Sysco Corporation SYY [NYSE] | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
29.30 USD	36.00 USD	25.20 USD	48.60 USD	Medium	Wide	B	A+	Food Distribution

Expenses Outpace Profit Growth in Sysco's 2Q; Shares Remain Undervalued

by Erin Lash, CFA
Senior Stock Analyst
Analysts covering this company do not own its stock.

Pricing data through February 14, 2012.
Rating updated as of February 14, 2012.

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

Analyst Note Feb. 06, 2012 | Lauren DeSanto

Second-quarter results from Sysco Corporation showcased strong sales growth of 9.2% to $10.2 billion, compared with the year-ago quarter, which included the benefit of a 6.3% increase from higher food costs the firm was able to pass along to its customers. Gross profits increased a healthy 4.8% as well as gross profit per case and gross profit per stop also showed improvement. With expenses up 7.1% on a reported basis, and 5.5% on an adjusted basis (which excludes costs related to the firm's restructuring efforts), however, operating profits were squeezed, increasing only 2.5% versus the same period last year on an adjusted basis. The stock has sold off today on the news, but we think the shares would need to trade lower before they would present an attractive entry point to our $36 fair value estimate that remains unchanged following today's results. At current market prices Sysco's shares are trading at a multiple of 14.2 times our estimate of fiscal 2012 earnings per share and relatively undervalued. As much as we like this stable, wide-moat company, however, we assign it a medium degree of uncertainty that we believe is appropriate given the high food inflation and stagnant growth environment the firm currently faces.

On the conference call, management discussed their surprise at the effort required to drive volume growth, but with it still very early innings in any consumer rebound, we see this as costs to take market share when the market isn't growing. Sysco should be well positioned when there is a more consistent, positive cadence to restaurant sales. Finally, about $58 million of increased expenses during the quarter were related to payroll expenses as the firm lapped a weak base period with much lower bonus accruals. In several weeks Sysco will present at the Consumer Analyst Group of New York, or CAGNY, conference in Boca Raton, Fla. We anticipate getting more insight into management's expectations for volume growth, and its impact on profitability, at that time.

Thesis Jan. 10, 2012 | Erin Lash, CFA

Sysco is the leading food-service distributor in the United States and Canada, with around 17% share of this estimated $220 billion market. Although food distributing is generally a low-margin, capital-intensive business, economies of scale have allowed Sysco to post returns consistently on invested capital in excess of our estimate of the firm's cost of capital. Through more than 150 acquisitions since its founding about 40 years ago, Sysco has developed a wide-reaching distribution network over which to spread high fixed costs that no other competitor has been able to replicate.

The firm distributes more than 400,000 traditional food and nonfood products, serving 400,000 customers in various industries and has expanded into other profitable niche segments, such as health care, education, and lodging. In an effort to solidify customer relationships, Sysco has made it a priority to consult with clients on how they can drive sales and minimize costs (an advantageous undertaking, given that about 80% of its sales are derived from smaller customers).

Despite being a low-cost operator, Sysco is keenly focused on trimming additional costs from its already lean operating structure. For instance, Sysco is working to improve its supply chain by more efficiently routing deliveries, as well as by building several redistribution centers. However, what has been most impressive to us is the pace by which Sysco is rolling out this vast undertaking. The firm has spent two years designing and testing these new processes and procedures thus far, and in light of some performance issues that have surfaced, Sysco is extending the testing phase in order to minimize problems on a broader scale--a wise move, from our perspective. Management has been vague regarding its expectations for the benefits of these efforts; but in our view, the potential for higher customer retention, the ability to better serve customers, and improved reporting should prop up revenue and limit unnecessary expenses.

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Sysco Corporation	USD	17,128	41,018	1,925	1,148
Kroger Co	USD	13,720	88,993	2,262	1,187

Morningstar data as of February 14, 2012.

That said, because the project is still in the very early stages, we aren't forecasting any meaningful benefit over the near term.

Even with these competitive advantages, Sysco is not without its share of challenges. While a modest level of food inflation (2%-3%) is ideal for Sysco, a rapid spike in food costs could pressure the firm and its customers--as it is now. Sysco estimates that food cost inflation amounted to 4.6% in fiscal 2011 (versus 1.5% deflation in the year-ago period). Historically, the company has been able to pass along these higher costs to its customers, but double-digit inflation in categories such as dairy, meat, and seafood make this pass-through more challenging. Further, the runup in raw material prices reflects recent supply constraints, but we think increasing demand for inputs in emerging markets will place upward pressure on commodities over the longer term. Although we expect sales volumes to remain lumpy in the near term, we believe Sysco's expansive distribution network will enable it to remain the dominant North American food distributor, generating strong cash flows and outsize returns for shareholders over the longer term.

Valuation, Growth and Profitability

After reviewing Sysco's fiscal first-quarter 2012 results, we're maintaining our $36 per share fair value estimate, which implies forward price/earnings of 17 times, enterprise value/EBITDA of 9.7 times, and a free cash flow yield of 3.9%. Given the fragile state of today's consumer, we expect that restaurant traffic (and ultimately consumer spending levels) could remain lumpy, which hinders near-term sales. We forecast that sales will increase 2.1% in fiscal 2012 compared with the year-ago period. Longer term, we forecast that Sysco will benefit as consumer spending picks up, resulting in 3%-4% annual sales growth through fiscal 2016. In our view, the firm's constant focus on improving its cost structure will enable Sysco to offset volatile input costs. By fiscal 2015, we forecast operating margins of 5.3% (about in line with fiscal 2010). We expect return on invested capital to average 17% compared with our 9% cost of capital assumption during the next five years, providing support to our opinion that Sysco maintains a wide economic moat.

Risk

If global economic headwinds persist and food inflation accelerates, Sysco's financial results could be pressured. Furthermore, given that two thirds of sales result from the restaurant industry, the firm depends on the strength of consumer spending, which has been fragile, partly as a result of high unemployment and anemic wage growth. Because input costs (such as food and fuel) are a significant component of Sysco's cost structure, high commodity costs can also weigh on results.

Bulls Say

- Sysco is the largest food-service distributor in North America, with 17% share of the market. It's followed by U.S. Foodservice with 9% share, and Performance Food Group with 5%.
- The firm's supply-chain initiatives, which include building nine distribution centers, should allow Sysco to consolidate inventory and negotiate more favorable procurement terms with suppliers.
- Because of its continued emphasis on stringent cost management, Sysco has realized returns that are about

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3 times the level of its peers.

- Although operating margins only amount to about 5%, Sysco has generated returns on invested capital (including goodwill) of about 18% on average during the last five years.
- We are encouraged by the diversity of the firm's customer base, as no single customer accounts for more than 10% of Sysco's consolidated sales.

Bears Say

- Erratic changes in energy prices, which affect packaging and distribution costs for Sysco, as well as volatile input costs are proving to be a major headwind for food-service distributors.
- Given that about two thirds of Sysco's sales result from the restaurant sector, we don't expect volume pressure to abate over the near term, as today's consumer still remains fragile.
- Sysco is undergoing a major business transformation, the results of which are far from a guarantee. In addition, any implementation challenges could distract management from the firm's core business operations.
- Elevated gas prices and stubbornly high unemployment levels are plaguing an already fragile consumer, and as a result, restaurants may back away from raising prices over the near term, which would ultimately force Sysco to bear the brunt of higher food costs.

Financial Overview

Financial Health: We aren't concerned about the amount of financial leverage on Sysco's balance sheet. At the end of fiscal 2011, the total debt/capital ratio amounted to around 0.4, and operating income covered interest expense more than 16 times. During the next five years, we forecast the debt/capital ratio to stay about flat relative to fiscal 2011 and earnings before interest and taxes to cover interest expense nearly 15 times.

Company Overview

Profile: Sysco operates as the largest North American food-service distributor, controlling 17% of the market. The firm distributes more than 400,000 food and nonfood products to 400,000 customers, including restaurants, health-care and educational facilities, and lodging establishments. From its founding in 1969 through the end of fiscal 2011, Sysco acquired more than 150 companies or divisions of companies to expand its footprint. Nearly 100% of the firm's sales are derived in North America.

Management: Overall, we think that Sysco's corporate governance practices are sound. Bill DeLaney, 55, assumed the role of CEO in 2009. With his nearly 25 years at Sysco, we believe DeLaney's experience is a huge asset to this food-service distributor, particularly given the challenging economic landscape the firm is facing. In our opinion, executive compensation appears reasonable, with about 80%-90% of management's annual pay based on the firm's performance. We commend executive management for taking a 5% reduction in its base pay in 2008 in light of the difficult economic environment. We believe this was a strong signal to the rest of its managers how committed the firm is to maintaining strict expense control. DeLaney earned $4.9 million in salary, bonus, and stock awards in fiscal 2011. We're pleased that Sysco operates with different individuals holding the CEO and chairman positions. Manuel Fernandez, 65, was appointed as Sysco's nonexecutive chairman in June 2009. Since 2000, Fernandez has served as a managing director for SI Ventures, a venture capital firm, and as chairman emeritus of Gartner, an information technology research and consulting company. The board consists of 11 members, nine of whom are independent. The firm already enacted majority voting for board members (which we applaud), and we're encouraged that Sysco has proposed to move

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away from its staggered three-year election structure.

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Analyst Notes

Feb. 06, 2012

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Nov. 07, 2011

Higher Food Costs Take Center Stage in Sysco's 1Q; Shares Modestly Undervalued

Food cost inflation has yet to abate, as evidenced by Sysco's fiscal first-quarter sales and profits, but results are tracking in line with our expectations and our $36 fair value estimate remains in place. While concerns surrounding higher food cost inflation and sluggish restaurant traffic have weighed on the shares, we take a longer-term view of the firm's prospects. From our perspective, management's focus to expand its distribution platform, improve supply-chain efficiency, and increase salesforce productivity will drive growth and will prevent its competitive advantages from eroding. Further, at just 13 times our forward fiscal 2012 earnings estimate (versus 17 times at our fair value estimate) and with a 4% dividend yield, Sysco should please both growth and income investors, in our opinion.

First-quarter sales increased 7.9% (excluding acquisitions), driven by 7.3% food cost inflation (primarily due to higher costs for dairy, meat, and canned/dry food). What strikes us is the degree to which food inflation has continued to run rampant--it's up from 3.3% in last year's first quarter and 5.9% in the sequential period. A modest level of food inflation (2%-3%) is ideal for Sysco, but a rapid spike in food costs similar to the current situation could weigh on the firm and its customers--as it is now. Elevated gas prices and stubbornly high unemployment levels are plaguing an already fragile consumer, and as a result, restaurants may back away from raising prices over the near term, which

Analyst Notes (continued)

forces Sysco to bear the brunt of these higher food costs, as compared with the past when Sysco would pass these cost increases on to its customers. We expect that restaurant traffic and ultimately consumer spending levels could remain lumpy, which may hinder near-term results; we forecast sales will increase just 2.1% in fiscal 2012 compared with the year-ago period.

Higher food costs also plagued the firm's margins, as the adjusted operating margin contracted 10 basis points to 5.2%, reflecting a 40-basis-point reduction in the gross margin. Sysco competes in a capital-intensive industry, but its stringent cost-management focus has enabled it to generate fairly consistent profitability in excess of 5% despite the onslaught of headwinds. Management isn't resting on its laurels, as it is working to trim additional fat from its already lean operating structure. Although the firm has been vague regarding its expectations for the benefits of these efforts, the potential for higher customer retention, the ability to better serve customers, and improved reporting should prop up revenue and limit unnecessary expenses, in our opinion. But because the project is still in the very early stages, we aren't forecasting any meaningful benefit over the near term. We forecast operating margins of 5.1% in fiscal 2012 (flat year over year but up from 4.8% on average over the past five years).

Aug. 24, 2011 **Mini-Tender Offer for Sysco's Shares Undervalues This Wide-Moat Name**

On Tuesday, Sysco disclosed that investment firm TRC Capital made an unsolicited tender offer to acquire 3.5 million shares (0.6% of outstanding shares) for $26.65 each, a 26% discount to our fair value estimate and a 2% discount to the food-service distributor's recent stock price. We are not making any changes to our fair value estimate based on this announcement, but we recommend that investors turn down the offer, as it grossly undervalues the firm. Concerns about higher food cost inflation and sluggish restaurant traffic are weighing on the shares, but from our perspective, this creates an attractive entry point for shareholders looking to build a position in a wide-moat consumer defensive name. We take a longer-term view of the firm's prospects and believe that management's focus to expand Sysco's distribution platform, improve supply-chain efficiency, and increase salesforce productivity will drive growth and prevent the firm's competitive advantages from eroding. At 12 times our fiscal 2012 earnings per share forecast (versus our fair value estimate of 16 times), the shares are trading at a discount to our fair value estimate.

Aug. 15, 2011 **Food Cost Inflation Plagues Sysco, but Stock's Retreat Could Create an Attractive Entry Point**

The sizable headwinds created by rampant cost inflation have yet to subside, as evidenced by Sysco's fourth-quarter and fiscal-year results. However, full-year results came in about where we expected, and we don't anticipate making any material changes to our fair value estimate. The stock has traded down nearly 6% in midday trading, as concerns surrounding higher food cost inflation and sluggish restaurant traffic are likely weighing on the shares. From our perspective, this sell-off could create an attractive entry point for shareholders looking to build a position in a wide moat consumer defensive name. We take a longer term view of the firm's prospects and believe that management's focus to expand Sysco's distribution platform, improve supply-chain efficiency, and increase salesforce productivity will drive growth and will prevent its competitive advantages from eroding. At 12 times our

Analyst Notes (continued)

fiscal 2012 earnings per share forecast (versus our fair value estimate of 16 times), the shares are trading at a discount to our fair value.

Adjusting for an extra week in the year-ago period, acquisitions, and foreign currency movements, fourth-quarter sales increased 6.9%, reflecting 5.9% food cost inflation (primarily due to higher costs for dairy, meat, seafood, and canned/dry food). Although a modest level of food inflation (2%-3%) is ideal for Sysco, a rapid spike in food costs (similar to the current situation) could pressure the firm and its customers--as it is now. Sysco has historically been able to pass along these higher costs to its customers, but excessive inflation in certain categories makes this pass-through more difficult. Management anticipates that as its primary customers (restaurants) begin to raise prices, it should become easier for Sysco to increase its prices as well. However, elevated gas prices, lackluster wage growth, and stubbornly high unemployment levels are still weighing on an already fragile consumer, and as a result, restaurants may back away from raising prices anytime soon.

It was a similar story with regards to the firm's profitability, as input cost inflation and increased promotional spending weighed on margins. The adjusted operating margin contracted 20 basis points to 5.4%, thanks to a 60 basis point reduction in the adjusted gross margin. But this level of profitability is still notable, given the capital-intensive nature of the food distribution industry. Beyond the pressures created by higher costs, Sysco continues to employ some strategic pricing to prop up its volume and market share in specific geographies and categories. In our opinion, competitive pricing is not a sustainable long-term strategy--and we think management agrees with us--but we expect that rational pricing will reemerge. We believe the high-level of service provided by Sysco's massive sales team--more than 8,000 individuals--is a more important differentiation (rather than merely just lower prices) that is difficult (if not impossible) for competitors to replicate given their lack of scale.

Sysco Corporation SYY

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
41,018	17,128	Food Distribution	Consumer Defensive

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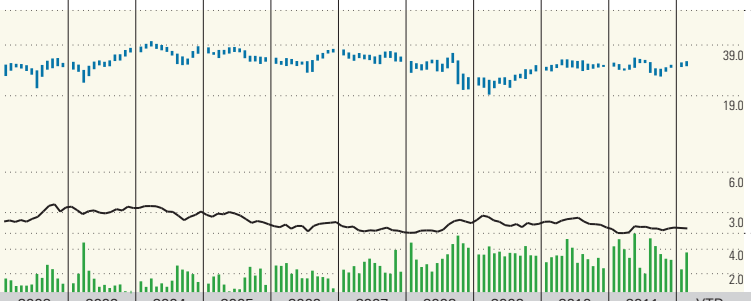
★★★★	29.30	36.00	Medium	Wide	B

per share prices in USD

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	
32.58 / 21.25	37.57 / 23.00	41.27 / 29.48	38.04 / 29.98	37.04 / 26.50	36.74 / 29.90	35.00 / 20.74	29.48 / 19.39	31.99 / 26.99	32.76 / 25.09	31.18 / 28.70	Annual Price High / Low / Recent Splits



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

52 week High/Low
32.76 - 25.09

10 Year High/Low
41.27 - 19.39

Bear-Market Rank
6 (10=worst)

Trading Volume Million

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
14.2	26.5	3.6	-17.1	20.6	-13.0	-22.9	26.0	7.9	3.3	0.8	Total Return %
37.6	0.1	-5.4	-20.1	7.0	-16.5	15.6	2.6	-4.9	3.3	-6.6	+/- Market
2.2	-1.5	-3.3	-1.4	-2.7	-1.1	2.2	0.3	-3.8	-1.9	-1.2	+/- Industry
1.3	1.2	1.4	1.9	1.9	2.4	3.9	3.5	3.4	3.5	3.6	Dividend Yield %
19566	24093	24421	19260	22722	18981	13744	16543	17201	17188	17128	Market Cap USD Mil

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Financials
23351	26140	29335	30282	32628	35042	37522	36853	37244	39323	41018	Revenue USD Mil
19.8	19.7	19.3	19.1	19.3	19.3	19.2	19.1	19.1	18.6	18.3	Gross Margin %
1161	1324	1533	1590	1495	1708	1880	1872	1976	1932	1925	Oper Income USD Mil
5.0	5.1	5.2	5.2	4.6	4.9	5.0	5.1	5.3	4.9	4.7	Operating Margin %
680	778	907	961	855	1001	1106	1056	1180	1152	1148	Net Income USD Mil
1.01	1.18	1.37	1.47	1.36	1.60	1.81	1.77	1.99	1.96	1.95	Earnings Per Share USD
0.34	0.42	0.50	0.58	0.66	0.74	0.85	0.94	0.99	1.03	1.05	Dividends USD
673	660	662	654	629	626	611	596	594	589	589	Shares Mil
3.35	3.66	4.44	4.37	5.15	5.48	5.50	6.64	6.83	8.00	8.02	Book Value Per Share USD
1085	1373	1190	1192	1124	1403	1596	1582	885	1092	1347	Oper Cash Flow USD Mil
-416	-436	-530	-390	-515	-603	-516	-465	-595	-636	-753	Cap Spending USD Mil
669	937	659	802	609	800	1080	1118	291	455	595	Free Cash Flow USD Mil

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Profitability
11.9	12.0	12.3	11.9	9.9	10.8	11.3	10.4	11.5	10.6	10.5	Return on Assets %
31.8	36.0	38.1	36.1	29.4	31.6	33.1	30.8	32.4	27.0	26.4	Return on Equity %
2.9	3.0	3.1	3.2	2.6	2.9	2.9	2.9	3.2	2.9	2.8	Net Margin %
4.08	4.04	3.97	3.76	3.78	3.79	3.83	3.63	3.63	3.62	3.77	Asset Turnover
2.8	3.2	3.1	3.0	3.0	2.9	3.0	3.0	2.7	2.4	2.4	Financial Leverage

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	12-11	Financial Health
946	928	725	544	1173	1260	1676	2121	2067	2158	2384	Working Capital USD Mil
1176	1249	1231	956	1627	1758	1975	2467	2473	2280	2649	Long-Term Debt USD Mil
2133	2198	2565	2759	3052	3278	3409	3450	3828	4705	4688	Total Equity USD Mil
0.55	0.57	0.48	0.35	0.53	0.54	0.58	0.72	0.65	0.48	0.57	Debt/Equity

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
27.5	29.1	26.9	22.0	25.4	18.1	12.7	14.6	15.2	15.1	15.0	Price/Earnings
—	—	—	—	—	—	—	—	—	0.9	1.0	P/E vs. Market
0.8	0.9	0.8	0.6	0.7	0.5	0.4	0.5	0.5	0.4	0.4	Price/Sales
8.9	10.2	8.6	7.1	7.1	5.7	4.2	4.2	4.3	3.7	3.6	Price/Book
16.9	19.1	21.2	17.8	17.0	15.3	7.9	14.2	17.0	12.8	12.8	Price/Cash Flow

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Growth Rates Compound Annual

Grade: C	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	5.6	1.6	3.8	6.1
Operating Income %	-2.3	0.9	5.3	6.4
Earnings/Share %	-1.5	2.7	7.7	8.3
Dividends %	4.0	6.6	9.3	14.3
Book Value/Share %	22.3	11.9	10.0	9.6
Stock Total Return %	8.3	11.0	-0.2	2.4
+/- Industry	-0.4	-3.5	-1.1	-1.3
+/- Market	6.9	-6.8	1.3	0.9

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	26.4	31.0	21.8	22.6
Return on Assets %	10.5	10.9	8.7	9.5
Fixed Asset Turns	11.5	12.6	13.1	7.5
Inventory Turns	16.1	17.1	13.0	16.1
Revenue/Employee USD K	891.7	816.2*	—	1050.9
Gross Margin %	18.3	19.1	16.9	38.3
Operating Margin %	4.7	5.0	4.2	16.7
Net Margin %	2.8	3.0	2.4	11.2
Free Cash Flow/Rev %	1.5	2.0	0.9	0.1
R&D/Rev %	—	—	—	9.7

Financial Position

Grade: A	06-11 USD Mil	12-11 USD Mil
Cash	640	337
Inventories	2074	2213
Receivables	2898	2883
Current Assets	5733	5648
Fixed Assets	3512	3736
Intangibles	1743	1733
Total Assets	11386	11454
Payables	2183	2074
Short-Term Debt	389	208
Current Liabilities	3575	3264
Long-Term Debt	2280	2649
Total Liabilities	6680	6766
Total Equity	4705	4688

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	15.0	15.1	15.4	14.6
Forward P/E	14.1	—	—	13.4
Price/Cash Flow	12.8	13.4	12.8	7.4
Price/Free Cash Flow	29.1	28.4	31.1	17.0
Dividend Yield %	3.6	—	3.0	2.0
Price/Book	3.6	4.4	3.1	2.0
Price/Sales	0.4	0.5	0.4	1.2
PEG Ratio	2.0	—	—	1.5

Quarterly Results

Revenue USD Mil	Mar 11	Jun 11	Sep 11	Dec 11
Most Recent Period	9761.7	10425.7	10586.4	10244.4
Prior Year Period	8945.1	10348.5	9751.3	9384.9

Rev Growth %	Mar 11	Jun 11	Sep 11	Dec 11
Most Recent Period	9.1	0.8	8.6	9.2
Prior Year Period	2.4	13.9	7.4	5.8

Earnings Per Share USD	Mar 11	Jun 11	Sep 11	Dec 11
Most Recent Period	0.44	0.57	0.51	0.43
Prior Year Period	0.42	0.57	0.51	0.44

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Sysco Corporation	17128	41018	15.0	26.4
Kroger Co	13720	88993	12.2	23.3

Major Fund Holders

	% of shares
	—
	—
	—

*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
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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.

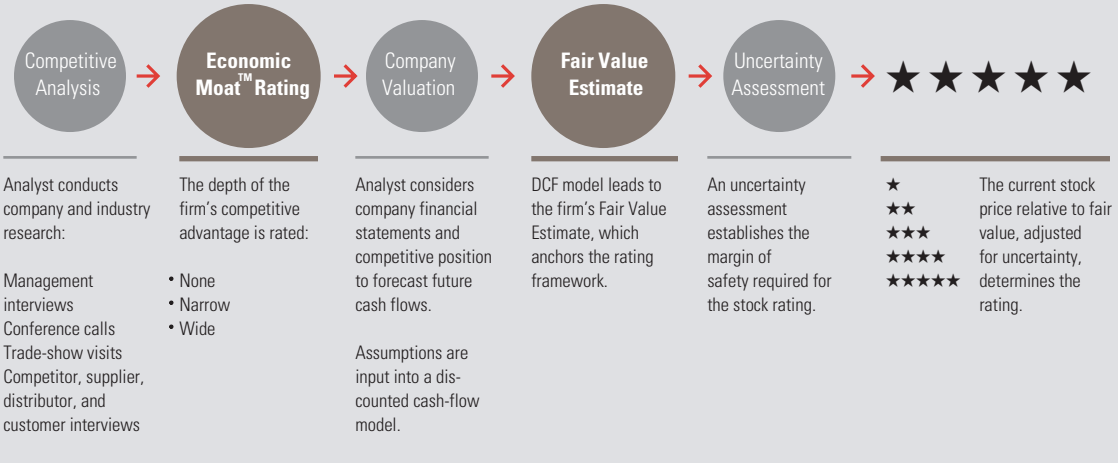
Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely 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



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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."