thesis Jan. 09, 2012

Oracle has astutely leveraged its dominance of the database software industry to become a major provider of enterprise software solutions. The recent acquisition of Sun has enabled the firm to further its strategy of providing complete IT solutions to its clients. We believe the firm has the scale, resources, and expertise to remain at the forefront of the consolidation of the enterprise software industry.

Oracle is the leading provider of database software and has successfully capitalized on its strong competitive position to enter new enterprise software markets. Database software provides the foundation for every information system; once installed, customers depend on databases to store, access, and secure all sorts of critical information for business operations. Meanwhile, enterprise software includes a wide collection of integrated applications designed to support and streamline business activities across the organization. Customers are often unwilling to switch database or enterprise software providers because it entails not only new software costs and installation expenses, but also operational disruptions and downtime costs.

Oracle has been extending its clout in the database market to the enterprise software industry. Building on the ubiquitous deployment of its database systems, the company has spent nearly $36 billion since 2005 acquiring and integrating dozens of enterprise software providers such as BEA, PeopleSoft, and Siebel.

We believe the key to Oracle's competitive advantage rests on its ability to cross-sell and upsell a wide range of enterprise software solutions bundled and well integrated with its pervasive database products. In contrast to IBM and SAP, its closest competitors, Oracle strives to be a one-stop shop for all the enterprise IT requirements of its clients. The firm offers a broad set of flexible software solutions tightly integrated with high-end hardware systems that require minor customizations and thus can be easily tailored to fulfill its customers' information technology requirements at a lower overall cost.

The crucial element behind Oracle's highly profitable operations stems from its software license updates and product support revenue. This segment, which accounts for about 42% of total revenue, provides Oracle with a stable and profitable source of revenue; gross margins from this segment hover around 90%. Moreover, the dozens of recent acquisitions not only provide additional sources of profitable software maintenance streams, but also give access to a loyal and substantial customer base, which represents an attractive opportunity to sell additional products and services.

Despite Oracle's enviable competitive position, we have a few concerns. While Oracle's maintenance fees provide customers with frequent enhancements and updates to their products, customers may grow weary of paying such fees. Moreover, some competitors provide support for Oracle's products at competitive prices. In addition, the open-source software model, while still a distant menace, remains a credible threat to the company's core database business. Lastly, the emergence of cloud computing represents a new set of challenges to the firm. Small providers of software-as-a-service solutions, such as Salesforce.com, have proved highly popular among certain customer segments. While Oracle is now offering a growing range of its applications under the SaaS model, it has largely adopted a wait-and-see approach while the economics of this new paradigm--which at this point aren't necessarily stacked in Oracle's favor--evolve.

We believe the maturity of the database market will prevent Oracle from experiencing any sizable expansion in this segment. However, the firm will benefit from new growth opportunities as it acquires niche competitors to penetrate large and fragmented industries such as insurance, health care, telecom, and retail.

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Oracle Corporation	USD	137,406	36,704	13,140	9,356
Microsoft Corporation	USD	237,644	71,120	27,248	23,478
International Business Machines Corp	USD	211,161	106,449	19,912	15,622
Sap AG	USD	64,908	19,284	5,253	3,740

Morningstar data as of January 13, 2012.

Valuation, Growth and Profitability

Our fair value estimate is $41 per share, which implies a forward fiscal 2012 price/earnings of 17.5 times, an enterprise value/EBITDA of 12.8 times, and free cash flow yield of 8.3%.

Oracle's strategy of providing complete IT products featuring tightly integrated software and hardware components is yielding positive results. We expect this strategy to generate solid new software license growth and steady margin improvement in the hardware business. Our updated assumptions reflect 7% average annual software growth and 1.6% average annual hardware growth over the next five years. We expect additional acquisitions and maintenance revenue to contribute to high-single-digit long-term revenue expansion. Operating margins have declined now that Sun's hardware business is part of Oracle. We model operating margins to remain in the low 30s through fiscal 2016 as the lower profitability of the hardware segment coupled with pricing pressures on maintenance contracts will slightly dent the benefits of Oracle's operational leverage. We incorporate about $17 billion in expenditures for acquisitions during the next five years. We use a 9.2% average cost of capital to discount our projected future cash flows.

Risk

Oracle's growth-through-acquisition strategy exposes the firm to the possibility of overpaying for an acquisition or having to spend more resources to achieve the expected synergies. Also, the firm's highly profitable maintenance revenue could be threatened if customers refuse to pay maintenance fees or increasing competition pushes maintenance fees down. Furthermore, business process outsourcing remains a viable option for large companies that don't want to handle their own IT operations.

Bulls Say

- Oracle is the top provider of database software. Research firm IDC estimates that Oracle commands 45% of the overall database market, followed distantly by IBM with 21% and Microsoft with 21%.
- Oracle's free cash flow as a percentage of revenue has remained fairly steady, averaging about 31% since fiscal 2005.
- Oracle's revenue growth and operating profits highlight management's impressive record of successfully identifying, buying, and integrating smaller software companies.

Bears Say

- Small IT companies, such as Rimini Street, provide cheaper support for Oracle's software products, putting pressure on the firm's maintenance revenue.
- Open-source databases, such as MySQL (now owned by Oracle), Ingres, and PostgreSQL, which small companies have been keen to deploy, pose a threat to Oracle's dominance of the database market.
- Although the overall growth of the database market is slowing, several small providers of specialized database applications are growing at a fast pace.
- The purchase of Sun can take Oracle too far afield if it dabbles in too many new areas, such as chip design and commercialization of products for individual users.

Financial Overview

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Financial Health: Oracle is in solid financial shape. As of Nov. 30, the company had $31 billion in cash and equivalents and $14.8 billion in debt, including $4.5 billion issued in fiscal 2010 to partially finance the acquisition of Sun. Interest coverage levels are adequate, in our view. We project an EBITDA/interest expense ratio of about 20 times for fiscal 2012.

Company Overview

Profile: Oracle sells a wide range of enterprise IT solutions, including databases, middleware, applications, and hardware. Software license updates and product support, the most profitable segment of its operations, account for about 42% of total revenue. An active acquisition program is a fundamental component of the company's overall strategy. Oracle has spent nearly $36 billion in acquisitions since fiscal 2005. The firm is based in Redwood City, Calif.

Management: Lawrence Ellison has been CEO of Oracle since he cofounded the company in 1977. He is the architect behind the firm's transformation into an enterprise software powerhouse. We believe Oracle has a talented and experienced management team. Jeffrey Henley became chairman in 2004 after spending 13 years as CFO. Although Ellison owns 22% of the company, his total compensation of $77.6 million during fiscal 2011 continues to be slightly excessive, in our opinion. In addition, given the size of his stake in Oracle, we don't believe that receiving a growing number of stock option grants will necessarily increase his commitment to the long-term success of the firm. Nonetheless, we think he plays an essential role in Oracle's vision, strategy, and operations. All directors and executive officers, with the exception of Ellison, own less than 1% of Oracle, which on a dollar basis aligns their interests with shareholders', in our opinion.

We are satisfied with Oracle's corporate governance: All directors stand for re-election every year, and the CEO and chairman roles are split. However, a few related-party transactions with entities in which Ellison has economic interests, including the recent acquisition of Pillar Data and the lease of a corporate jet from a flight-services company controlled by him, might create a potential conflict of interests to the detriment of shareholders.

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Oracle Corporation ORCL [Nasdaq] | ★★★★★

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Analyst Notes

Dec. 21, 2011

Deal Delays Hit Oracle's 2Q; Hardware Segment Disappoints Again

The performance of Oracle's core software business during the second quarter of fiscal 2012 was below the range of our expectations. New license revenue, which generates a future stream of recurring and highly profitable maintenance fees, grew at the weakest pace since the June-August 2009 quarter. Furthermore, the results of the hardware segment, which posted the third straight year-over-year decline in quarterly revenue, were disappointing. Not surprisingly, results from Europe and North America reflected difficult business conditions. While year-to-date revenue is slightly trailing our current-year projection, operating income is ahead of our expectations. We are leaving our fair value estimate unchanged.

Oracle's subpar quarterly results were partially a result of some delayed deals caused by clients' additional approval processes and by some customers' desire to evaluate the company's new SPARC T4 processor (introduced in late September) before placing hardware orders. Nonetheless, Oracle's meager results in light of its position as a provider of core software products (for example, databases), its exclusive focus on large enterprises and government entities, and recent quarter-end (Nov. 30) may also be an early sign of an upcoming downturn not only in the enterprise software industry, but also in the wider information technology sector.

Overall, we believe Oracle's long-term hardware strategy--staked around Exadata, Exalogic, and an expanding array of highly engineered systems--remains intact. Nonetheless, management acknowledged that achieving the previously stated goal of selling 3,000 Exadata systems during the current fiscal year will be challenging. In fact, management's third-quarter guidance for the hardware segment foretells further challenges to this business.

Still, looking below the aggregate numbers, there were some positive underlying trends in the hardware segment. For instance, the Exadata business grew more than 100% year over year, and Exalogic increased more than 100% sequentially. We believe the solid growth of these high-end products was a driving factor behind the 4 percentage points in gross margin expansion for the overall hardware segment. Meanwhile, despite adding 1,700 salespeople during the first half of the fiscal year, management has kept costs under control. Operating margins for the quarter increased 3 percentage points to 35.4%.

We continue to believe that the shares remain significantly undervalued and view the board's decision to authorize as much as an additional $5 billion in stock repurchases as a good way to deploy the company's growing cash balance.

Oct. 24, 2011

Oracle To Acquire RightNow

On Monday, Oracle announced the acquisition of RightNow Technologies, a provider of software-as-a-service (SaaS) products, for $43 per share or about $1.5 billion net of cash and debt. We are leaving our fair value estimate for Oracle unchanged. Oracle's acquisition of RightNow is in line with our Oracle thesis, which states that the company will continue to play an active role as a consolidator of the IT industry. We continue to expect the firm to spend roughly

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Analyst Notes (continued)

$20 billion in acquisitions during the next five years. Given the rich multiple that Oracle is paying for RightNow, the primary motivation for the acquisition appears to be strategic, rather than financial. Specifically, RightNow should enable Oracle to accelerate its foray into cloud-based services without disrupting its highly-profitable core on-premise business model.

Furthermore, the acquisition of RightNow complements Oracle's three-pronged strategy to compete more effectively against Salesforce.com. First, RightNow could enable Oracle to preemptively stem Salesforce.com's advances into on-demand customer service products. Second, RightNow complements the SaaS services in Oracle's upcoming public cloud service, which also is aimed at preventing Salesforce's Force.com cloud from becoming the de-facto platform for SaaS products. Third, RightNow's customer service cloud, which offers an integrated service across contract centers, web portals, and social networks, should complement and enrich the functionality of Oracle's recent acquisitions (such as ATG and Fatwire) and Fusion applications. Fusion, the latest version of the company's enterprise software suite, was designed to provide clients with a relatively straightforward option to switch between on-demand and cloud computing models.

We believe the deal is in the best interests of RightNow

Sept. 21, 2011

Despite Seemingly Disappointing Hardware Results, We Remain Positive on Oracle's Hardware Strategy

Strong demand for database and enterprise software applications drove Oracle's growth and profitability during the first quarter of fiscal 2012. We are leaving our fair value estimate of $41 per share unchanged and emphasize that priced at 11.9 times our estimated fiscal 2012 earnings, the shares continue to represent an attractive long-term investment opportunity.

As expected, the hardware segment, which accounts for about 20% of total revenue, posted a nearly 1.5% year-over-year decline. However, we remain unconcerned about the underwhelming top-line performance of the segment. To the contrary, the hardware results reflect Oracle's continuing efforts to wind down unprofitable hardware products (for example, low-end servers or third-party products), rather than weak underlying demand for the company's high-end hardware products.

Investors should brace for a few more quarters of subpar growth in the hardware business as Oracle continues to transition to a premium-priced hardware strategy. In the meantime, we see double-digit growth in the high-end servers (Exadata, Exalogic, and M-series servers) and 5 percentage points in overall hardware gross margin improvement as encouraging signs of the company's progress in this segment.

Oracle's core software business performed strongly. New software licenses and software maintenance fees each increased 17% year over year. Solid growth combined with cost controls enabled the company to expand operating margins nearly 7 percentage points to 32%. Oracle's wide economic moat and strong, resilient business model should enable the company to continue to do well in a tough macroeconomic environment.

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Oracle Corporation ORCL

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
36,704	137,406	Software - Infrastructure	Technology

Oracle sells a wide range of enterprise IT solutions, including databases, middleware, applications, and hardware. Software license updates and product support, the most profitable segment of its operations, account for about 42% of total revenue. An active acquisition program is a fundamental component of the company's overall strategy. Oracle has spent nearly $36 billion in acquisitions since fiscal 2005. The firm is based in Redwood City, Calif.

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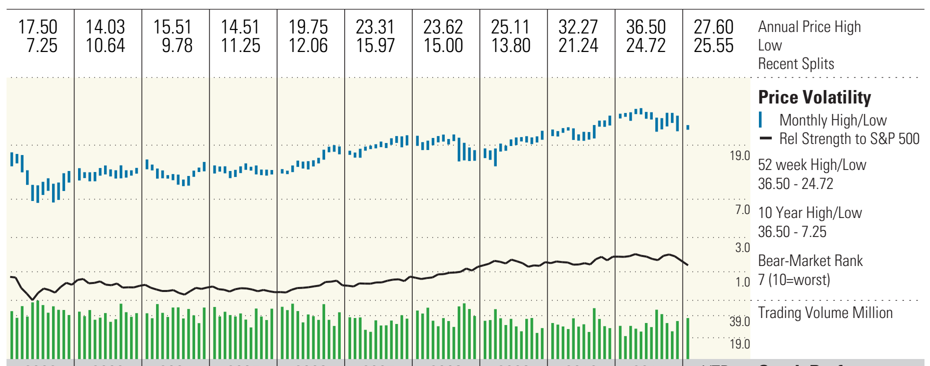
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★★★★	27.34	41.00	Medium	Wide	B

per share prices in USD



Stock Performance

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD
Total Return %	-21.8	22.5	3.7	-11.0	40.4	31.7	-21.5	39.2	28.4	-17.3	6.8
+/- Market	1.6	-3.9	-5.3	-14.0	26.8	28.2	17.0	15.8	15.6	-17.3	4.3
+/- Industry	3.2	9.4	-4.9	-7.9	22.1	8.4	18.9	-14.2	17.5	-8.4	-0.5
Dividend Yield %	—	—	—	—	—	—	—	0.6	0.6	0.9	0.9
Market Cap USD Mil	56906	69161	71685	63028	88823	115984	89469	122925	158141	128913	137406

Financials

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM
Revenue USD Mil	9673	9475	10156	11799	14380	17996	22430	23252	26820	35622	36704
Gross Margin %	75.1	75.3	77.2	77.5	77.5	76.7	77.8	79.4	78.5	76.4	77.9
Oper Income USD Mil	3571	3440	3864	4022	4736	5974	7844	8321	9062	12033	13140
Operating Margin %	36.9	36.3	38.0	34.1	32.9	33.2	35.0	35.8	33.8	33.8	35.8
Net Income USD Mil	2224	2307	2681	2886	3381	4274	5521	5593	6135	8547	9356
Earnings Per Share USD	0.39	0.43	0.50	0.55	0.64	0.81	1.06	1.09	1.21	1.67	1.82
Dividends USD	—	—	—	—	—	—	—	0.05	0.20	0.21	0.23
Shares Mil	5689	5418	5326	5231	5287	5269	5229	5130	5073	5128	5146
Book Value Per Share USD	1.01	1.38	1.65	2.35	2.99	3.76	4.52	5.49	6.81	8.34	8.34
Oper Cash Flow USD Mil	3243	3023	3177	3552	4541	5520	7402	8255	8681	11214	13129
Cap Spending USD Mil	-278	-291	-189	-188	-236	-319	-243	-529	-230	-450	-500
Free Cash Flow USD Mil	2965	2732	2988	3364	4305	5201	7159	7726	8451	10764	12629

Profitability

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM
Return on Assets %	20.4	21.1	22.5	17.3	13.6	13.4	13.5	11.8	11.3	12.7	13.4
Return on Equity %	35.9	37.1	37.5	30.6	26.2	26.8	27.6	23.3	21.9	24.2	24.5
Net Margin %	23.0	24.3	26.4	24.5	23.5	23.7	24.6	24.1	22.9	24.0	25.5
Asset Turnover	0.89	0.87	0.85	0.71	0.58	0.57	0.55	0.49	0.49	0.53	0.52
Financial Leverage	1.8	1.8	1.6	1.9	1.9	2.0	2.0	1.9	2.0	1.9	1.7

Financial Health

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	11-11
Working Capital USD Mil	4768	5069	7064	416	5044	3496	8074	9432	12313	24982	27410
Long-Term Debt USD Mil	298	175	163	159	5735	6235	10235	9237	11510	14772	14778
Total Equity USD Mil	6117	6320	7995	10837	15012	16919	23025	25090	30798	39776	41920
Debt/Equity	0.05	0.03	0.02	0.01	0.38	0.37	0.44	0.37	0.37	0.37	0.35

Valuation

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM
Price/Earnings	29.4	28.5	24.5	22.2	24.6	24.7	16.1	21.4	23.5	14.1	15.0
P/E vs. Market	—	—	—	—	—	—	—	—	—	0.8	1.1
Price/Sales	6.4	7.3	6.8	5.0	5.7	5.9	3.9	5.3	5.0	3.6	3.8
Price/Book	10.7	9.6	8.3	5.2	5.7	6.0	3.9	4.5	4.6	3.1	3.3
Price/Cash Flow	18.7	22.5	21.4	18.2	19.6	17.0	11.4	14.3	17.6	10.1	10.7

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	32.8	16.7	19.9	12.6
Operating Income %	32.8	15.3	20.5	12.3
Earnings/Share %	38.0	16.4	21.1	14.3
Dividends %	5.0	—	—	—
Book Value/Share %	28.1	20.5	22.8	21.5
Stock Total Return %	-11.4	17.7	9.8	6.6
+/- Industry	-8.1	-0.8	6.5	4.7
+/- Market	-11.8	3.8	11.9	5.7

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	24.5	24.8	31.8	22.3
Return on Assets %	13.4	12.5	17.4	9.4
Fixed Asset Turns	12.7	12.5	10.0	7.3
Inventory Turns	35.8	—	13.7	15.7
Revenue/Employee USD K	339.9	285.2*	—	1044.9
Gross Margin %	77.9	77.8	76.6	38.1
Operating Margin %	35.8	34.3	36.5	16.3
Net Margin %	25.5	23.9	28.3	10.9
Free Cash Flow/Rev %	34.4	31.2	33.6	0.1
R&D/Rev %	12.1	0.1	—	9.9

Financial Position

Grade: B	05-11 USD Mil	11-11 USD Mil
Cash	16163	13286
Inventories	303	218
Receivables	6628	4434
Current Assets	39174	38482
Fixed Assets	2857	2900
Intangibles	29413	29146
Total Assets	73535	72910
Payables	701	445
Short-Term Debt	1150	0
Current Liabilities	14192	11072
Long-Term Debt	14772	14778
Total Liabilities	33759	30990
Total Equity	39776	41920

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	15.0	20.0	12.9	14.1
Forward P/E	10.6	—	—	13.8
Price/Cash Flow	10.7	14.1	10.0	7.1
Price/Free Cash Flow	11.1	14.7	10.9	16.4
Dividend Yield %	0.9	—	1.6	2.0
Price/Book	3.3	4.4	3.8	1.9
Price/Sales	3.8	4.8	3.6	1.2
PEG Ratio	0.8	—	—	1.5

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

Quarterly Results

Revenue USD Mil	Feb 11	May 11	Aug 11	Nov 11
Most Recent Period	8764.0	10775.0	8374.0	8792.0
Prior Year Period	6404.0	9505.0	7502.0	8582.0

Rev Growth %	Feb 11	May 11	Aug 11	Nov 11
Most Recent Period	36.9	13.4	11.6	2.5
Prior Year Period	17.4	38.5	48.4	46.5

Earnings Per Share USD	Feb 11	May 11	Aug 11	Nov 11
Most Recent Period	0.41	0.62	0.36	0.43
Prior Year Period	0.23	0.47	0.27	0.37

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Oracle Corporation	137406	36704	15.0	24.5
Microsoft Corporatio	237644	71120	10.3	44.2
International Busine	211161	106449	14.1	70.2

Major Fund Holders

	% of shares
	—
	—
	—

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

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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.

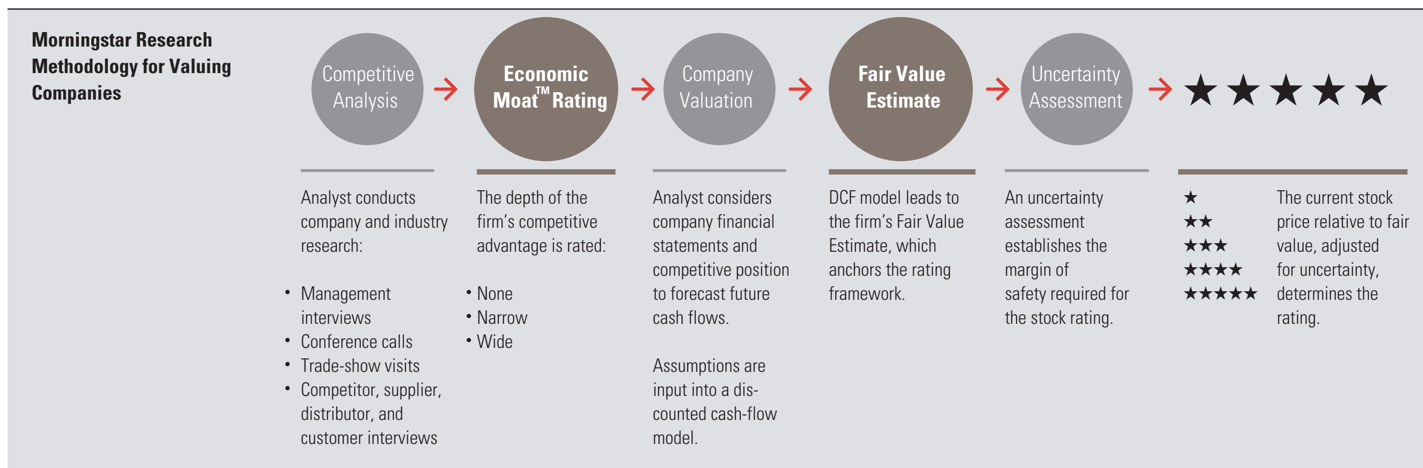
Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our 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



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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

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."

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