

# Whole Foods Market, Inc. WFMI [Nasdaq] | ★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
66.10 USD	31.00 USD	18.60 USD	52.70 USD	High	Narrow	B	—	Grocery Stores

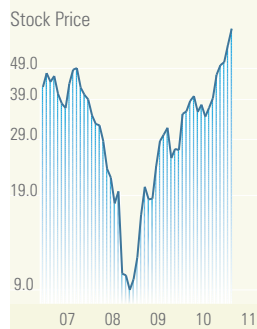
## Whole Foods Has Momentum, but Market Pricing In Outrageously Optimistic Scenario

by Morningstar Equity Analysts

Analysts covering this company do not own its stock.

Pricing data through April 04, 2011.  
Rating updated as of April 04, 2011.

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



**Analyst Note** Feb. 10, 2011 | Philip Gorham, CFA

Whole Foods Market reported strong fiscal 2011 first-quarter results thanks to solid store productivity. The firm is benefiting from growing confidence among middle- and high-income consumers, and this momentum continues to carry the stock higher. In after-hours trading following the release of the earnings report Wednesday, the shares were trading 8% higher, and at 25 times our estimate of fiscal 2011 earnings, the stock is grossly overvalued, in our view. Our fair value estimate and 1-star rating remain in place because our assumptions for 2011 are in line with the firm's improved guidance, and we think there may be risks on the horizon that are not being accounted for by the market.

Total revenue for the quarter increased 14% to \$3 billion, driven by new store growth and a 9% increase in identical-store sales. Greater traffic led to a 50-basis-point year-over-year improvement in the operating margin, which increased to more than 5%. We are impressed by the firm's ability to reinvigorate the top line, which we attribute to an improved price perception and effective merchandising efforts. However, comparisons will become more difficult going forward, and we do not expect the same level of identical-store sales growth for the remainder of the fiscal year. In addition, rising gas prices and the food inflation that may filter through to retail prices throughout the year may persuade the subsection of Whole Foods' customers who are still sensitive to price to trade down to cheaper stores once again.

We forecast revenue growth of 10% in fiscal 2011, which is at the high end of the firm's 7%-9% guidance for same-store sales and allows for some new store openings. We think the firm's inherent operating leverage will lead to modest profitability improvements. However, the current market valuation implies far too optimistic a scenario, in our opinion. The after-hours share price of \$58 implies 14% growth in fiscal 2011 and double-digit growth

thereafter, as well as operating margins of 7% every year, above the peak margin of 6% achieved only once in the past 14 years. This scenario assumes that consumer confidence grows indefinitely, and it gives Whole Foods the revenue benefit from an inflationary environment, which in itself is a lofty assumption, but none of the drawbacks of rising wage rates and health-care costs if inflation occurs. Greater store traffic is likely to lead to some operating leverage, and we do assume limited margin expansion (we forecast an average operating margin of 5% over the next decade, up from the 4.8% achieved on average over the past 10 years), but we think the margin expansion and revenue growth being implied by the current market valuation are unachievable.

**Thesis** Dec. 31, 2010 | Morningstar Equity Analysts

Whole Foods closed out fiscal 2010 on a strong note, and positive momentum is on its side. Comparable-store sales growth increased 7.1% last fiscal year, and operating margin improved 1.4 percentage points. The bounceback was much stronger than we anticipated, and we believe this speaks to the firm's knack for innovation and brand strength. However, we believe delivering consistent results will be difficult for the firm even as the domestic economy recovers.

In 2009, Whole Foods was reeling from a series of large, costly bets that did not pan out. Accelerating growth and opening larger, more-theatrical stores pressured margins because the new locations were expensive to open and initially costly to operate. The large and very expensive London store that Whole Foods debuted in 2007 opened below expectations, although we are seeing signs of improvement overseas.

Another costly endeavor was the acquisition of Wild Oats. Whole Foods paid a rich price to begin with, but after selling 35 stores at fire-sale prices, incurring substantial legal costs, and closing 19 other Wild Oats stores, it effectively increased the transaction price substantially. The firm improved performance for the stores that it kept through better merchandising and service, and there are

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
<b>Whole Foods Market, Inc.</b>	USD	11,473	9,370	483	279
<b>Kroger Company</b>	USD	14,821	82,189	2,182	1,116
<b>Safeway Inc.</b>	USD	8,627	41,050	1,159	590
<b>Supervalu Inc.</b>	USD	1,840	38,079	-909	-1,508

Morningstar data as of April 04, 2011.

benefits with added scale in some of its regions. However, the return profile has changed given the additional costs that came subsequent to the acquisition.

These issues were compounded by a weakening store base as the firm lost a portion of its customers in the economic downturn. Whole Foods has spent the past year strategically lowering prices in an attempt to change its image of being too expensive. The strategy has paid off, with both traffic and number of transactions increasing throughout the prior year. After slowing store growth to focus on the existing base, the firm is now ready to grow at a faster pace again next year.

We expect Whole Foods' positive momentum to continue in the near term, but we remain cautious regarding our longer-term outlook. We believe much of Whole Foods' success can be attributed to its brand equity, which can be difficult to cultivate and maintain, as we've seen through the economic downturn. The company's culture is very important, and anything that could damage its image could negatively impact results as well.

## Valuation, Growth and Profitability

Our fair value estimate is \$31 per share, which implies forward price/earnings of 18 times, enterprise value/EBITDA of 6.8 times, and free cash flow yield of 6.4%. For fiscal 2011, we expect a 10% increase in revenue, driven by a 6.5% increase in comparable-store sales. We expect 17 new stores this year, and 20 in fiscal 2012. Longer term, however, we project store growth in

the midteens range. Tight inventory management along with the ability to leverage fixed expenses has helped margin expansion, and we expect a 5% operating margin this year. In the long run, we project an operating margin averaging 5.3% as the revenue grows and the company can spread fixed operating costs over the larger sales base.

## Risk

Whole Foods was not immune to the macroeconomic weakness that strained consumer spending, and the rate at which the economy recovers is unpredictable. Another slowdown could lead to margin erosion again, despite the company's efforts to improve cash flow. In a highly competitive industry, Whole Foods relies heavily on its brand; any concern about its image would damage sales heavily. Additionally, more conventional grocers are trying to capitalize on the natural and organics food trend, which could negatively impact sales at Whole Foods.

## Bulls Say

- Whole Foods possesses a strong brand that resonates with consumers not only seeking a high-quality shopping experience, but also desiring stores that deliver on demands for health and wellness, premium fresh foods, and environmental friendliness.
- Even with the less productive Wild Oats stores and weak same-store sales, Whole Foods generated over \$800 in sales per square foot in fiscal 2010, significantly higher than that of the average supermarket.
- According to Natural Foods Merchandiser, sales of organic products increased 17.1% from 2007 to 2008.
- Whole Foods has plenty of room remaining to grow as it improves its density in large markets and expands further into secondary markets.

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## Bears Say

- Whole Foods has a much wider customer base than it had during past economic downturns, and its top line is proving to be much more sensitive to economic conditions.
- Unlike low-price leaders such as Wal-Mart, Whole Foods dominates because of its brand image, which is trickier to manage and less impervious to competitive threats.
- Conventional grocery chains such as Safeway have remodeled stores at a rapid clip and attempted to narrow the gap with premium grocers like Whole Foods in terms of shopping experience, product quality, and selection of takeout foods.

## Financial Overview

Financial Health: Whole Foods ended fiscal 2010 holding \$508 million in long-term debt on its books, with total debt/EBITDA at less than 1.0 times and EBITDA/interest expense of over 21 times.

## Company Overview

Profile: Whole Foods Market is the largest U.S. retailer of natural and organic foods. The firm operates about 300 stores in the United States, Canada, and England. The stores sell high-grade conventional and organically grown produce and grocery products; environmentally safe household items; meat, poultry, and seafood free of growth hormones and antibiotics; bakery goods and takeout meals; and vitamins, homeopathic remedies, and body-care products.

Management: In many ways, overall corporate governance at Whole Foods is sound, but management's feet should be held to the fire amid some costly moves that have backfired and led to the firm's suspending its dividend, reducing store growth for 2009, seeking ways to reduce

costs, and raising expensive capital. Of course, management can't control the economy, but we wonder whether it got itself in over its head trying to ramp up store growth, acquire and integrate a collection of stores that were essentially being run for cash, and make a bold move into a foreign country. The capital injected by an affiliate of Leonard Green & Partners gives that firm a 17.4% voting interest and two board seats. Whole Foods has eight remaining board seats, and all but one are held by independent directors. Founder and CEO John Mackey recently stepped down as chairman of the board; we like that the two roles are now split so as to ensure an independent party is overseeing the CEO. Executive compensation is sound for the most part. Salary and bonus is capped at 19 times employees' average salary, and the company employs economic value added. We also note that Mackey's salary last year was \$1.

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## Analyst Notes

Feb. 10, 2011

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Dec. 08, 2010

### Whole Foods Reinstates Dividend

We've said before that we believe Whole Foods has the ability to reinstate its dividend as economic conditions continue to improve. The firm confirmed our beliefs Wednesday, when it announced that the board of directors approved a quarterly cash dividend of \$0.10 per share. The

economic downturn forced Whole Foods to suspend its dividend to conserve cash, but since then the company has experienced a resurgence in its results. The firm delivered \$329 million in free cash flow in its most recent fiscal year. We like the focus on returning a portion of this cash to shareholders. The dividend implies a 1.3% yield at our fair

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## Analyst Notes (continued)

value estimate.

**Nov. 04, 2010**

### Whole Foods Identical-Store Sales Accelerate, Drive Margin Growth

Whole Foods reported strong fourth-quarter results due to solid store productivity. After reviewing our discounted cash flow analysis, we are modestly increasing our fair value estimate to account for cash generated since our last update, as well as increased operating assumptions in the near term. Nonetheless, at nearly 28 times fiscal 2011 earnings, we believe that shares more than fully reflect a resurgence in the company's growth and profitability.

Total revenue for the quarter increased 14.7% to \$2.1 billion, driven by new store growth and a 8.7% increase in identical-store sales. We are impressed by the firm's ability

to reinvigorate the top line, which we attribute to an improved price perception and effective merchandising efforts. However, with stronger comparisons to lap next year, we do not expect the same level of identical-store sales growth for fiscal 2011. The ability to leverage fixed expenses like rent, as well as better product costs, helped drive operating margin expansion to 4.8%, up from 3.8% in the year-ago quarter. We expect modest margin growth in fiscal 2011, but again, with more difficult comparisons as well as continued uncertainty in the economic environment, the rate of expansion should be smaller than exhibited in the prior year.

## Disclaimers & Disclosures

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

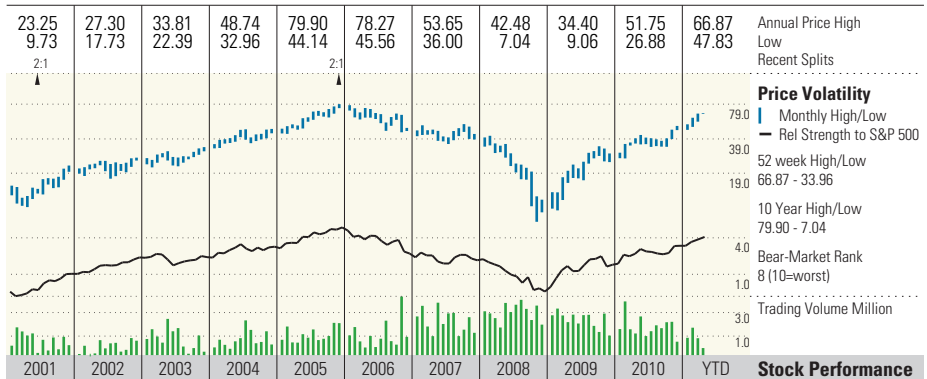
# Whole Foods Market, Inc. WFMI

**Sales USD Mil** 9,370 **Mkt Cap USD Mil** 11,473 **Industry** Grocery Stores **Sector** Consumer Defensive

Whole Foods Market is the largest U.S. retailer of natural and organic foods. The firm operates about 300 stores in the United States, Canada, and England. The stores sell high-grade conventional and organically grown produce and grocery products; environmentally safe household items; meat, poultry, and seafood free of growth hormones and antibiotics; bakery goods and takeout meals; and vitamins, homeopathic remedies, and body-care products.

550 Bowie Street  
Austin, TX 78703  
Phone: 1 512 477-4455 Website: <http://www.wholefoods.com>

**Morningstar Rating** ★ **Last Price** 66.10 **Fair Value** 31.00 **Uncertainty** High **Economic Moat™** Narrow **Stewardship Grade** B  
per share prices in USD



Growth Rates Compound Annual					
Grade: C	1 Yr	3 Yr	5 Yr	10 Yr	
Revenue %	12.1	11.0	13.9	17.2	
Operating Income %	54.0	13.8	13.8	15.8	
Earnings/Share %	68.2	3.5	7.6	18.4	
Dividends %	—	—	—	—	
Book Value/Share %	19.1	9.5	6.3	16.8	
Stock Total Return %	79.3	25.3	0.8	21.0	
+/- Industry	70.5	23.9	-1.0	19.9	
+/- Market	66.2	26.2	0.4	20.3	

Profitability Analysis				
Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	12.1	11.0	2.1	22.5
Return on Assets %	7.0	6.1	0.7	8.5
Fixed Asset Turns	4.9	4.6	5.1	7.3
Inventory Turns	18.4	17.8	11.4	14.4
Revenue/Employee USD K	160.7	152.9*	—	936.8
Gross Margin %	34.9	34.6	24.3	40.2
Operating Margin %	5.2	4.5	2.7	14.7
Net Margin %	3.0	2.4	0.3	10.0
Free Cash Flow/Rev %	4.4	—	1.9	0.1
R&D/Rev %	—	—	—	9.8

Financial Position		
Grade: B	09-10 USD Mil	12-10 USD Mil
Cash	132	162
Inventories	323	342
Receivables	133	142
Current Assets	1162	1301
Fixed Assets	1886	1903
Intangibles	734	733
Total Assets	3987	4121
Payables	213	229
Short-Term Debt	—	—
Current Liabilities	748	822
Long-Term Debt	—	—
Total Liabilities	1613	1606
Total Equity	2373	2515

Valuation Analysis				
	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	41.8	27.2	24.9	16.8
Forward P/E	31.8	—	—	13.6
Price/Cash Flow	17.2	10.7	6.1	8.9
Price/Free Cash Flow	28.3	—	14.0	18.5
Dividend Yield %	0.1	—	1.4	1.7
Price/Book	4.6	2.9	2.3	2.3
Price/Sales	1.3	0.7	0.3	1.4
PEG Ratio	1.9	—	—	1.8

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
42.5	21.1	27.3	42.9	63.3	-36.0	-11.5	-75.4	190.8	84.3	30.9	Total Return %
55.5	44.5	0.9	33.9	60.3	-49.6	-15.0	-36.9	167.4	71.5	24.9	+/- Market
61.2	55.6	-1.8	32.9	44.3	-46.1	-20.9	-46.8	178.6	73.7	22.8	+/- Industry
—	—	—	0.6	0.6	1.3	1.8	6.4	—	—	0.1	Dividend Yield %
2408	3062	4050	5968	10655	6708	5686	1325	3861	8750	11473	Market Cap USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
2272	2690	3149	3865	4701	5607	6592	7954	8032	9006	9370	Revenue USD Mil
34.8	34.7	34.3	34.8	35.1	34.9	34.8	34.0	34.3	34.8	34.9	Gross Margin %
112	149	175	229	230	319	297	328	284	438	483	Oper Income USD Mil
4.9	5.5	5.6	5.9	4.9	5.7	4.5	4.1	3.5	4.9	5.2	Operating Margin %
68	84	104	137	136	204	183	115	119	240	279	Net Income USD Mil
0.61	0.70	0.83	1.05	0.99	1.41	1.29	0.82	0.85	1.43	1.58	Earnings Per Share USD
—	—	—	0.30	0.35	0.58	0.69	0.78	0.00	0.00	0.10	Dividends USD
112	127	131	135	140	145	142	140	140	172	177	Shares Mil
4.08	5.44	6.78	8.61	9.22	10.17	10.49	10.79	15.02	14.54	14.49	Book Value Per Share USD
173	229	279	329	411	453	399	326	588	585	677	Oper Cash Flow USD Mil
-49	-61	-84	-110	-116	-357	-555	-523	-315	-257	-265	Cap Spending USD Mil
124	168	195	219	295	96	-156	-198	273	328	412	Free Cash Flow USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
8.5	9.5	9.7	10.1	8.0	10.4	7.0	3.5	3.3	6.2	7.0	Return on Assets %
18.9	16.9	15.2	15.5	11.6	14.7	12.8	7.7	7.6	12.0	12.1	Return on Equity %
3.0	3.1	3.3	3.5	2.9	3.6	2.8	1.4	1.5	2.7	3.0	Net Margin %
2.86	3.04	2.94	2.85	2.76	2.85	2.51	2.41	2.24	2.32	2.34	Asset Turnover
2.0	1.6	1.5	1.5	1.4	1.5	2.2	2.2	2.3	1.7	1.6	Financial Leverage

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	12-10	Financial Health
-12	-4	124	154	254	114	-117	-44	371	414	478	Working Capital USD Mil
251	162	163	165	13	9	736	929	—	—	—	Long-Term Debt USD Mil
409	589	776	988	1366	1404	1459	1506	1628	2373	2515	Total Equity USD Mil
0.61	0.27	0.21	0.17	0.01	0.01	0.50	0.62	0.45	0.21	0.16	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
43.7	38.0	37.9	44.4	74.1	34.0	34.3	12.3	23.3	31.9	41.8	Price/Earnings
—	—	—	—	—	—	—	—	—	1.8	2.5	P/E vs. Market
1.0	1.2	1.3	1.6	2.2	1.2	0.8	0.2	0.5	0.9	1.3	Price/Sales
5.3	4.8	5.0	5.5	8.4	4.6	3.9	0.9	1.8	3.5	4.6	Price/Book
11.3	15.3	15.1	17.8	28.6	14.3	16.2	3.3	6.5	13.2	17.2	Price/Cash Flow

Quarterly Results						
Revenue USD Mil	Mar 10	Jun 10	Sep 10	Dec 10		
Most Recent Period	2106.1	2163.2	2097.4	3003.7		
Prior Year Period	1857.6	1878.3	1829.2	2639.2		
Rev Growth %	Mar 10	Jun 10	Sep 10	Dec 10		
Most Recent Period	13.4	15.2	14.7	13.8		
Prior Year Period	-0.5	2.0	2.3	7.0		
Earnings Per Share USD	Mar 10	Jun 10	Sep 10	Dec 10		
Most Recent Period	0.39	0.38	0.33	0.51		
Prior Year Period	0.19	0.25	0.21	0.32		

Industry Peers by Market Cap				
	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Whole Foods Market,	11473	9370	41.8	12.1
Kroger Company	14821	82189	13.7	22.0
Safeway Inc.	8627	41050	15.1	11.9

Major Fund Holders		% of shares
Principal Large Cap Growth R5		0.66
Fidelity Blue Chip Growth		0.60
Fidelity Mid-Cap Stock		0.46

\*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

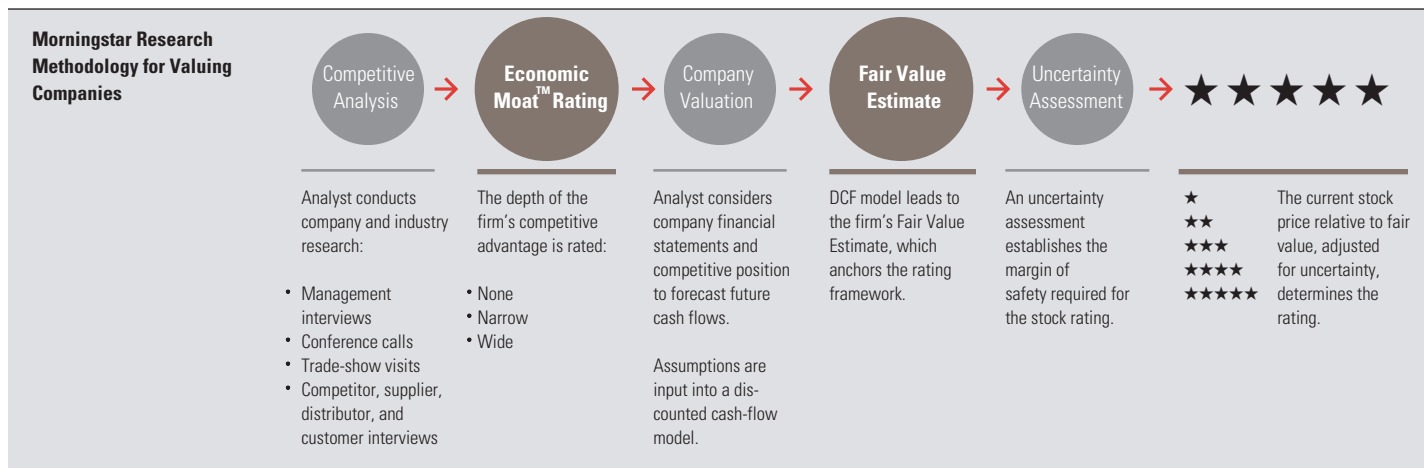
just on movement in the share price. If we think a stock's fair value is \$50, and the shares decline to \$40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at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

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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.

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### 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.

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### 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.

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### 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.

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### 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.

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### 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.

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### 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.

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### Stewardship Grades

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

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