O'Reilly Automotive Inc ORLY [Nasdaq] | Under Review

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
78.70 USD	—	—	—	—	None	C	—	Specialty Retail

O'Reilly Cruises Along on Positive Momentum During 3Q

by Morningstar Equity Analysts

Analysts covering this company do not own its stock.

Pricing data through November 11, 2011. Rating updated as of November 11, 2011.

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

Analyst Note Oct. 27, 2011 | Liang Feng

O'Reilly reported third-quarter results that were slightly ahead of our expectations, and it is on track to achieve our full-year projections. We expect the firm will continue to perform very well as a result of favorable industry conditions, its extensive experience in the rapidly growing commercial sector, and improving operations at CSK stores. However, we think the shares are moderately overvalued, as the market has already priced in many of these factors. Thanks to low new-car sales, in part due to waning consumer confidence, O'Reilly and other large auto-part retailers have made substantial profitability gains over the past few years. O'Reilly's competitive position, in our view, has grown much stronger during this time as the industry consolidates, but we think the shares could experience a pullback if the situation doesn't unfold in line with many investors' rosy expectations. Management released its fourth-quarter outlook for 3%-5% comparable sales growth and $0.80-$0.84 diluted earnings per share, which does not differ materially from our existing projections.

Year over year, revenue grew 8% to $1.54 billion, driven by a strong 4.8% comp and the addition of 171 net new stores over the past 12 months. In addition to favorable industry conditions, O'Reilly is benefiting from a turnaround at former CSK outlets, so we expect comp store growth at the O'Reilly chain to continue its relative outperformance over the next few years. Gross margins improved an impressive 50 basis points year over year to a record 59.1%. In combination with 90 basis points of selling, general, and administrative expense leverage, the operating margin increased 21% from the prior year to $241 million (or 15.7% of sales). Our initial view is that this improvement was largely due to improved operational efficiency at CSK stores, as the firm gains commercial traction in the West Coast, and a product mix shift toward high-margin hard part sales, but we will tune in to the conference call in search of more color on the major drivers. Management aggressively repurchased 8.2 million shares at a total cost of $840 million in the quarter; O'Reilly has about $141 million remaining under its original $1 billion board-authorized share-repurchase program.

Thesis Jul. 28, 2011 | Morningstar Equity Analysts

O'Reilly Automotive has successfully integrated the CSK Auto business into its operations. We believe the acquisition has been an excellent strategic move, and the firm has begun to realize substantial cost savings from purchasing synergies and the elimination of duplicate functions. In our view, the firm has done a great job with the integration, given the smooth transition of the CSK stores into the O'Reilly systems. While we believe this acquisition puts the firm in a better competitive position, O'Reilly faces stiff competition from other auto-parts retailers such as AutoZone and Advance Auto Parts, which have also been expanding aggressively during the past few years. With little product differentiation and low barriers to entry, we think it is difficult for the firm to dig an economic moat in this industry.

Following the CSK acquisition in April 2008, O'Reilly has transformed itself from a strong regional player into an industry leader with a nationwide footprint. O'Reilly now has 3,560 stores, putting it head-to-head with the number-two player, Advance Auto (3,563 stores). We believe the deal was an attractive opportunity for the firm because O'Reilly and CSK stores operated in distinct regions, with minimal geographic overlap. Although CSK's business has been battered during the past few years, it holds attractive real estate on the West Coast, particularly California--a notoriously difficult market for retailers to expand into internally.

Given the magnitude of the CSK acquisition, which represented a 70% increase to O'Reilly's store base, the integration process has taken several years. Over the past two years, the firm has improved the productivity of CSK's struggling store base and has successfully migrated all the CSK stores into the O'Reilly distribution systems.

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
O’Reilly Automotive Inc	USD	10,099	5,708	824	490
AutoZone Inc	USD	13,469	8,073	1,495	849
Genuine Parts Company	USD	9,149	12,252	892	549
Advance Auto Parts Inc	USD	5,182	6,055	606	358

Morningstar data as of November 11, 2011.

Converted stores have the added capability to serve professional installers in the commercial business as well. Before the acquisition, commercial sales represented only 10% of CSK’s overall sales, versus about 50% at the core O’Reilly stores. We think overlaying the firm’s dual-market strategy onto CSK’s store base should boost productivity and decrease the variability in the firm’s business, as demand in the professional installer market tends to be less cyclical than the consumer-driven retail channel.

To ramp up the commercial business, O’Reilly has made significant investments to enhance the distribution infrastructure surrounding CSK’s store base. Before the acquisition, CSK operated one distribution center for every 335 stores, compared with 125 at O’Reilly. Therefore, O’Reilly have been adding distribution centers and upgrading CSK’s inventory-replenishment system. This will improve parts availability and ensure timely deliveries, which is critical for success in the commercial segment, as mechanics typically work with time-sensitive schedules.

Valuation, Growth and Profitability

We have increased our fair value estimate to $49 per share from $45 previously, to reflect the time value of money as well as a slightly more favorable margin outlook for the back half of 2011. Our new fair value estimate implies forward fiscal-year price/earnings of just under 14 times, enterprise value/EBITDA of 7 times, and free cash flow yield of 4.6%. Although these metrics appear punitive versus retail industry averages, we anticipate decelerating profits as the firm cycles out of peak earnings trends over the next few years. In 2011, we estimate that top-line growth will be in the high single digits, driven by a 5% increase in comparable store sales (in line with management’s 3%-6% growth forecast), incremental sales from 170 new stores and improved productivity in converted CSK stores. Over the next few years, however, we anticipate a modest deceleration in comparable sales to the low-single-digit range, as improving new car sales will likely pressure demand for replacement parts in the near term. Over the long term, we continue to believe that the company can deliver revenue growth in the midsingle digits, fueled by 4.5% annual same-store sales growth and new store expansions. Overall, we anticipate that the company can expand its store base to just above 5,000 stores during our 10-year forecast horizon, up from about 3,600 stores in 2010, implying 3.5% annual unit growth over that period.

Excluding charges, we anticipate that the operating margin will expand to 14.2% for the year, from 13.6% in 2010, as the firm benefits from operating leverage, tight expense control and distribution efficiencies, partially offset by a mix shift toward lower-margin commercial sales. Over the long term, we expect that O’Reilly can achieve operating margins in the midteens, as the firm is likely to benefit from incremental operating leverage stemming from a larger revenue base.

Risk

Macroeconomic pressures such as higher energy costs, food inflation, and tighter credit could pressure consumer spending, resulting in maintenance deferrals. Additionally, a significant rebound in new vehicle sales could have a negative impact on demand for replacement parts, given fewer old vehicles on the road. Besides that, legal charges tied to the ongoing legacy Department of Justice investigation of CSK’s historical accounting practices may be higher than expected, which will weigh on cash flow.

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Bulls Say

- The CSK acquisition gives O'Reilly a national platform to roll out its dual-market strategy. The deal puts the combined entity on par with number-two player Advance Auto Parts, in terms of number of stores, and gives the firm an instant presence in the Western U.S.
- With the average age of cars on the road at 10.3 years and rising, the $200 billion automotive aftermarket should benefit from increased demand. Sluggish new-car sales amid the uncertain economic climate also bode well for this trend.
- O'Reilly boasts a seasoned management team with extensive industry expertise and relationships. CEO Greg Henslee has been with the firm for more than 25 years and COO Ted Wise for more than 35 years.
- We believe the firm will benefit from a surge in demand for automotive replacement parts as consumers defer new vehicle purchases amid the weak economic environment.

Bears Say

- A significant rebound in new vehicle sales over the next few years could have a negative impact on demand for auto replacement parts, given fewer old vehicles on the road.
- Technological improvements have extended the quality and useful life of automotive parts, which may result in less frequent replacement and maintenance.
- High gasoline prices could result in deferrals of vehicle maintenance, which would weigh on the firm's results.

Financial Overview

Financial Health: O'Reilly is in good financial health. The firm leveraged up in 2008 due to the CSK acquisition, where long-term debt totaled $700 million. While O'Reilly has gradually paid off its borrowings over the past two years, the firm has recently taken up $500 million in debt to finance a three-year share repurchase program starting in January 2011. We estimate that O'Reilly can easily service its debt load using internally generated cash flows. Earnings before interest and taxes were on average a comfortable 10 times interest expense over the past five years, and we project that this rate will continue to improve going forward.

Company Overview

Profile: Founded in 1957, O'Reilly Automotive is one of the largest specialty retailers of automotive aftermarket parts, tools, supplies, equipment, and accessories in the United States. As of December 2010, the firm operated approximately 3,600 stores in 38 states serving both do-it-yourself customers and professional installers.

Management: Greg Henslee became CEO in February 2005, marking the first non-O'Reilly to hold that position. Former CEO David O'Reilly retained the role of chairman of the board. We like that the roles of CEO and chairman are split, as it ensures that an independent party is overseeing the CEO. Additionally, the firm appointed Paul Lederer as the lead independent director in 2001. However, we still have issues with the firm's corporate governance. The O'Reilly family has great influence over the board, accounting for four out of the nine board seats despite holding just 4%-5% of common stock. This could put the family's interests before those of shareholders. Upon retirement, each O'Reilly is entitled to a generous severance package and can remain as a consultant to the firm for as long as 10 years. The three members of the family who are retired earned about $170,000 each for their services in 2009. Finally, we frown upon the board's staggered election structure and poison pill, which insulate the company from takeovers.

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Analyst Notes

Oct. 27, 2011

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Sept. 08, 2011

O'Reilly Automotive Under Review

We are placing O'Reilly Automotive under review as we assess our financial modeling assumptions and transfer coverage to a new analyst.

With new-car sales still hovering at multiyear lows, industry tailwinds are not likely to meaningfully moderate in the near term, which gives us confidence in management's full-year revenue growth target of roughly 7%. With operating margins touching record levels yet again, this is shaping up to be another solid year for the firm. We like that O'Reilly generates significant free cash flow, has plenty of runway for growth, and has done a solid job integrating the CSK business.

Jul. 28, 2011

In-Line 2Q Operating Results for O'Reilly as Buybacks Add $0.02 to EPS; Increased Guidance Positive

O'Reilly Automotive posted second-quarter results that were in line with our projections, as solid end market demand and improving store productivity continue to drive near-term growth. Management increased its full-year earnings per share outlook to $3.42-$3.52 from $3.37-$3.47, but left sales guidance unchanged at $5.7 billion-$5.8

Analyst Notes (continued)

billion--a prudent move, in our view, given that the firm laps a 10% comp in the back half of the year. We are cognizant of these headwinds, but we plan to increase our fair value estimate by $4 (to $49), reflective of the time value of money ($2) and a slightly more favorable margin outlook for the balance of the year.

Total quarterly revenue rose 7% to nearly $1.5 billion, driven by a 4.4% increase in consolidated comparable-store sales--in line with management's guidance, but a little light of consensus estimates. While the industry's cyclical tailwinds (older cars on the road today) appeared less prevalent in the second-quarter results, this was still a strong sales showing, particularly given rising gas prices and lackluster economic growth. Operating margins rose 80 basis points year over year, to 15.0%, reflecting solid execution across the consolidated distribution system. Diluted earnings per share increased to $0.96, while a decreased share count (owing to $193 million in buybacks during the quarter) contributed $0.02.

With new-car sales still hovering at multiyear lows, industry tailwinds are not likely to meaningfully moderate in the near term, which gives us confidence in management's full-year revenue growth target of roughly 7%. With operating margins touching record levels yet again, this is shaping up to be another solid year for the firm. We like that O'Reilly generates significant free cash flow, has plenty of runway for growth, and has done a solid job integrating the CSK business. We do not view the shares as overly expensive (18 times our forward fiscal-year earnings estimate and an enterprise/EBITDA value of more than 9 times), but we would advise investors to wait for a more opportunistic entry point.

Disclaimers & Disclosures

No Morningstar employees are officers or directors of this company. Morningstar Inc. does not own more than 1% of the shares of this company. Analysts covering this company do not own its stock. The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.

O'Reilly Automotive Inc ORLY

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
5,708	10,099	Specialty Retail	Consumer Cyclical

Founded in 1957, O'Reilly Automotive is one of the largest specialty retailers of automotive aftermarket parts, tools, supplies, equipment, and accessories in the United States. As of December 2010, the firm operated approximately 3,600 stores in 38 states serving both do-it-yourself customers and professional installers.

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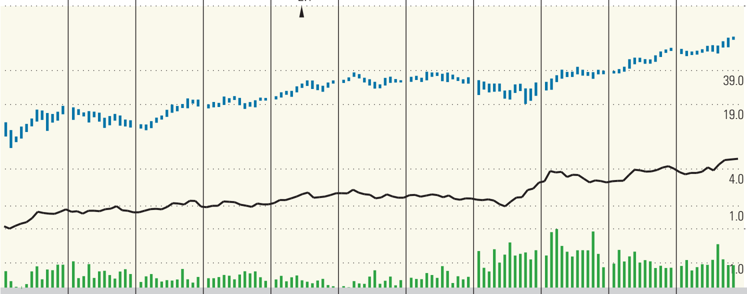
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
Under Review	78.70	—	—	None	C

per share prices in USD

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	
19.22	18.63	22.45	23.54	32.53	38.30	38.84	32.68	42.92	63.05	78.99	Annual Price High
7.75	12.05	11.46	18.03	21.98	27.49	30.43	20.00	26.47	37.47	53.33	Low
				2:1							Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low
78.99 - 53.33
10 Year High/Low
78.99 - 7.75
Bear-Market Rank
4 (10=worst)
Trading Volume Million

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
36.3	-30.7	52.5	16.8	42.1	0.2	1.1	-5.2	24.0	58.5	30.3	Total Return %
49.3	-7.3	26.1	7.8	39.1	-13.4	-2.4	33.3	0.6	45.7	29.8	+/- Market
-18.2	-20.7	-20.7	-10.4	48.1	4.5	-6.9	38.0	-48.7	30.9	22.5	+/- Industry
—	—	—	—	—	—	—	—	—	—	0.0	Dividend Yield %
1917	1348	2093	2487	3588	3643	3732	4135	5240	8521	10099	Market Cap USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
1092	1312	1512	1721	2045	2283	2522	3577	4847	5398	5708	Revenue USD Mil
42.8	42.2	42.2	43.2	43.6	44.1	44.4	45.5	48.0	48.6	48.7	Gross Margin %
114	138	165	190	253	282	305	336	538	713	824	Oper Income USD Mil
10.4	10.5	10.9	11.1	12.3	12.4	12.1	9.4	11.1	13.2	14.4	Operating Margin %
66	82	100	140	164	178	194	186	308	419	490	Net Income USD Mil
0.63	0.77	0.92	1.26	1.45	1.55	1.67	1.48	2.23	2.95	3.49	Earnings Per Share USD
—	—	—	—	—	—	—	—	—	—	—	Dividends USD
106	107	109	111	113	115	116	125	138	142	141	Shares Mil
5.29	6.10	7.22	8.58	10.22	12.00	13.84	16.97	19.54	22.76	22.06	Book Value Per Share USD
50	105	173	227	213	186	299	299	285	704	951	Oper Cash Flow USD Mil
-69	-102	-137	-173	-205	-229	-283	-342	-415	-365	-332	Cap Spending USD Mil
-18	2	36	53	8	-43	17	-43	-130	338	619	Free Cash Flow USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
8.4	8.8	9.1	10.7	10.4	9.7	9.1	5.8	6.8	8.5	9.4	Return on Assets %
13.0	13.6	13.9	16.1	15.7	14.2	13.1	9.6	12.4	14.2	16.6	Return on Equity %
6.1	6.2	6.6	8.1	8.0	7.8	7.7	5.2	6.3	7.8	8.6	Net Margin %
1.39	1.41	1.38	1.31	1.30	1.24	1.18	1.11	1.08	1.10	1.10	Asset Turnover
1.5	1.6	1.5	1.5	1.5	1.5	1.4	1.8	1.8	1.6	1.9	Financial Leverage

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	09-11	Financial Health
430	484	442	480	425	567	573	822	995	1072	1030	Working Capital USD Mil
166	190	121	100	25	110	75	725	684	357	797	Long-Term Debt USD Mil
556	651	784	948	1146	1364	1592	2282	2686	3210	2831	Total Equity USD Mil
0.30	0.29	0.15	0.11	0.02	0.08	0.05	0.32	0.25	0.11	0.28	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
29.0	16.5	21.0	21.4	22.1	20.7	19.4	20.8	17.1	20.5	22.6	Price/Earnings
—	—	—	—	—	—	—	—	—	1.2	1.6	P/E vs. Market
1.8	1.0	1.4	1.5	1.8	1.6	1.5	1.1	1.1	1.6	1.9	Price/Sales
3.5	2.1	2.7	2.6	3.1	2.7	2.3	1.8	2.0	2.6	3.6	Price/Book
38.5	13.0	12.2	11.1	16.9	19.8	12.6	12.9	18.4	12.2	11.6	Price/Cash Flow

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	11.4	28.9	21.4	19.8
Operating Income %	32.6	32.7	23.1	23.0
Earnings/Share %	32.3	20.9	15.3	19.4
Dividends %	—	—	—	—
Book Value/Share %	16.5	18.0	17.4	17.6
Stock Total Return %	30.4	47.1	19.2	18.0
+/- Industry	21.4	9.2	12.2	5.3
+/- Market	26.2	35.1	21.0	16.3

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	16.6	12.7	15.8	22.2
Return on Assets %	9.4	8.0	6.9	9.4
Fixed Asset Turns	2.9	2.9	9.2	7.4
Inventory Turns	1.5	1.6	4.8	15.6
Revenue/Employee USD K	121.1	103.5*	—	1045.0
Gross Margin %	48.7	46.1	31.4	38.3
Operating Margin %	14.4	11.6	4.7	16.3
Net Margin %	8.6	7.0	3.8	10.8
Free Cash Flow/Rev %	10.8	—	4.9	0.1
R&D/Rev %	—	—	—	9.9

Financial Position

Grade: A	12-10 USD Mil	09-11 USD Mil
Cash	30	277
Inventories	2023	2009
Receivables	184	202
Current Assets	2301	2537
Fixed Assets	1930	2058
Intangibles	744	744
Total Assets	5048	5397
Payables	952	1203
Short-Term Debt	1	1
Current Liabilities	1229	1506
Long-Term Debt	357	797
Total Liabilities	1838	2566
Total Equity	3210	2831

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	22.6	19.7	26.0	13.7
Forward P/E	18.1	—	—	13.8
Price/Cash Flow	11.6	15.2	13.3	6.9
Price/Free Cash Flow	17.9	—	20.9	15.8
Dividend Yield %	—	—	0.3	2.0
Price/Book	3.6	2.3	4.0	1.8
Price/Sales	1.9	1.4	1.0	1.2
PEG Ratio	1.0	—	—	1.6

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

Quarterly Results

Revenue USD Mil	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	1310.3	1382.7	1479.3	1535.5
Prior Year Period	1173.7	1280.1	1381.2	1425.9

Rev Growth %	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	11.6	8.0	7.1	7.7
Prior Year Period	5.3	10.0	10.4	13.3

Earnings Per Share USD	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	0.73	0.72	0.96	1.10
Prior Year Period	0.52	0.70	0.71	0.82

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
O'Reilly Automotive	10099	5708	22.6	16.6
AutoZone Inc	13469	8073	17.3	—
Genuine Parts Compan	9149	12252	16.9	19.4

Major Fund Holders

	% of shares
	—
	—
	—
	—

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

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
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."