

Capella Education Company CPLA [Nasdaq] | Under Review

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
49.29 USD	—	—	—	—	Wide	B	—	Education & Training Services

Final Department of Education Gainful Employment Rules Could Be Released Within the Next Week

by Morningstar Equity Analysts

Analysts covering this company do not own its stock.

Pricing data through May 17, 2011.
Rating updated as of May 17, 2011.

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



Analyst Note May 03, 2011 | Peter Wahlstrom, CFA
On its conference call May 3, 2011, Corinthian Colleges chairman and CEO Jack Massimino concluded his prepared remarks by stating that it was his understanding the proposed gainful employment rules were delivered to the Office of Management and Budget (OMB) the previous night. We contacted the OMB this afternoon, and a spokesperson confirmed that the proposed rules were received and that their office began its review this morning.

No additional information regarding the potential timing of a final ruling was made available; however, we note that when the initial draft of the gainful employment rule was submitted to the OMB last October, its review took approximately 10 days.

The hotly contested issue has drawn commentary, accolades, and criticism from multiple angles during its extended review period. The key factors at stake in the proposed gainful employment ruling (as of the most recent draft) were specific debt/income or debt/discretionary income ratios, and repayment rates. Although the gainful employment standards have arguably loosened a bit through an iterative process, they still have the potential to dramatically impact all of the for-profit education providers.

Our base-case financial models incorporate no meaningful change from the November 2010 draft; hence, if the previously defined cutoffs or variables were to shift substantially (or if further limitations were added), we would revisit our long-term financial assumptions. On the flip side, should the final rules be less restrictive than previously communicated, our fair value estimates for Apollo Group and Strayer Education could edge upward.

In the meantime, several for-profit institutions have attempted to improve their internal controls (and outward

appearance) by adopting changes to admissions and marketing programs, introducing student orientation programs, announcing new student service initiatives, and investing millions of dollars in advanced technology. Over the long term, we view some of these added costs to be structural in nature and have attempted to capture the potential impact in our operating margin assumptions.

Finally, department officials have been silent on the ultimate implementation date in recent months, despite a six-month delay in its ruling. We assume that adoption of the gainful employment proposals will remain at the current July 2012 date.

Thesis Jul. 27, 2010 | Morningstar Equity Analysts
Capella Education is a well-positioned company in the highly profitable education industry. With high demand for education, price-insensitive customers, minimal investment requirements, government-aided pricing, and a solid industry position, Capella possesses a wide economic moat, in our opinion.

Industry dynamics in the for-profit education sector are very favorable. The demand for education is much higher than that which traditional not-for-profit schools can supply. For-profit education companies, like Capella, have stepped in to fill this gap. However, tuition pricing is typically set by traditional schools, which have higher cost structures, and financial-aid limits are based upon those prices. The intense demand and government-set pricing allow companies like Capella, which have lower cost structures, to provide educational services at prices similar to those of traditional schools. With the availability of financial-aid and corporate tuition assistance, students tend to be price-inelastic, as up-front, out-of-pocket costs are low. This helps Capella, and others, raise tuition at rates above inflation.

Along with good industry dynamics, Capella's focus on working adults and advanced-degree, online education has positioned the company rather nicely. The average age of Capella's students is roughly 40 years old, and more than

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Industry Education & Training Services

Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Capella Education Company	USD	775	436	94	61
Apollo Group, Inc.	USD	5,860	4,972	829	392
DeVry, Inc.	USD	3,602	2,142	485	327

Morningstar data as of May 17, 2011.

80% are enrolled in master's or doctorate programs. Although this demographic is less countercyclical than the younger trade school demographic, Capella should do well in both good and bad economic environments. During good economic times, there is less demand for education, as more people are employed. However, with higher employment, more people have access to corporate tuition assistance, helping to prop up demand for higher-level online degrees for working adults. Although Capella does not benefit as much as trade schools from increased demand during weak economic times, Capella's more financially mature customers are less likely to drop out, helping to keep demand stable.

Additionally, Capella student demographics help it avoid the recent student lending issues because of concerns in the credit market. Less than 1% of revenue comes from private student loans. With a default rate well below industry averages, students should have limited issues securing financing for their education.

Also, Capella's online focus bodes well for increased profitability. Its high-teen operating margins are well below those of some of its competitors, which boast margins above 30%. However, Capella has only been public since 2006 and has yet to perfect its systems and gain the same scale advantages as others. As long as the company can keep costs contained (especially marketing costs), we expect to see sizable profitability improvements as the company expands its enrollment numbers.

Valuation, Growth and Profitability

We are raising our fair value estimate to \$105 from \$95 due to higher growth profitability expectations. We forecast compound annual revenue growth of 17% through 2014. This forecast includes revenue-per-student increases as well as a compound annual student enrollment growth of 16%. We forecast operating margins expanding from 19% in 2009 to 25% in 2014, as the company should be able to leverage its fixed cost structure, given the sizable top-line growth.

Risk

As economic times remain difficult, corporations may be less willing to provide tuition assistance to employees, and layoffs could affect current students, lowering demand for Capella's services. Also, lower-margin bachelor's degree programs are growing faster than more profitable advanced-degree segments, potentially slowing profitability gains. The education industry is highly regulated, and new rules could adversely affect the company. An audit of Capella's practices, pertaining to refunding government-aided loans for students who have dropped out, could cause the company to return funds and potentially face fines.

Bulls Say

- Less than 1% of revenue is derived from private student loans, and less than 1% of students utilize private loans. This limits the company's exposure to credit issues pertaining to private student lending.
- Capella's student default rates are low. Its 2.5% cohort default rate in 2007 (the most recent available cohort) is well below even the rates experienced at not-for-profit institutions.
- With its online focus, Capella has significant room for margin expansion.

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Bears Say

- As corporate layoffs mount, some students who previously received corporate tuition assistance may need to find other financing, or delay their education.
- As the economy remains weak, course loads per student may decline, which could lead to lower revenue.
- The Department of Education has proposed new rules that could limit growth or access to government financial aid for schools that fall outside of the proposed compliance standard.

directors are compensated in both cash and equity. We would like to see a larger percentage of equity in their compensation, as some directors have limited equity exposure to the company. Increased exposure would better align their interests with those of shareholders.

Financial Overview

Financial Health: Capella is in excellent financial health. It has zero debt and more than \$200 million in cash and marketable securities.

Company Overview

Profile: Capella is a regionally accredited, exclusively online postsecondary education company. It offers bachelor's, master's, and doctoral programs in behavioral health and human services, business management and technology, public service leadership, and education. More than 80% of students are enrolled in master's or doctoral programs. Capella serves roughly 39,000 students.

Management: In March 2009, Kevin Gilligan assumed the CEO position from founder Stephen Shank, who had served as CEO and chairman. In February 2010, Gilligan assumed the chairman role as well, with Shank remaining on the board. We think the recombining of the two positions is a step backward in terms of corporate governance. Gilligan most recently served as CEO of United Subcontractors, and previously was president and CEO of Honeywell International's second-largest business unit. Management compensation seems reasonable, and

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Analyst Notes

May 03, 2011

Final Department of Education Gainful Employment Rules Could Be Released Within the Next Week

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In the meantime, several for-profit institutions have attempted to improve their internal controls (and outward appearance) by adopting changes to admissions and marketing programs, introducing student orientation programs, announcing new student service initiatives, and investing millions of dollars in advanced technology. Over the long term, we view some of these added costs to be structural in nature and have attempted to capture the potential impact in our operating margin assumptions.

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Apr. 26, 2011

Capella Posts In-Line 1Q Amid Ongoing Shift Toward Investment

Capella Education reported in-line first-quarter results as strength in recurring (continuing) students offset a 36% drop in new enrollments. These enrollment trends are consistent with others in for-profit education, considering that increased economic, regulatory, and market/competitive uncertainty are clouding the near-term outlook.

We are keeping the company under review as we revisit our financial assumptions, but there were few signs from the quarterly results that suggest a near-term stabilization in new enrollments (something that we've been looking for across the industry).

The company is shifting its focus toward investing and brand-building in a more competitive external environment,

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Analyst Notes (continued)

which we view as prudent, but it will take time for these initiatives to bear fruit. Additionally, management indicated that its tuition increases would be smaller than last year, a somewhat surprising statement that we'll keep a close eye on. In the meantime, Capella is carefully managing expenses, as evidenced by the respectable 21.8% operating margin posted during the first quarter. The firm is spending more on advertising and marketing (in an attempt to attract and retain higher-quality candidates) and adjusting several of its programs and businesses to conform with potential Department of Education rule changes.

On the regulatory front, the Department of Education is

expected to release its final rules in the coming months, which has become a near-term industrywide overhang. It is still our view that the intent is not to permanently cripple the for-profit education industry, but rather increase transparency, accountability, and outcomes while addressing problem areas. We see a case for mid-single-digit top-line growth for the better-run for-profit education providers over a longer-term horizon, which still produces solid returns on invested capital and earnings power, but we recognize that there are still plenty of moving parts at this (late) stage in the process.

Mar. 31, 2011

8-K Filings Indicate Department of Education, Principal Accreditor Becoming More Active

Strayer Education filed an 8-K on Thursday disclosing that late last week, one of its smaller programs received an unfavorable preliminary program review report from the Department of Education. According to the filing, the firm's associate in arts in general studies is not an eligible program under Title IV of the Higher Education Act of 1965.

On the surface, the financial impact appears to be negligible, as the company will look to simply shift the roughly 700 affected students into another program at the institution. Details were limited, but we have two quick takeaways: (1) Strayer has apparently sidestepped the DoE's findings with relative ease, which makes us wonder whether the pending regulatory review contains more bark or bite. (2) We think the better-run for-profit institutions could ultimately benefit if the DoE cuts Title IV funding for other underperforming programs and the affected students seek to continue their educations at another institution.

In an unrelated event, Apollo Group filed an 8-K stating that its principal accreditor, the Higher Learning Commission,

has raised questions surrounding a number of the University of Phoenix's recruiting, admissions, and financial aid practices. This release follows an initial August 2010 inquiry by the HLC, and is not new news per se. Apollo has been furiously conducting an image overhaul through such acts as adjusting its recruiting process and introducing a new student orientation program. Again, the firm's goal is to shore up the appearance of its student services and support programs, an admittedly tough task given the sheer size of the organization (405,000 students).

We continue to believe Apollo and the other for-profit players face a net increase in administration, marketing and advertising, and information technology expenses over the longer term as firms adjust to comply with current and proposed operational and regulatory changes, which could ultimately pressure margins. Our cash flow projections take these additional costs into consideration, and despite increased near-term regulatory scrutiny, we continue to believe that current share prices excessively discount the normalized earnings power of the better-run for-profit education providers.

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Analyst Notes (continued)

Feb. 15, 2011

Capella Reports In-Line 4Q, Cites Additional Headwinds in 2011; Shares Remain Under Review

Capella Education posted in-line fourth-quarter and full-year results, but failed to offer any indication that the current headwinds have begun to abate. To the contrary, like many of its peers, Capella's management indicated that increased economic, regulatory, and market/competitive uncertainty has further clouded the near-term outlook. With many of the for-profit education providers now spending more on marketing to attract and retain higher-quality candidates and adjusting several of their programs and businesses to conform with potential Department of Education rule changes, we believe this will usher in a new era of more normalized enrollment growth and operating margins for even the better-positioned and well-regarded operators.

We are keeping our valuation under review while we rethink our near-term assumptions, which had previously factored in a more optimistic enrollment outlook for 2011. Management now expects a 35% drop in new enrollments

for the first quarter of 2011, which sets the stage for a potentially volatile year. Management also announced Tuesday that it will cut 8% of its nonfaculty workforce and adjust its discretionary and market spending in response to current business levels, a prudent move, in our view.

While the near-term uncertainty surrounding the three primary factors listed above is unnerving, it is still our view that the intent of the Department of Education is not to permanently cripple the for-profit education industry, but rather increase transparency, accountability, and outcomes while addressing problem areas. This isn't an easy task or quick fix, and there are still plenty of moving parts at this stage. We see a case for mid-single-digit top-line growth for the better-run for-profit education providers over a longer-term horizon, which still produces solid returns on invested capital and earnings power, yet we recognize the near-term industrywide overhang, which is unlikely to be resolved until (at the earliest) the Department of Education releases its final rules, expected in the first half of 2011.

Feb. 07, 2011

Three-Year Trial Cohort Default Rate Data Hold Few Surprises, but Ample Room for Improvement

On Friday, the Department of Education released its fiscal 2008 "three-year trial" cohort default rates for postsecondary institutions, with little fanfare. The data was widely expected to provide a more grim snapshot of the number (and percentage) of borrowers in default on student loans, which it did. The total number of borrowers in default nearly doubled under the stricter three-year measurement standard to more than 465,000 students systemwide, representing 13.8% of total borrowers. What drew more attention, was the fact that defaults at proprietary education providers jumped 114% and the three-year borrower default rate reached 25%.

Under the current rules, colleges with two-year default

rates of 25% or more for three consecutive years can lose eligibility for federal student aid; under the new rules, which go into effect next year, if default rates exceed 30% for three consecutive years colleges could lose eligibility. Most for-profit institutions are in decent shape, and there's time to adjust, but there's certainly ample room for improvement across the board.

The majority of the publicly traded for-profit education stocks were only down a couple percentage points following the release, with the exception of Universal Technical Institute (which separately reported a relatively weak outlook on Thursday evening) and Corinthian Colleges (where cohort default rates at its Everest College were in the 40% and 50% range). From an investor's standpoint, the

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data carried few major surprises, and the general stock reaction, while still negative, was somewhat rational and indicative of a more mixed and balanced sentiment than in the past.

We expect the Department of Education to publicly report preliminary cohort default rates for the 2009 federal fiscal year in the coming weeks, which could provide yet another catalyst for these stocks. Oddly, loans previously purchased by the Department of Education from the FFELP lenders (called "put loans") inadvertently excluded the cohort default rate data, which could add yet another layer of complexity (and confusion) to the upcoming release. We believe that, based on potentially lower overall service and quality of these loans, the fiscal 2009 data are more than

likely to reflect yet another increase in overall cohort default rates.

Uncertainty surrounding pending regulatory changes is still a meaningful overhang, and it's extremely difficult to handicap the ultimate impact on the share prices. Shares of most for-profit education stocks appear to be excessively discounting the normalized earnings power of these businesses over the medium and longer term. While we are not updating our fair value estimates for these stocks on the basis of Friday's release, we continue to monitor this entire sector closely, and we await further updates from the Department of Education and Congress.

Dec. 09, 2010

Latest Congressional Report Raises Additional Questions Surrounding For-Profit Education Funding

Shares of Apollo Group dropped 3% Thursday, in line with most of the firm's publicly traded peers, following the release of yet another congressional report that highlighted concerns surrounding the for-profit education sector.

The publication, "Benefitting Whom? For-Profit Education Companies and the Growth of Military Educational Benefits," points out the dramatic increase in Department of Defense and Veterans Affairs funds to for-profit education companies over the past few years. For example, revenue from military educational benefits at 20 for-profit schools increased 211% between 2009 and 2010, while revenue from DoD and VA educational programs at 18 for-profit schools more than sextupled (to \$460 million) over the past five years.

The release of the report is concerning on many levels. While it is not indicative of any wrongdoing on either party's side, it does raise some flags. For an industry that

indirectly generates the vast majority of its revenue from the U.S. government through various loan and grant programs, we think regulators have a vested interest and reason to keep a close watch on the educational system, its inputs, inner workings, and outputs.

We recently took a fresh look at the proprietary (for-profit) education industry and the companies under coverage and downgraded our moat rating on Apollo Group because of subtle changes inherent in its business model and financials, largely as a result of pending regulation, which we believe adds near-term uncertainty to nearly all players across the for-profit education sector.

Thursday's release reinforces our view. While we believe regulators do not intend to cripple this integral sector, the current message suggests that some level of change is required, and educators will probably need to adhere to a higher standard of accountability. Despite our pared-back growth forecasts, we continue to view shares of Apollo

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Group as undervalued and believe the current stock price does not fully reflect the company's normalized earnings

power over the medium term.

Nov. 12, 2010

Capella Education Remains Under Review

We are keeping Capella Education under review as we continue to test the sensitivity of our operating assumptions. Given the Department of Education regulatory overhang, we believe that near-term uncertainty will continue among the for-profit education sector. We are still evaluating Capella's longer-term ability to gain market

share, particularly in Associate/Bachelor degree and online markets, amid proposed regulatory changes and elevated competition from other education providers. Additionally, we plan to further analyze the firm's enrollment and tuition growth potential in North America, which is a key driver of our valuation.

Disclaimers & Disclosures

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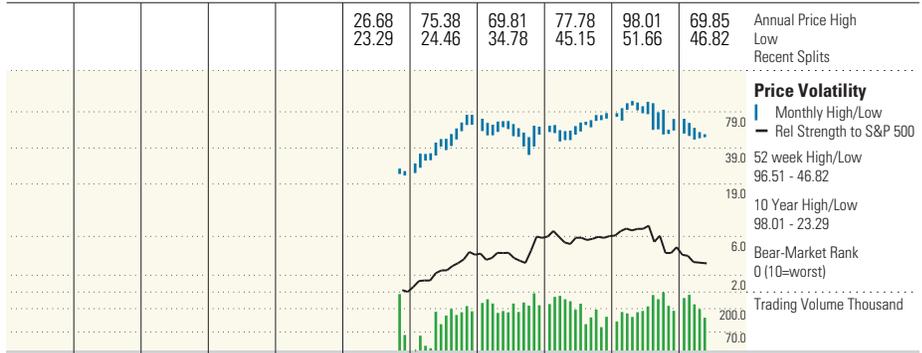
Capella Education Company **CPLA**

Sales USD Mil 436 **Mkt Cap USD Mil** 775 **Industry** Education & Training Services **Sector** Consumer Defensive

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per share prices in USD



Growth Rates Compound Annual					
Grade: B	1 Yr	3 Yr	5 Yr	10 Yr	
Revenue %	27.3	23.5	23.4	—	
Operating Income %	48.6	46.9	44.9	—	
Earnings/Share %	45.0	39.9	33.5	—	
Dividends %	—	—	—	—	
Book Value/Share %	16.4	12.0	—	—	
Stock Total Return %	-47.0	-8.0	—	—	
+/- Industry	-18.2	-0.9	—	—	
+/- Market	-63.9	-5.7	—	—	

Profitability Analysis				
Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	30.9	24.4	11.9	23.0
Return on Assets %	24.1	17.2	6.1	8.8
Fixed Asset Turns	10.4	8.4	5.5	7.3
Inventory Turns	—	—	55.9	14.7
Revenue/Employee USD K	147.0	169.8*	—	942.1
Gross Margin %	61.3	57.2	57.6	39.5
Operating Margin %	21.6	15.9	16.7	15.3
Net Margin %	13.9	11.0	5.8	10.3
Free Cash Flow/Rev %	13.2	11.7	12.8	0.1
R&D/Rev %	—	—	—	9.9

Financial Position		
Grade:	12-10 USD Mil	03-11 USD Mil
Cash	77	77
Inventories	—	—
Receivables	14	12
Current Assets	218	208
Fixed Assets	45	44
Intangibles	—	—
Total Assets	263	252
Payables	5	14
Short-Term Debt	—	—
Current Liabilities	41	41
Long-Term Debt	—	—
Total Liabilities	54	54
Total Equity	209	198

Valuation Analysis				
	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	13.5	31.2	13.4	15.7
Forward P/E	15.3	—	—	13.5
Price/Cash Flow	9.9	18.9	7.1	9.0
Price/Free Cash Flow	14.3	30.1	10.0	18.2
Dividend Yield %	—	—	0.5	1.8
Price/Book	3.9	6.0	2.7	2.2
Price/Sales	1.9	3.4	1.3	1.4
PEG Ratio	0.9	—	—	1.6

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
—	—	—	—	—	—	169.9	-10.2	28.1	-11.6	-26.0	Total Return %
—	—	—	—	—	—	166.4	28.3	4.7	-24.4	-31.7	+/- Market
—	—	—	—	—	—	129.4	5.3	31.0	14.5	-31.2	+/- Industry
—	—	—	—	—	—	—	—	—	—	0.0	Dividend Yield %
—	—	—	—	—	373	1128	979	1262	1086	775	Market Cap USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
30	50	82	118	149	180	226	272	335	426	436	Revenue USD Mil
28.8	43.4	—	50.0	52.3	53.5	55.7	55.8	59.6	61.5	61.3	Gross Margin %
-14	-6	—	10	15	18	30	40	64	95	94	Oper Income USD Mil
-45.9	-12.1	—	8.4	10.0	9.9	13.2	14.7	19.1	22.3	21.6	Operating Margin %
-13	-6	4	19	10	13	23	29	43	61	61	Net Income USD Mil
-1.54	-0.58	0.39	1.62	0.86	1.06	1.33	1.66	2.51	3.64	3.64	Earnings Per Share USD
—	—	—	—	—	—	—	—	—	—	—	Dividends USD
8	10	11	12	12	13	17	17	17	17	17	Shares Mil
—	—	—	—	—	6.10	9.11	8.45	10.99	12.79	12.59	Book Value Per Share USD
-10	0	—	16	29	29	37	45	69	88	83	Oper Cash Flow USD Mil
—	-4	—	-8	-9	-15	-16	-14	-16	-25	-26	Cap Spending USD Mil
—	-4	—	9	20	14	21	30	53	63	57	Free Cash Flow USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
-54.3	-19.1	—	23.5	11.0	11.4	13.8	15.2	20.8	24.8	24.1	Return on Assets %
—	—	—	—	—	26.9	18.2	19.3	26.3	31.2	30.9	Return on Equity %
-43.5	-11.4	5.4	16.0	6.9	7.5	10.1	10.6	12.8	14.4	13.9	Net Margin %
1.25	1.67	—	1.47	1.60	1.53	1.37	1.43	1.63	1.72	1.73	Asset Turnover
—	—	—	—	18.2	1.4	1.3	1.3	1.3	1.3	1.3	Financial Leverage

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	03-11	Financial Health
—	—	—	38	54	69	129	113	156	177	168	Working Capital USD Mil
—	—	—	—	—	—	—	—	—	—	—	Long-Term Debt USD Mil
-21	-26	—	0	14	94	157	141	184	209	198	Total Equity USD Mil
—	—	—	—	—	0.00	—	—	—	—	—	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
—	—	—	—	—	22.9	49.3	35.3	30.0	18.3	13.5	Price/Earnings
—	—	—	—	—	—	—	—	—	1.0	0.9	P/E vs. Market
—	—	—	—	—	1.6	5.0	3.7	3.8	2.6	1.9	Price/Sales
—	—	—	—	—	4.0	7.2	7.0	6.8	5.2	3.9	Price/Book
—	—	—	—	—	10.1	30.2	22.7	18.6	12.7	9.9	Price/Cash Flow

Quarterly Results						
Revenue USD Mil	Jun 10	Sep 10	Dec 10	Mar 11		
Most Recent Period	105.2	105.0	114.7	111.3		
Prior Year Period	80.1	83.6	94.5	101.2		
Rev Growth %	Jun 10	Sep 10	Dec 10	Mar 11		
Most Recent Period	31.3	25.7	21.4	10.0		
Prior Year Period	21.3	28.1	24.8	32.4		
Earnings Per Share USD	Jun 10	Sep 10	Dec 10	Mar 11		
Most Recent Period	0.86	0.80	1.09	0.90		
Prior Year Period	0.56	0.57	0.89	0.89		

Industry Peers by Market Cap				
	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Capella Education Co	775	436	13.5	30.9
Apollo Group, Inc.	5860	4972	15.5	29.5
DeVry, Inc.	3602	2142	11.3	26.5

Major Fund Holders		% of shares
TCW Small Cap Growth I		1.23
TimesSquare Small Cap Growth Instl		0.30
TCW Growth Equities I		0.22

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

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

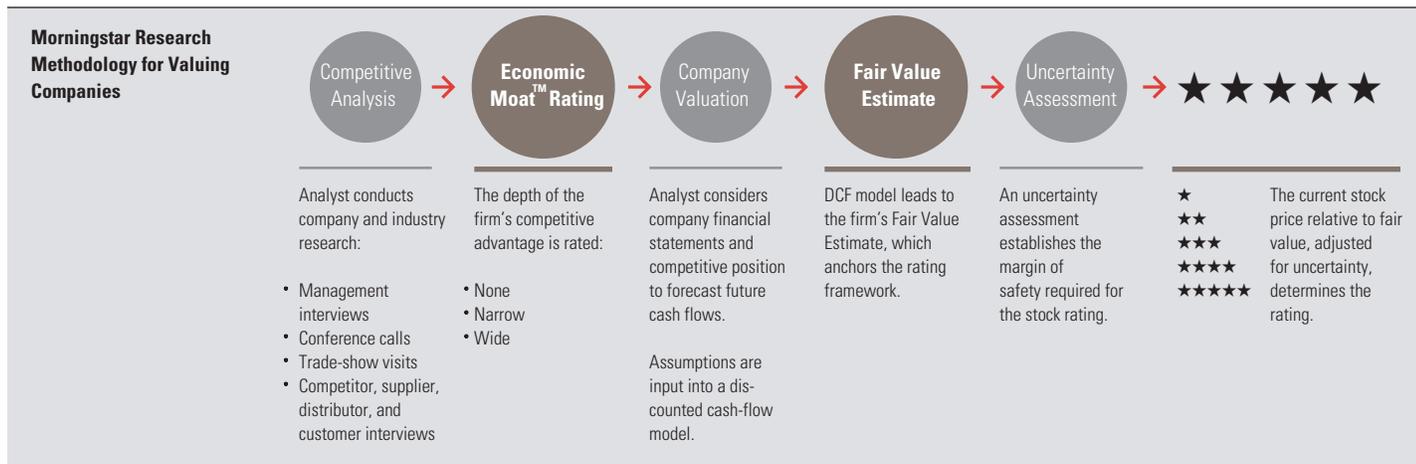
just on movement in the share price. If we think a stock's fair value is \$50, and the shares decline to \$40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at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

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."