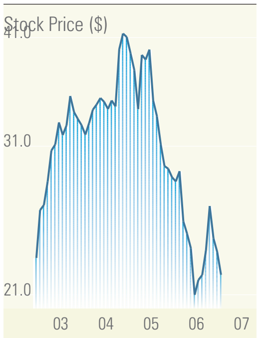
Dell DELL

Morningstar Rating	Last Price	Fair Value	Consider Buy	Consider Sell	Business Risk	Economic Moat	Stewardship Grade	Industry	Sector
★★★★★	$22.50	$34.00	$26.20	$42.60	Average	Wide	D	Computer Equip.	Hardware

Dell's Turnaround Will Take Time

by Rick Hanna
Stock Analyst
Analysts covering this company do not own its stock or those of its closest competitors.

Report updated on March 02, 2007.
Data and Rating updated as of March 16, 2007.



Analyst Note 03-02-07

Dell reported weak results for its fourth quarter of fiscal 2007, but they were in line with our expectations. We are maintaining our fair value estimate. Steep declines in desktop revenue were offset by growth in international markets and services, consistent with our investment thesis. While we believe Dell can perform much better, we were encouraged by its slight improvement in gross margins from the previous quarter, driven by cost controls and a favorable business mix.

Dell has a fundamentally sound business model and will be able to turn around its recent performance, in our opinion. Michael Dell is back as CEO and committed to improving performance. His short-term priorities have been to strengthen the management team, drive down costs, expand growth opportunities by pursuing consumer and international markets, and improve customer service. He has made recent executive appointments in operations, consumer marketing, and services, which are all key growth areas. There is preliminary evidence of change, as the company is renegotiating supply contracts for its notebook computers in an effort to improve product features and drive down costs. We expect the turnaround to take some time, but we believe Dell will ultimately succeed.

Thesis 12-20-06

Dell is a company in transition, facing slowing PC growth and increasing competition. We believe that Dell will meet this challenge by expanding internationally and growing non-PC revenue such as enterprise hardware (servers and storage) and enhanced services.

World-class supply chain efficiencies have provided Dell with a wide economic moat. The company holds substantial negotiating power and earns favorable terms from its component suppliers. It holds inventory an average of five days, while competitors average 15 days. Furthermore, customers pay Dell in approximately 36 days, while Dell pays suppliers in 75 days, enabling Dell to receive cash before paying. Dell's control of the supply chain and working capital management have provided the company with the highest operating margins and returns on capital in the PC industry.

Despite Dell's advantages, it has recently struggled. Gross margins have declined over 1 percentage point as it lowered prices in an attempt to gain market share. Operating margins have been squeezed by investments in customer service. We think these investments are wise, as Dell's highly regarded customer satisfaction had been declining. We think the problems the company experienced in 2006 are mostly short term, however. Strategically, the company maintains its focus on high-margin segments of enterprise customers, which should receive a boost from corporations upgrading their systems for the new Microsoft operating system.

We believe Dell's biggest growth opportunity is international expansion. Dell consistently has gained share in virtually every product category and every geographic region over the last 10 years. The top PC manufacturers have captured nearly two thirds of the overall market growth, as their scale and distribution have given them a competitive advantage. Dell has more than doubled its share in the Asia/Pacific region over the last five years, exceeding even the growth rate of Lenovo. Overall, we project non-U.S. revenue will grow at twice the rate and represent a larger percentage than U.S. revenue for Dell over the next five years.

In spite of a slowing PC market, the next growth thrust for Dell is to bundle additional products and services with PC hardware. Non-PC categories now represent more than one third of Dell's consolidated revenue and have grown almost 3 times faster than the PC segment. We expect the company's operating margin to increase from the growth of these higher-margin segments.

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Close Competitors	Market Cap $Mil	TTM Sales $Mil	Oper Income $Mil	Net Income $Mil
Dell	51,111	56,738	4,122	3,400
Hewlett-Packard	108,587	91,658	6,560	6,198
Sun Microsystems	22,469	13,760	-518	-441
Gateway	836	4,084	-44	-23

Morningstar data as of March 16, 2007.

Valuation

We are lowering our fair value estimate for Dell to $34 per share from $39. We forecast that higher operating expenses will temper the companys ability to grow operating margins. This revision reflects our assumption that Dell will incur greater sales expense to improve customer service and transition to selling more complex hardware and software systems. We project overall annual sales growth of 7% through 2011. While we project global desktop revenue to be flat, Dell will continue to gain share in the notebook market. Non-PC categories will be more important to Dell as it expands its enterprise solutions, growing revenue by 11% per year. We project operating income to grow by 15% compounded over the next five years as margins recover from 5.5% to 7.1% by 2011, largely the result of the faster growth of higher-margin businesses.

Risk

Ongoing intense price competition, slowing growth, and a narrowing cost advantage are our biggest concerns for Dell. The company is exposed to business spending and technology upgrade cycles. Also, as Dell outsources more products and components, it becomes more vulnerable to declining cost advantages. Lastly, the SEC investigation over Dell's accounting for deferred revenue and warranty liability looms.

Bulls Say

- Dell's direct model remains the best operating model in the industry, maximizing operating cash flow and minimizing total supply chain costs.
- Dell will continue to leverage its direct model to new geographies and new products and services.
- The adoption of Microsoft Vista should provide a fresh product upgrade cycle and boost demand for desktop and mobility systems.
- Revenue from higher-margin software and peripherals, storage, and enhanced services continue to grow as part of Dell's overall revenue mix.

Bears Say

- Dell's increasing reliance on technology partners may decrease its control over the overall supply chain.
- Increasing competition will continue to pressure prices and margins.
- Lack of a retail presence may damp Dell's overall market opportunity as consumer demand has been growing faster than enterprise.
- The company may not be able to extend its competitive advantages in PC hardware to service offerings.

Financial Overview

Growth: Dell intends to invest in international markets and offer complete enterprise solutions, including software and peripherals, storage and services. We forecast 7% annual revenue growth to 2011, propelled by double-digit growth in non-PC segments.

Profitability: Increasing competition and cost pressures have squeezed operating margins recently. We have forecast modest margin expansion as the company replicates its operating model internationally and expands into higher-margin non-PC products and services. Dell maintains a very high return on invested capital, however, due to its low-cost supply chain and superior cash conversion cycle.

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Financial Health: Dell maintains outstanding fiscal health, with close to $11 billion in cash and investments and only $500 million in long-term debt.

Company Overview

Profile: Dell designs and distributes a wide range of computer systems and services worldwide. Products include enterprise systems (such as servers, storage, workstations and networking), client systems (such as notebook and desktop systems, printing and imaging systems, software and peripherals), and other services. The company sells its products directly to customers, which include corporate, government, and education accounts, small to medium-sized businesses, and individuals.

Strategy: Dell attempts to deliver superior value through developing a low-cost supply chain of standards-based technologies and marketing directly to customers. Aggressive supply chain management enables Dell to manage working capital and generate superior returns on capital. We anticipate the company to continue capturing share in desktop and notebooks, as well as other enterprise products and services.

Management: There is a deep management bench at Dell. Kevin Rollins became CEO in 2004 and has shared overall operating responsibility with Michael Dell, the company founder. Rollins has 11 years of experience with the company. The average tenure for other senior executives is 10 years. Donald Carty, former CEO of American Airlines' parent company AMR, is the new CFO as of 2007. Many positions have shared responsibility, which minimizes the risk of any individual departure. Such deep company and industry experience should serve them well as they continue to expand their business model worldwide. While the company professes an incentive compensation plan that rewards the achievement of company goals, historical pay from lucrative stock options has been extensive. The company has paid a cumulative $10 billion over the last seven fiscal years to prevent dilution from employee stock options. Also, missing two straight quarterly SEC filings is a bit disturbing as the company deals with the ongoing SEC probe into certain accounting and financial reporting matters.

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Analyst Notes

03-02-07

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02-01-07

Michael Dell Is Back as CEO

Dell announced Wednesday that embattled CEO Kevin Rollins had resigned. The board of directors appointed chairman Michael Dell to assume once again the duties of CEO. Rollins had been under fire for some time over a number of successive missteps, from customer-service problems to an accounting probe by the Securities and Exchange Commission to increasing competitive pressure from Hewlett-Packard. The company lost worldwide market share in 2006 for the first time in more than 10 years and announced that financial results for the latest fiscal year will miss expectations. We believe the management change sends a clear message that the board is not satisfied with Dell's recent performance and is eager to get back to what made the company great: outstanding customer service with quality products, low costs, and industry-leading growth and profits. For now we are standing by our fair value estimate, which is based on fairly conservative growth assumptions.

12-20-06

Dell Announces New CFO

Dell has announced the appointment of Donald Carty, former CEO of American Airlines' parent company AMR and current Dell director, as CFO effective Jan. 1, 2007. Carty, who currently serves as the chairman of Dell's audit committee, will succeed James Schneider, who is leaving the company. Although this change does not affect our thesis, we continue to highlight our low Stewardship Grade for Dell, which will not be cleared until the SEC completes its investigation and Dell files its two delinquent quarterly reports.

11-22-06

Dell Shows Progress in 3Q

Dell's earnings for the third quarter of fiscal 2007

Dell DELL

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Analyst Notes (continued)

significantly exceeded Wall Street's expectations, finishing at $0.30 per share versus the analyst consensus of $0.24. Sales growth was again tepid, advancing only 3.4% from a year ago. This growth performance reflected a calculated retreat from certain PC segments, however, and helped the company post an improvement in operating profitability. The 6.2% operating margin was a 150-basis-point improvement from the prior quarter's disastrous results and provides support to our long-term operating thesis. Dell is in the midst of an evolution away from a PC-centric business model toward a more balanced set of hardware, software, and service offerings to corporate customers. This should allow the firm to move past its recent fundamental challenges and post a much more respectable growth and operating profit performance than its current share price reflects. We are maintaining our fair value estimate at $39 per share.

Dell's surprising profit margin was due to several developments. Desktop and notebook PCs accounted for only 59% of total sales in the quarter, compared with 63% in the year-ago quarter. Dell's emerging offerings feature higher margins than its core PC offerings, and the growth of these product and service categories should offset the pricing pressure the firm faces in its traditional PC markets. Dell might also be benefiting from its decision to multisource key components and be more selective about the business it chases. There has been speculation that Dell has received generous terms from new chip supplier Advanced Micro Devices, which seemed to be confirmed by AMD's slumping margin in its latest quarter and chatter from smaller PC builders that they are being shut out of AMD chips in favor of Dell. Dell's gross margin finished at 17% for the quarter, compared with 15.5% in the prior quarter.

Dell does faces several margin headwinds (most notably its near-term program to invest in customer service), and its reliance on the mature North American PC market should continue to constrain its overall sales growth. Counterbalancing these challenges, however, are improving component costs, a favorable shift in its business model toward new hardware items and services, and a better balance in PC sales between developed and higher-growth international markets. Layer on top of this outlook the anticipated shot in the arm from the release of Windows Vista, and we remain comfortable with our modeling assumptions for the next five years.

11-16-06

Dell's SEC Woes Continue

Dell is delaying the release of third-quarter results until the end of November and announced that the previously informal investigation by the Securities and Exchange Commission into the firm's accounting practices has been stepped up to a formal probe. We deem the formal probe to be the more serious of the two announcements. Still, we reiterate the stance we assumed when the SEC first came calling over the summer. We still have no decent take on the size and the scope of any potential restatement and therefore will wait for the company to give a full account of its findings. In the absence of quality information, we will hold off on contemplating any fair value estimate revision. We have already lowered Dell's Stewardship Grade in response to what is either lax internal accounting or aggressive use of accrual-based accounting estimates.

The escalation of the SEC investigation into a formal probe is unquestionably negative news, although the preliminary nature of Dell's upcoming earnings release could give investors some insight into exactly what the accounting authorities are taking the company to task for. Dell blamed the delay on the complexity of the SEC's and its own audit committee's demands regarding the quarterly report, which indicates some progress has been made in coming to terms on specific concerns. Potential areas of investigation include the timing of extended warranties and service contracts, estimates of bad debts realized from Dell's growing financing business, customer returns, and the timing of revenue realized from sizable corporate relationships that entail multiple products and services over an extended period. We are most curious about Dell's "other current asset" category, which has ballooned to $2.6 billion, or 11% of total assets, in fiscal 2006 from $1.5 billion, or less than 8% of assets, in fiscal 2004. This account is hard to reconcile despite a thorough scrubbing of Dell's footnotes, with only half of the stated value attributable to financing reserves, deferred product costs, and deferred taxes.

Even with a formal SEC probe, however, many factors point to minor to moderate restatements rather than the scandalous fallout witnessed at firms like Enron and WorldCom. For one, Dell's business, from unit shipments to average selling price, is thoroughly monitored by third-party industry watchers on a quarterly basis. This makes outright fraud unlikely. Second, cash is king, and Dell's balance sheet sported more than $11 billion in cash and investments in its latest 10-Q, which accounted for nearly half of its total asset base. Barring massive ignorance on the part of auditors, Dell's balance sheet and returns in invested capital should still be the envy of the investment community after the investigation runs its course.

10-19-06

HP Gains Ground on Dell

Third-party technology watchers released their estimates for global PC unit shipments in the third quarter, and the results showed HP continuing to gain ground on rival Dell. HP leapfrogged Dell for the number-one global market share spot in one survey (Gartner Group) and finished in a statistical tie in another (IDC). Looking past the headline-grabbing announcement that Dell might have been unseated as the global market share leader, trends continue to show strength in emerging markets versus developed economies and that the retail customer market continues to grow much faster than the corporate market. In all, year-over-year unit shipment growth finished at a rather depressing 8% versus a year ago, down from 10% last quarter and well below the low teens rate that the industry has enjoyed over the last few years. Developed markets such as the U.S., Western Europe, and Japan all showed sickly growth. In terms of form factor, desktop sales continue to wane and notebook sales, previously a torrid growth story, were not nearly strong enough to compensate.

Given these trends and HP's relatively beneficial customer and geographic exposure, it is not too surprising that HP is growing at a much faster rate than Dell (15% unit growth year over year compared with 3.6%). Dell earns roughly 80% of its revenue from its corporate customers and is heavily leveraged to desktop sales in developed economies. HP is simply advantaged at the moment due its retail exposure and stronger presence in high-growth emerging economies. This trend should continue until several developments take place. Retail purchasing should cool in the event of an economic downturn, and corporate spending could pick up due to industry drivers such as the release of the Windows Vista operating system. Additionally, Dell is in the early stages of building its presence in high-growth emerging markets like India, and its mix of developed and emerging markets should balance over time.

It is difficult to make sweeping conclusions from this data. While Dell's tepid unit growth points to another subpar growth quarter, it could also point to operating margin improvement. Dell slashed and burned in its last quarter in a failed attempt to stimulate unit growth and could be pricing more selectively to boost operating profits in the quarter. Also, new Dell chip supplier AMD posted a large drop in gross margin in its quarterly earnings release, prompting speculation that Dell received excellent terms on its new chips. As the semiconductor makes up a large portion of the overall PC bill of sale, this development could also aid Dell's gross margin. Similarly, HP's PC segment is a relatively small contributor to its overall operating income, accounting for 16.5% of operating income in the latest quarter, so it is hard to speculate that its overall fundamental performance will be meaningfully better than current expectations based on this data.

09-11-06

Dell Postpones 10-Q

Dell postponed its upcoming second-quarter fiscal 2006 10-Q report as it continues to muddle through an internal investigation of potential accounting issues. While such an announcement is always a cause for concern, we still have no decent take on the size and the scope of any potential restatement and therefore will continue to wait for the company to give a full account of its findings. In the absence of quality information, we will hold off on contemplating any fair value estimate revision. We have already lowered Dell's Stewardship Grade in response to what is either lax internal accounting or aggressive use of accrual-based accounting estimates.

Dell did change the verbiage with which it describes the nature of this investigation, citing accounting issues that are an area of concern for any appraiser of conservative accounting. The company, along with the SEC and several other bodies, is taking a second look at "issues relating to accruals, reserves and other balance sheet items that may affect the company's previously reported financial results" (according to Monday morning's press release). Accruals and reserves rely on management estimates and provide the most room for management to insert aggressive estimates of its future revenue recognition and expense realization.

A survey of Dell's 10-K shows that the firm cites many areas of its operating business that require managerial judgment over such accounting estimates. Potential areas of investigation include the timing of extended warranties and service contracts, its estimate of bad debts that could be realized from its growing financing business, customer returns, and the timing of revenues realized from sizable corporate relationships that entail multiple products and services over an extended time period. While this certainly provides Dell a fertile field for potentially aggressive accounting, it also provides it multiple opportunities to innocently and incorrectly apply GAAP accounting conventions. As we don't know which is the likelier scenario, we will remain in a wait-and-see mode.

Dell DELL

Sales Mil	Mkt Cap Mil	Industry	Sector
$56,738	$51,111	Computer Equip.	Hardware

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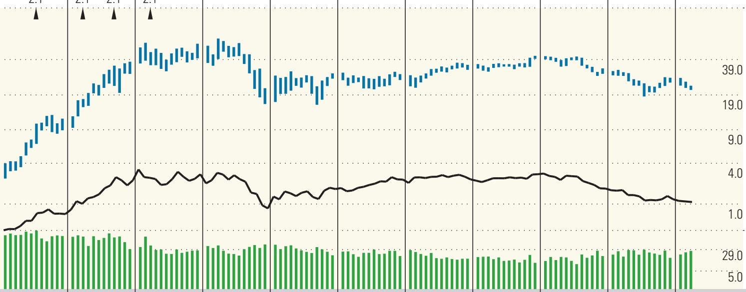
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	YTD
Annual Price High	12.98	37.91	55.00	59.69	31.32	31.06	37.18	42.57	42.30	32.24	27.48
Low	3.12	9.92	31.38	16.25	16.01	21.90	22.59	31.14	28.62	18.95	21.61
Recent Splits	2:1	2:1 2:1	2:1								



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

52 week High/Low $
30.80 - 18.95

10 Year High/Low $
59.69 - 3.12

Bear-Market Rank
3 (10=worst)

Trading Volume Million

Stock Performance	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	YTD
Total Return %	216.2	248.5	39.4	-65.8	55.9	-1.6	27.1	24.0	-28.9	-16.2	-10.3
+/- Market	185.2	221.8	19.9	-55.7	68.9	21.8	0.7	15.0	-31.9	-29.8	-8.1
+/- Industry	191.4	165.0	-40.9	-41.3	64.1	30.8	-9.8	8.4	-31.4	-32.8	-9.2
Dividend Yield %	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Market Cap $Mil	27384	93022	130823	45110	70858	68968	87003	104689	70488	56995	51111

Financials	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Revenue $Mil	7759	12327	18243	25265	31888	31168	35404	41444	49205	55908	56738
Gross Margin %	21.5	22.1	22.5	20.7	20.2	17.7	17.9	18.2	18.3	17.8	17.5
Oper Income $Mil	714	1316	2046	2263	2663	1789	2844	3544	4254	4347	4122
Operating Margin %	9.2	10.7	11.2	9.0	8.4	5.7	8.0	8.6	8.6	7.8	7.3
Net Income $Mil	518	944	1460	1666	2177	1246	2122	2645	3043	3572	3400
Earnings Per Share $	0.16	0.32	0.53	0.61	0.79	0.46	0.80	1.01	1.18	1.46	1.42
Dividends $	—	—	—	—	—	—	—	—	—	—	—
Shares Mil	3153	2952	2772	2728	2746	2726	2644	2619	2568	2449	2416
Book Value Per Share $	0.30	0.50	0.92	2.05	2.15	1.81	1.90	2.48	2.64	1.79	1.49
Oper Cash Flow $Mil	1362	1592	2436	3926	4195	3797	3538	3670	5310	4839	4671
Cap Spending $Mil	-114	-187	-296	-397	-482	-303	-305	-329	-525	-728	-769
Free Cash Flow $Mil	1248	1405	2140	3529	3713	3494	3233	3341	4785	4111	3902

Profitability	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Return on Assets %	20.1	26.0	26.2	18.2	17.5	9.2	14.6	15.2	14.3	15.4	14.9
Return on Equity %	59.8	91.2	82.1	46.5	39.8	24.4	44.3	47.5	47.6	70.8	80.7
Net Margin %	6.7	7.7	8.0	6.6	6.8	4.0	6.0	6.4	6.2	6.4	6.0
Asset Turnover	3.02	3.40	3.27	2.75	2.56	2.31	2.44	2.38	2.31	2.41	2.49
Financial Leverage	3.0	3.5	3.1	2.6	2.3	2.6	3.0	3.1	3.3	4.6	5.4

Financial Health	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	04-06
Working Capital $Mil	1089	1215	2644	2489	2948	358	-9	-263	2761	1779	1077
Long-Term Debt $Mil	18	17	512	508	509	520	506	505	505	504	503
Total Equity $Mil	806	1293	2321	5308	5622	4694	4873	6280	6485	4129	3374
Debt/Equity	0.02	0.01	0.22	0.10	0.09	0.11	0.10	0.08	0.08	0.12	0.15

Valuation	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Price/Earnings	24.5	38.8	94.3	63.0	32.3	59.8	29.8	33.1	35.4	20.1	15.9
P/E vs. Market	1.0	1.4	2.9	2.6	1.4	3.0	1.4	1.7	2.0	1.2	0.8
Price/Sales	1.7	3.0	7.6	4.2	2.3	2.4	1.8	2.1	2.2	1.3	1.0
Price/Book	13.7	24.6	54.6	18.7	12.1	15.2	12.6	13.5	15.8	16.4	15.2
Price/Cash Flow	9.6	23.1	56.9	26.7	17.1	19.7	17.8	23.9	20.2	14.8	11.6

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	13.6	16.4	11.9	26.6
Operating Income %	2.2	15.2	10.3	27.7
Earnings/Share %	23.7	22.2	12.5	42.8
Dividends %	—	—	—	—
Book Value/Share %	-32.1	-1.9	-3.6	18.3
Stock Total Return %	-22.6	-11.9	-3.3	17.8
+/- Industry	-31.7	-20.5	-8.8	9.0
+/- Market	-28.9	-19.6	-6.8	11.9

Profitability Analysis

Grade: A+	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	80.7	46.9	24.1	20.1
Return on Assets %	14.9	13.8	8.1	8.0
Fixed Asset Turns	29.7	34.0	12.4	7.9
Inventory Turns	83.7	94.7	23.0	11.4
Revenue/Employee $K	1233.4	—*	623.3	873.4
Gross Margin %	17.5	18.0	31.0	33.4
Operating Margin %	7.3	7.8	10.0	17.4
Net Margin %	6.0	5.8	7.6	11.4
Free Cash Flow/Rev %	6.9	9.1	5.2	10.2
R&D/Rev %	0.8	1.1	5.1	4.0

Financial Position

Grade: B	01-06 $Mil	04-06 $Mil
Cash	7042	6877
Inventories	576	636
Receivables	4089	4332
Current Assets	17706	17397
Fixed Assets	2005	2074
Intangibles	—	—
Total Assets	23109	22871
Payables	9840	10069
Short-Term Debt	—	—
Current Liabilities	15927	16320
Long-Term Debt	504	503
Total Liabilities	18980	19497
Total Equity	4129	3374

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	15.9	35.6	28.1	20.2
Forward P/E	19.9	—	22.0	16.7
Price/Cash Flow	11.6	19.3	13.0	14.6
Price/Free Cash Flow	13.9	21.4	18.4	23.7
Dividend Yield %	—	—	0.6	1.8
Price/Book	15.2	14.7	5.3	4.1
Price/Sales	1.0	2.0	2.4	2.8
PEG Ratio	1.6	—	1.5	1.5

Quarterly Results

Revenue $Mil	Jul 05	Oct 05	Jan 06	Apr 06
Most Recent Period	13428.0	13911.0	15183.0	14216.0
Prior Year Period	11706.0	12502.0	13457.0	13386.0

Rev Growth %	Jul 05	Oct 05	Jan 06	Apr 06
Most Recent Period	14.7	11.3	12.8	6.2
Prior Year Period	19.7	17.7	16.9	16.0

Earnings Per Share $	Jul 05	Oct 05	Jan 06	Apr 06
Most Recent Period	0.41	0.25	0.43	0.33
Prior Year Period	0.31	0.33	0.26	0.37

Industry Peers by Market Cap

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
Dell	51111	56738	15.9	80.7
Hewlett-Packard	108587	91658	17.3	16.4
Sun Microsystems	22469	13760	—	-6.7

Major Fund Holders

	% of shares
Longleaf Partners	1.80
Dodge & Cox Stock	1.27
American Funds Grth Fund of Amer A	1.02

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

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Business Risk
- 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

This 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 economic profits, but companies

Morningstar Research Methodology for Valuing Companies

Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade shows visits
- Competitor, supplier, distributor, and customer interviews

The depth of the firm's competitive advantage is rated:

- None
- Narrow
- Wide

Analyst considers company financial statements and competitive position to forecast future cash flows.

Assumptions are input into a discounted cash-flow model.

DCF model leads to the firm's fair value estimate, which anchors the rating framework.

A business-risk analysis establishes the margin of safety required for the stock rating.

★
★★
★★★
★★★★
★★★★★

The current stock price relative to fair value, adjusted for risk, determines the rating.

that can earn them for an extended time by creating a competitive advantage possess an economic moat. We see these companies as superior investments.

We're big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because all of these characteristics allow companies to protect their competitive position. For example, Tiffany is far more profitable than a run-of-the-mill jewelry chain because it has a strong brand that creates a moat around its business, allowing it to charge more than competitors.

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.

Business Risk
Based on fundamental factors such as cyclicality, leverage, competitive strength, and profitability, we divide our coverage universe into four broad risk categories: Below Average, Average, Above Average, and Speculative. Unlike some risk ratings, ours is not based on the volatility of the firm's shares, but rather the predictability and strength of the underlying business.

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."