General Electric Company GE [NYSE] | ★★★★

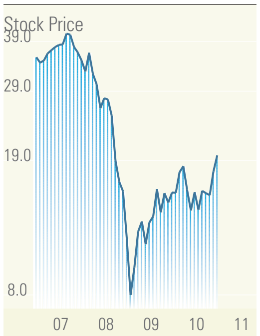
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
21.28 USD	25.00 USD	17.50 USD	35.00 USD	Medium	Wide	B	AA-	Diversified Industrials

GE Caps Off 2010 With Strong Earnings Growth As Industrial Orders Climb

by Daniel Holland
Stock Analyst
Analysts covering this company do not own its stock.

Pricing data through February 08, 2011.
Rating updated as of
February 08, 2011.

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



Analyst Note Jan. 21, 2011

Growth returned in the fourth quarter for General Electric , capping off a year that exceeded our expectations and setting the stage for solid growth in 2011 and beyond. Our long-term thesis is unchanged, but we may adjust our fair value estimate slightly to account for better-than-expected results. Industrial revenue excluding NBC Universal increased 3% in the quarter, with health-care and transportation growth more than offsetting weakness in GE's energy segment. Importantly, orders grew 12% in the quarter, with new equipment increasing 20% and service orders up 5%, supporting future growth.

The company delivered impressive operating margins in the quarter, increasing 20 basis points from the prior quarter to 17.6%. The improvement was largely driven by the return to profitability in the transportation segment. Incremental margins were 26% in the quarter; while healthy, they were held down somewhat by new product launch and production costs in the aviation segment. Aviation margins should continue to be muted through 2011 as shipments of the GEnx engine ramp up.

GE Capital generated $1 billion of earnings from continuing operations as provisions declined $1.5 billion to nearly $1.4 billion. All segments showed improvement versus the prior year and management noted that new business margins continued to strengthen, contributing to earnings growth. Trailing-12-month pretax, preprovision income increased to $9.6 billion, the highest since the first quarter of 2009. As the economy recovers, we expect GE Capital's earnings to improve materially.

Capital allocation remains a central issue for GE shareholders entering 2011, given the company's high cash balance and management's weak appetite for acquisitions exceeding $3 billion. The NBC Universal divestiture, which the company expected to close before the end of 2010 but will now close before the end of January, adds $8 billion to the current cash balance. In addition to the company's stated objective to buy back the preferred shares issued during the height of the credit crunch, we think the stage has been set for a major share-repurchase announcement in the next several quarters. The fourth quarter's results and order pattern serve as a solid precursor to 2011 and beyond, supporting our thesis for the company.

Thesis Jan. 06, 2011

General Electric positions itself to be a leader in all markets in which it competes. After shedding underperforming businesses during the past few years, the firm has energy infrastructure square in its sights. We believe that GE will emerge as a leader in the power infrastructure market, which will be the backbone for the firm's growth.

GE avoids the typical characterization of a conglomerate by combining businesses with strong synergies and opportunities for information-sharing across business lines. Add to this GE's ability to invest large amounts of money in expanding businesses, and virtually any barrier to enter a new market is significantly lower. With its legendary knack for squeaking out operating efficiencies, the firm is able to generate healthy returns on invested capital in many of its markets. By focusing its efforts on the most value-added components for customers, GE is able to remain relevant with customers and focus its research and development efforts on projects that customers will be willing to pay the most for.

The portfolio of businesses continues to be correlated with industrialization and the needs of growing economies. GE has changed its focus as the world has shifted; it now has a heavy focus on clean-energy products, such as wind and gas turbines. The strength of GE's competitive advantage is most notable in wind turbines, where the company was able to unseat longtime incumbent Vestas with its superior manufacturing execution and better customer satisfaction. With the economic stimulus bill signed in February, demand for

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
General Electric Company	USD	226,732	151,375	13,375	9,822
Siemens AG	USD	112,181	104,087	9,646	5,516
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Morningstar data as of February 08, 2011.

renewable-energy products should increase and have a noticeable impact on GE by 2010. Because the renewable-energy industry is still fairly new, many opportunities will exist where a proven manufacturer like GE will be able to make solid gains and outperform startups and other new entrants.

GE's financial unit, GE Capital Services, saw profits continue to fall in 2009, as rapidly deteriorating capital markets and weaker consumers put significant pressure on the unit's ability to maintain past successes. The same factors that confronted GE during the back end of 2009 should persist through 2010, although we see this abating as time moves on and the global economy heals. GE's assets are largely held to maturity, meaning that the firm loans money and collects the principal and interest checks from the borrower as opposed to depending on the capital markets to securitize the portfolio. As a result, GE will bear the financial burden of any underwriting problems. These assets include equipment leases, middle-market commercial loans, private-placement credit cards, and real estate. GE's decisions to wind down its non-U.S. mortgage portfolio and shift to higher-quality asset classes is welcome, even though these decisions will probably pressure earnings. With near-term headwinds easing, investors should benefit from a better-capitalized bank with higher asset quality over the long run.

Valuation, Growth and Profitability

Our fair value estimate for GE shares is $25 per share. Over our forecast horizon we expect organic revenue growth to average 5%, with organic sales rising 1% in 2010. Operating margins should be a bit more resilient to the slowdown than industry peers' because of GE's higher mix of service-based revenue. We model a 120-basis-point improvement from 2009 levels, to 13.8%, with a long-term forecast of 14.5%. Declines in the stock market have weighed down GE's pension plan, resulting in an underfunded liability of $8.7 billion, which we subtract from our estimate of enterprise value.

Although the bank will emerge as a stronger and more stable company, we are concerned about the intensity of the credit cycle and its ramifications for GE Capital's receivables portfolio. In particular, GE's heavy exposure (roughly 20% of invested assets) to commercial real estate gives us pause, since property rent rates hover at low levels. Improvements in the credit card markets and U.K. residential markets help to release some of the pressure on the portfolio. Per GE's income maintenance agreement with GE Capital, we anticipate a payment of $2 billion from the parent to GE Capital during the first quarter of 2011.

Risk

GE's industrial businesses are susceptible to economic downturns, and are particularly sensitive to changes in infrastructure spending. The health-care business is sensitive to changes in government health-care reimbursement rates. GE Capital Services originates and underwrites loans for its own portfolio, as opposed to securitizing these loans in the open market, reducing potential exposure to liquidity risk. It is, however, exposed to the creditworthiness of its counterparties, and may experience steeper write-downs as delinquencies rise. The firm's credit rating gives it access to lower-cost financing, and losing it could hurt profitability, and make growth more difficult to achieve.

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Bulls Say

- The economic stimulus package heavily provides incentive for activity in markets that GE supports.
- The NBC Universal joint venture with Comcast CMCSA boosts GE's cash position and allows the infrastructure businesses receive more capital and management attention.
- GE's global presence gives it access to more information about the direction of economic activity than other firms, giving the company an advantage in getting its feet on the ground in emerging economies.
- A number of GE Capital's competitors are struggling or have already exited the market due to the rise in delinquencies in residential and commercial real estate, leaving a less crowded competitive landscape for GE.

Bears Say

- Efficient manufacturing programs like Six Sigma and lean manufacturing have been around long enough for other firms to successfully implement and catch up to GE, reducing the strength of GE's cost advantage.
- GE's bank portfolio still has more than $100 billion on non-U.S. consumer loans outstanding which will keep charge-off rates high for the foreseeable future.
- By shifting to long-term financing, GE is opting for more expensive financing, which will pressure GE Capital's profitability.
- Oversight by financial regulators is imminent and GE Capital will more than likely have to retain more of its capital going forward as opposed to giving it back to the parent company.

Financial Overview

Financial Health: GE's industrial unit generated healthy free cash flow of $16.6 billion, or 16% of revenue, in 2009 and held $9 billion in cash at the end of the year. We are confident that GE will be able to repay or refinance its upcoming obligations.

Company Overview

Profile: General Electric is a diversified manufacturer and is organized into five segments: technology infrastructure, energy infrastructure, home and business services, and capital services. Financial services accounted for 13% of the firm's profit in 2009.

Management: GE is known for the strength and depth of its management team, which has a long history of creating value for shareholders. As testament to its depth, several former executives have gone on to lead other large companies. CEO Jeff Immelt took the reins from the legendary Jack Welch just days before 9/11, and his tenure to date has been characterized by a stronger balance sheet, significant acquisition spending, and the divestiture of most of the firm's insurance and plastics businesses. Immelt's management style is more collaborative and less transient than his predecessor's. It also keeps managers in jobs longer to take advantage of their expertise. Overall, we're satisfied with GE's corporate-governance practices but would prefer to see Immelt's variable compensation more closely linked to return on invested capital, as that metric provides a better proxy for corporate stewardship than operating cash flow. GE's shareholders face a 3% dilution on average from equity-based compensation, but this does not alarm us.

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Jan. 13, 2011

GE Increases Exposure to Data Centers with Purchase of Lineage Power

The surging growth in network power applications attracted General Electric to purchase Lineage Power, a specialist in embedded power and power conversion for data centers and telecom. GE paid $520 million dollars for the business, which is roughly 8 times 2010 EBITDA or 1.1 times 2010 sales. We think the purchase of Lineage Power is a continuation of a trend that investors should expect to see from GE as acquisitions play a bigger part in GE's growth strategy.

The deal comes at an impressive discount to recent transactions in the space by Emerson and Eaton. The rapid growth of smartphones and devices like the iPad increase the strain on data centers, requiring more investment in technology and capacity. GE's acquisition, while at a reasonable price, is curious because GE's presence in network power application is small compared to Emerson,

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Analyst Notes (continued)

Eaton, and Schneider. Emerson fought valiantly for Chloride, keeping out of the industry, but GE managed to get Lineage Power at less than half the valuation Emerson paid for Chloride. Even though Emerson has a strong presence in embedded power applications, GE's presence as a disciplined but highly motivated competitor will make economic profits a bit tougher to come by in the industry.

Dec. 10, 2010

GE Raises the Dividend for the Second Time in a Year

General Electric increased its quarterly dividend for the second time this year to $0.14 per share, or an annualized rate of $0.56 per share. The prior dividend rate was $0.12 per quarter. This announcement is consistent with management's stated intentions and supports our thesis for the company. More important, we think the decision reflects the board's confidence in GE's core business. We expect GE to continue to repurchase shares up to the stated threshold of $22 per share as well as pursue acquisitions below $3 billion. Additionally, GE is first eligible to repurchase the preferred shares sold to Berkshire Hathaway in October 2011. We expect GE to buy these back as soon as possible, given the steep 10% dividend.

Oct. 15, 2010

GE Reports 3Q Results

General Electric delivered third-quarter results in line with our expectations, but weak top-line performance raised some concerns. Industrial revenue was $19.7 billion, down 6% versus last year, but order growth of 7% bodes well for future quarters. Energy was the weakest link in the portfolio, with wind revenue down 32%. While GE's other energy businesses will likely rebound in 2011 and 2012, we think the wind business will face both volume headwinds in the United States as well as margin compression as the company expands into more global markets with lower margin profiles.

GE Capital performed as expected, generating $832 million in earnings from continuing operations. Losses continue to decline across the portfolio, with every segment except for commercial real estate producing a profit. We are impressed with the progress that GE Capital has made while executing management's long-term plan for GE Capital involving a smaller, more focused portfolio. During the quarter, GE booked an additional $1.1 billion reserve in discontinued operations related to the disposition of GE Money Japan to Shinsei Bank. By the company's estimate, this should adequately cover any claims made over the next 24 months, but the lack of stability in the consumer banking environment gives us pause.

GE's cash generation ability remains one of its best attributes, in our opinion. Management expects the company to generate $14 billion-$15 billion in cash this year, which is at the high end of the original forecast. More importantly, we are encouraged by GE's recent capital moves including the acquisition of Dresser for $3 billion, the $1 billion of share repurchases, and the announced dividend increase. Combined, these actions signal that the company may exit the protective stance that it needed to take during the downturn, indicating the worst is behind us.

On Nov. 4, General Electric's investor relations director, JoAnna Morris, will be speaking at the 5th Annual Morningstar Stocks Forum. We are looking forward to having her speak about the company's prospects and its strategy in this uncertain economic environment.

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Analyst Notes (continued)

Oct. 06, 2010

GE to Acquire Dresser for $3 Billion

General Electric announced that it will acquire Dresser, an energy infrastructure technology and service provider, for $3 billion. This values the enterprise at 9.4 times 2009 earnings and 1.5 times 2009 sales. This is precisely the type of acquisition that we expected GE to begin making after moving NBC Universal out of its portfolio, given its ample cash flow from the residual businesses. Dresser helps build GE's presence in the energy flow markets, giving the firm a broader product offering and an ability to provide differentiated solutions to customers.

We expect GE to have more than $20 billion of cash on its balance sheet at the end of this year, net of this announced purchase and the closing of the NBC Universal divestiture. This leaves plenty of room for the company to buy back the $3 billion preferred shares currently outstanding, repurchase common shares, and pursue more acquisitions. We admire GE's discipline and execution over the past several quarters, given that other diversified firms have stretched deal valuations to beyond justifiable levels. GE's currently low relative valuation (15 times 2010 earnings) and strong business fundamentals provide a compelling investment case, in our opinion. We maintain our fair value estimate.

On Nov. 4, General Electric's investor relations director, JoAnna Morris, will be speaking at the 5th Annual Morningstar Stocks Forum. We are looking forward to having her speak about the company's prospects and its strategy in this uncertain economic environment. To attend the event, please go to:

s/Store_StockForum.html?t1=1285597664&t1=1285597818

Sept. 22, 2010

New Credit Rating: General Electric

Morningstar is initiating credit coverage of General Electric with an issuer rating of AA-. Our rating methodology is to focus on the industrial company's financial metrics,

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Analyst Notes (continued)

adjusted for the cash flows to and from GE Capital, but to also capture the business risk of GE Capital through our Business Risk and Distance to Default scores. For example, GE's fair Distance to Default score reflects the firm's stock price volatility over the past year, much of which may have been driven by the risks of the finance subsidiary. As such, the Distance to Default represents a consolidated company rating metric. Similarly, the very good Business Risk score reflects the operations of the entire firm. This includes the company's impressive size and diversity of operations and its entrenched business positions, which we believe warrants a wide economic moat.

The good Solvency Score, on the other hand, reflects the low leverage of the industrial company as well as its solid returns on invested capital, but does not factor in GE Capital's operating results. Finally, the fair Cash Flow Cushion score is primarily driven by the cash flows and obligations of the industrial company, but also takes into account projected financial support to GE Capital as well as forecast dividends paid by GE Capital to General Electric. We do not forecast any additional funding requirements to GE Capital, for example, but expect dividends to resume flowing back to GE beginning in 2012. The company's Cash Flow Cushion is hurt by upcoming debt maturities of $2 billion in 2011 and $5 billion in 2013, annual dividend payments of more than $5 billion, and acquisitions.

GE is not immune to cyclical downturns, as reflected in its 10% top-line decline in 2009, along with operating margins falling almost 300 basis points from 2008. We expect modest growth this year followed by mid-single-digit growth over our forecast horizon, along with a rebound in margins approaching historical levels. This should drive substantial free cash flow generation and impressive liquidity, which could result in modest improvement in credit metrics over time.

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General Electric Company GE

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
151,375	226,732	Diversified Industrials	Industrial Materials

General Electric is a diversified manufacturer and is organized into five segments: technology infrastructure, energy infrastructure, home and business services, and capital services. Financial services accounted for 13% of the firm's profit in 2009.

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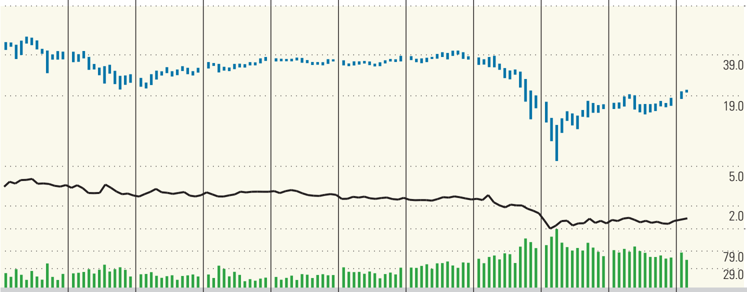
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★★★	21.28	25.00	Medium	Wide	B

per share prices in USD

53.55	41.83	32.18	37.75	37.34	38.49	42.15	38.52	17.52	19.70	21.31	Annual Price High
28.50	21.41	21.82	28.88	32.67	32.06	33.90	12.58	5.73	13.75	18.12	Low
											Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low
21.31 - 13.75
10 Year High/Low
53.55 - 5.73
Bear-Market Rank
1 (10=worst)
Trading Volume Million

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
-15.0	-37.4	30.4	20.5	-1.5	9.1	2.7	-53.0	-2.8	23.9	16.4	Total Return %
-2.0	-14.0	4.0	11.5	-4.5	-4.5	-0.8	-14.5	-26.2	11.1	11.1	+/- Market
2.8	-10.4	-4.4	5.3	-3.7	-4.3	-16.2	-6.0	-23.7	14.4	7.8	+/- Industry
1.6	3.0	2.5	2.3	2.6	2.8	3.1	7.7	4.0	2.5	2.2	Dividend Yield %
397889	242308	311066	385883	370344	383564	370240	161278	161332	194875	226732	Market Cap USD Mil

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	TTM	Financials
129417	125913	131698	134187	152363	149702	163391	172738	182515	156783	151375	Revenue USD Mil
65.9	61.0	59.9	61.8	59.5	55.4	54.6	57.7	54.1	51.6	52.5	Gross Margin %
30157	31111	29433	31133	32941	38302	44814	52842	19141	10344	13375	Oper Income USD Mil
23.3	24.7	22.3	23.2	21.6	25.6	27.4	30.6	10.5	6.6	8.8	Operating Margin %
12735	13684	14118	15002	16593	16353	20829	22208	17335	10725	9822	Net Income USD Mil
—	1.37	1.41	1.49	1.59	1.54	2.00	2.17	1.72	1.01	0.92	Earnings Per Share USD
—	0.66	0.73	0.77	0.82	0.91	1.03	1.15	1.24	0.61	0.42	Dividends USD
—	10052	10028	10075	10445	10611	10394	10218	10098	10615	10681	Shares Mil
5.52	6.40	7.89	10.43	10.35	10.85	11.57	10.51	11.00	10.84	10.84	Book Value Per Share USD
22690	32195	29488	30289	36484	37641	30646	45683	48601	24593	37141	Oper Cash Flow USD Mil
-16299	-15520	-13351	-9767	-13118	-14441	-16650	-17870	-16010	-8634	-7241	Cap Spending USD Mil
6391	16675	16137	20522	23366	23200	13996	27813	32591	15959	29900	Free Cash Flow USD Mil

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	TTM	Profitability
—	2.9	2.6	2.5	2.4	2.3	3.0	3.0	2.2	1.4	1.3	Return on Assets %
—	26.0	23.8	21.0	17.5	14.9	18.8	19.5	15.7	9.7	8.4	Return on Equity %
9.8	10.9	10.7	11.2	10.9	10.9	12.7	12.9	9.5	6.8	6.5	Net Margin %
—	0.27	0.25	0.22	0.22	0.21	0.24	0.23	0.23	0.20	0.20	Asset Turnover
—	9.0	9.0	8.2	6.8	6.2	6.2	6.9	7.6	6.7	6.6	Financial Leverage

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	09-10	Financial Health
139551	141804	204950	238969	287542	184959	218214	244405	254715	316579	298878	Working Capital USD Mil
82132	79806	140632	170004	213161	212281	260804	319015	330067	338215	307517	Long-Term Debt USD Mil
50492	54824	63706	79180	110284	109354	112314	115559	104665	117291	115536	Total Equity USD Mil
—	1.46	2.21	2.15	1.93	1.94	2.32	2.76	3.15	2.88	2.66	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
28.4	16.1	20.0	22.9	22.8	18.7	16.9	9.1	14.7	15.9	18.5	Price/Earnings
—	—	—	—	—	—	—	—	—	0.9	1.1	P/E vs. Market
3.2	1.9	2.3	2.5	2.5	2.4	2.2	0.9	1.0	1.3	1.5	Price/Sales
7.3	3.8	3.9	3.5	3.4	3.4	3.2	1.5	1.4	1.7	2.0	Price/Book
12.5	8.3	10.3	10.4	9.9	12.7	8.3	3.4	6.5	5.3	6.1	Price/Cash Flow

Growth Rates Compound Annual

Grade: C	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	-14.1	-1.4	0.6	3.5
Operating Income %	-46.0	-38.7	-20.7	-8.5
Earnings/Share %	-42.1	-19.7	-8.3	-0.4
Dividends %	-50.8	-16.0	-5.8	2.3
Book Value/Share %	4.6	0.3	1.1	9.8
Stock Total Return %	39.4	-11.3	-4.7	-4.7
+/- Industry	16.0	-6.0	-5.3	-4.1
+/- Market	14.1	-11.1	-5.6	-4.1

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	8.4	15.7	10.1	21.9
Return on Assets %	1.3	2.4	2.4	8.5
Fixed Asset Turns	2.2	2.3	3.6	7.2
Inventory Turns	5.7	6.3	5.9	14.6
Revenue/Employee USD K	497.9	536.3*	—	897.4
Gross Margin %	52.5	54.7	36.2	39.1
Operating Margin %	8.8	20.1	8.8	14.3
Net Margin %	6.5	10.6	5.6	9.5
Free Cash Flow/Rev %	19.8	13.6	9.7	0.1
R&D/Rev %	—	—	—	9.8

Financial Position

Grade: C	12-09 USD Mil	09-10 USD Mil
Cash	72260	78392
Inventories	11987	11997
Receivables	359867	348704
Current Assets	496055	484783
Fixed Assets	69212	65538
Intangibles	77503	74359
Total Assets	781818	758824
Payables	20844	14617
Short-Term Debt	133054	145376
Current Liabilities	179476	185905
Long-Term Debt	338215	307517
Total Liabilities	664527	643288
Total Equity	117291	115536

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	18.5	15.1	24.6	16.6
Forward P/E	13.0	—	—	14.0
Price/Cash Flow	6.1	7.2	10.9	8.7
Price/Free Cash Flow	7.6	12.6	15.5	17.3
Dividend Yield %	2.2	—	1.9	1.7
Price/Book	2.0	2.3	2.7	2.3
Price/Sales	1.5	1.6	1.5	1.4
PEG Ratio	1.1	—	—	1.6

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

Quarterly Results

Revenue USD Mil	Dec 09	Mar 10	Jun 10	Sep 10
Most Recent Period	41438.0	36605.0	37444.0	35888.0
Prior Year Period	46213.0	38411.0	39082.0	37799.0

Rev Growth %	Dec 09	Mar 10	Jun 10	Sep 10
Most Recent Period	-10.3	-4.7	-4.2	-5.1
Prior Year Period	-4.9	-7.9	-16.6	-20.0

Earnings Per Share USD	Dec 09	Mar 10	Jun 10	Sep 10
Most Recent Period	0.28	0.17	0.28	0.18
Prior Year Period	0.35	0.26	0.24	0.23

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
General Electric Com	226732	151375	18.5	8.4
Siemens AG	112181	104087	18.9	13.9
Siemens AG	112181	104087	18.9	13.9

Major Fund Holders

	% of shares
Vanguard Total Stock Mkt Idx Inv	1.06
Vanguard 500 Index Investor	0.92
Dodge & Cox Stock	0.73

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

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Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

Morningstar Research Methodology for Valuing Companies

Competitive Analysis →	**Economic Moat™ Rating** →	Company Valuation →	**Fair Value Estimate** →	Uncertainty Assessment →	★★★★★
Analyst conducts company and industry research: • Management interviews • Conference calls • Trade-show 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.	An uncertainty assessment establishes the margin of safety required for the stock rating.	★ ★★ ★★★ ★★★★ ★★★★★ The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

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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."

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