Royal Caribbean Cruises, Ltd. RCL [XNYS] | ★★★

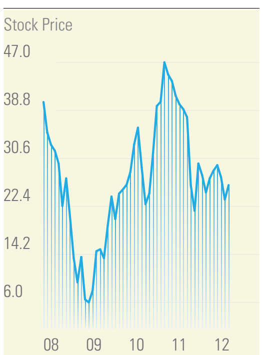
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
24.3 USD	30.00 USD	15.00 USD	52.50 USD	Very High	Narrow		B-	Leisure

RCL Exceeds 1Q Expectations, but Revises FY12 Down; Expect Normalized Demand to Resume in FY13

by Jaime M. Katz, CFA
Equity Analyst
Analyst covering this company do not own its stock.

Pricing data through Jul 25, 2012.
Rating Updated as of Jul 25, 2012.

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



Analyst Note Apr. 20, 2012

Royal Caribbean RCL delivered first-quarter estimates that were better than expected but still down year over year even after adjusting for one-time, mark-to-market gains on the company's fuel option portfolio. The company reported net yield growth of 6.4% during the quarter, helped by two changes to the business that we expect will keep yields resilient over the course of 2012 in spite of the industrywide impact from the Concordia disaster and weaker pricing for the second and third quarters. First, the company upgraded its international distribution system (that is, consolidating charter arrangements) which will boost yields. Second, deployment initiatives (like expansion into China) will help increase revenue. These two initiatives alone are expected to increase yields by 200 basis points in 2012, but will also increase expenses, driving a 300-basis-point increase in net cruise costs (ex-fuel) during the year. We plan to incorporate Royal Caribbean's updated guidance in our outlook, but anticipate no change to our $30 fair value estimate at this time.

While the net yield improvement of 6.4% was impressive, we note that 350 basis points of the improvement were due to the two initiatives discussed above, and the company was lapping a particularly weak first quarter last year when net yields were down 3.4%. Pricing (net yield per APCD) of $169.42 per cruise day during the first quarter is higher than both last year and 2009's first quarters, but still has failed to eclipse pricing reached in 2008 ($172.55). We are close to that price now, and believe that we can get at or above those lofty pricing levels again in the first quarter of 2013. The above initiatives also had an effect on the cost side of the equation, impacting net cruise costs by a whopping 500 basis points. Combined with increasing fuel prices during the quarter, these additional cost headwinds generated net cruise cost growth of 10.1%. Although bookings have remained weaker than either the company or the investing community would have liked, we think it is promising that pricing has held outside of Europe. In addition, although it is very early, bookings for the seasonally small fourth quarter and 2013 appear to be coming in strongly, with both load and pricing ahead of last year. This bodes well for our thesis that next-year demand should resume as normal.

Management offered an updated outlook for both the second quarter and full year that was lighter than expected. The second quarter is expected to deliver earnings per share in a range of ($0.05) to $0.05, helped by net revenue yield growth of 2% to 3% but hindered by significant net cruise cost growth of 11%-12%. For the full year, earnings per share guidance was revised down to a range of $1.80-$2.10 from $1.90-$2.30, which we think is decent in light of the negative press the cruise industry has encountered. Royal Caribbean expects to see full-year net revenue yield growth in the order of 1%-4%, which raised the low end of its initial guidance (0%) and net cruise cost growth of 6%-7% which increased by 1% on the high and low end of its initial forecast. While an earnings per share decline of 27% year over year is not something we usually get excited about, we recognize the 2012 year could have been much worse and think the company is taking the appropriate steps via the revenue management team to ensure that the ships sail full at the best rate possible.

Thesis Feb. 03, 2012

Royal Caribbean is the second-largest company in the cruise industry, operating global brands that include Royal Caribbean International, Celebrity Cruises, and Azamara. The company also operated the Pullmantur brand, which is tailored to serve the cruise markets in Spain, Portugal, and Latin America; the CDF Croisières de France brand, which provides a tailored product targeted at the French market; and its joint venture TUI Cruises, which focuses on the German market. Currently, Royal Caribbean has the largest ships on the seas, albeit a smaller fleet than its closest rival Carnival Cruise Lines CCL. The 39 ships currently in service and passenger capacity of more than 92,000 allow Royal Caribbean to reach a broad group of consumers in a lightly penetrated vacation segment. The scale advantages, capital

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Carnival Corporation	USD	26,305	15,874	1,912	1,429

intensity, and scarcity in building that are inherent in the cruise industry prevent new competitors from easily entering the market and provide Royal Caribbean with a narrow economic moat. While Royal Caribbean is a strong competitor in the cruise industry, overarching concerns about the global political and economic environments, along with the Costa Concordia tragedy in January 2012, are likely to weigh on the stock in the near term.

We believe the audience that Royal Caribbean caters to remains relatively underpenetrated. The core target market for cruisers includes roughly 133 million people in the U.S. alone. To date, only approximately 20% of this population has ever cruised (according to the Cruise Lines International Association). With low domestic penetration rates, and the more recent dedication to source cruisers from international markets (with an even lower penetration rate), the upside potential remains significant. In addition, cruises have some of the highest satisfaction rates in the vacation market and percentage of repeat clients. We believe reaching deeper into this underserved population base is imperative for Royal Caribbean's growth over the long term. More specifically, we believe penetrating the baby boomer demographic will serve the cruise industry well as this segment of the population retires and increases their allocated leisure time. According to the Census Bureau, an American turns 65 years old every 13 seconds and some 10,000 baby boomers retire every day. The aging population is the linchpin in our opinion regarding supply and demand imbalance in the cruise industry. This segment will drive excess demand and create a modest disruption between the demand in the market and the supply of berths during the next five years at a minimum. We expect the 55- to 64-year-old demographic to grow 15% and the 65 and above demographic to grow faster than 20% for the years 2010 through 2015 (based on Census data), while overall cruise capacity grows only 2.9%. The excess demand created in this environment will allow Royal Caribbean to implement more lucrative pricing strategies in years ahead. The value proposition that cruising will still offer relative to land-based vacations will remain a compelling selling point to this audience.

We also believe that it would be nearly impossible for any new competitor to enter the market en masse and take material share from either Royal Caribbean or Carnival due to the structural anomalies of the business. Specifically, issues with the limited number of shipyards available for new builds along with the lead time to take the ship from design to market would prevent any new ships from sailing on the seas for at least three years. New market entrants would find it difficult to scale up at a reasonable pace and, with a less than optimal cost structure, might then struggle to price their vacations competitively. In addition, scaling up in an industry in which one ship runs north of $500 million requires very deep pockets or access to massive liquidity.

Although the above issues provide the potential for Royal Caribbean to protect its position and grow at a healthy clip, we note there are a number of risk factors to our fair value estimate assumptions. First, although Royal Caribbean does a fair job of hedging its fuel costs, it hedges only about half of the current year total costs, and an extended period of high energy prices can materially affect profitability. Second, the geopolitical environment remains unstable and may lead to cruise cancellations and reschedules, which may affect near-term cruise pricing. Third, another global economic slowdown could dampen demand and pricing in an unpredictable fashion. And finally, the magnitude of the impact from the Costa Concordia's demise has yet to be quantified.

Valuation, Growth and Profitability

We are lowering our fair value estimate for Royal Caribbean to $30 from $33 per share, as we have taken into account tempered 2012 guidance after the Costa Concordia tragedy.

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We expect the company will still grow free cash flow over the long term as debt gets paid down diligently and capital spending slows. Our fair value estimate implies a 2012 fiscal year price/earnings ratio of 14.8 times and, an enterprise value/EBITDA multiple of 8.5 times, and a free cash flow yield of 2.1%. More resilient pricing after the 2012 year should help Royal Caribbean, as fewer new ships come on line and supply more closely meets demand. We expect that pricing can grow midsingle digits over the medium term (including 3% in 2013), as capacity growth remains under 3% annually until at least 2015, which is significantly slower than the 6% cruise industry capacity CAGR during the last two decades. In conjunction with slower capacity growth, we have forecast occupancy rates at 102%, which we believe is reasonable based on historically achieved rates. Longer term, we have both pricing and costs stabilizing at a low-single-digit growth rate, as the cruise industry remains in the mature phase of its life cycle with rational competition. We anticipate Royal Caribbean's operating margins can expand from the forecast 9.7% in 2012 (compared with the five-year historical operating margin of 12.0%) as the company recovers from the media scrutiny surrounding the Costa Concordia tragedy and gains some cost leverage due to more efficient fuel consumption and stronger vendor relationships.

Royal Caribbean has historically generated ROICs in the mid-single-digit range; however, we believe the board's directive to achieve mid-double-digit ROICs is ultimately achievable by improving long-term cash flows through paying down debt, managing expenses, and delivering a compelling value-oriented vacation product to a broad consumer base. We think the Costa accident has set the company on a slower trajectory to boosting ROICs in the short term and considering the capital-intensive nature of the business, we think this might be a goal that takes some time to achieve (we don't have ROICs exceeding our current 10.8% weighted average cost of capital assumption until 2020).

Risk

Royal Caribbean faces a number of inherent risks that may affect its enterprise value. The global geopolitical environment has kept headline risk in the forefront for cruise companies during 2011. As turmoil continues in the Mediterranean, we cannot predict the duration, and thus the magnitude of impact this will have on ship deployments and pricing in the region. We do, however, acknowledge that management is very diligent in redeploying capacity as needed, which we think is particularly helpful, as the Costa Concordia accident has added insult to injury for the cruise lines in the Southern European markets. Also, the consensus remains divided as to whether the global economy has recovered from the most recent slowdown, and concern remains that the near-term economic environment will become less favorable (yet again). Additionally, the recent volatility in commodity prices, specifically energy, may affect profitability if fuel prices remain inflated for an extended period of time. A longer term concern that warrants consideration is that changes to the company's tax status under the U.S. Internal Revenue Code could materially affect profitability.

Bulls Say

- The slower rate of shipbuilding in the industry better matches supply with demand, which will help support cruise pricing over the next few years. Both Royal Caribbean and Celebrity Cruises have fewer ships for delivery over the next three years than in the past.
- As the baby boomers enter retirement, more leisure travel will likely be pursued. Recent investments in new ships should position Royal Caribbean to capture the leisure dollars spent in this demographic segment.

- If the U.S. employment situation improves, pent up demand for vacations that have been delayed over the last few years will rebound and pricing will improve, driving incremental cash flow.
- The value proposition that cruise vacations offer over a land-based vacation is likely to be compelling to more cautious spenders across all demographic bases.

Bears Say

- A continued weakness in the employment picture would likely dampen demand and cause pricing to soften materially.
- A persistent increase in commodity prices, particularly in energy and food, could pressure profitability.
- Although Royal Caribbean has benefited from sourcing cruisers globally, continued political turmoil and hesitancy due to the Costa Concordia grounding may cause additional cruise cancellations as itineraries change.

Financial Overview

Financial Health:We expect Royal Caribbean's financial health will improve over the next few years, as the company will need to rely less on external financing as fewer ships are delivered. Management seems dedicated to returning the firm to an investment grade rating which, by our estimate, Royal Caribbean could manage to reach by the end of 2014 at the earliest. We arrive at an investment grade rating in the year 2014 by assuming that Royal Caribbean allows some of its debt to mature without refinancing, which results in a measured reduction in leverage. We currently assign Royal Caribbean a B- issuer rating, which implies high default risk, but continued debt repayment would improve the company's creditworthiness. The Board of Directors' mandate to improve returns on invested capital should also keep Royal Caribbean focused on making appropriate decisions for improvements in the company's overall financial health.

Company Overview

Profile: Royal Caribbean is the world's second-largest cruise company, operating 39 ships in the cruise vacation industry, with approximately 92,300 berths as of Dec. 31, 2010. Company brands include Royal Caribbean International, Celebrity Cruises, Azamara Club Cruises, Pullmantur, and CDF Croisières de France. The company also has a 50% investment in a joint venture that operates TUI Cruises (tailored for the German market) and competes on the basis of innovation, quality of ships and service, variety of itineraries, choice of destinations, and price.

Management: Richard Fain has been the chairman and CEO of Royal Caribbean since 1988. Fain and the management team have extensive experience, with an average tenure of more than 17 years at the company. We believe that shareholders would likely be better served if the chairman and CEO roles were divided to promote greater independence across the board of directors. The company also has its board divided into three classes, with each class having a three-year term. These staggered board elections prevent a shakeup of directors when a change in power is pursued by shareholders. Additionally, the Wilhelmsen family controls 19%, and the Pritzker and Ofer families together control 33% of voting rights, effectively minimizing the voting power of minority shareholders. Overall, management incentives appear to be well aligned, with compensation based on a blend of base salary, performance-based annual incentives, and long-term incentive awards. Named executive officers are expected to accumulate company stock, along with derivative forms of company equity having a fair market value equal to or greater than 3 times their base salaries. We believe this aligns the management's risk and decisions with shareholder interests and the firm's long-term goals.

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Royal Caribbean Delivers Decent 4Q, but Costa Tragedy Acts as Drag on 2012 Feb. 02, 2012

Royal Caribbean RCL reported a fourth quarter that was largely in line with our and the consensus expectations. The company reported earnings per share of $2.77, the same as our forecast, driven by net yield increases of 3.2% but

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Analyst Notes (continued)

affected by net cruise cost growth of 6.3% (including fuel) on an as-reported basis. While we like the long-term prospects for the cruise industry and Royal Caribbean, the company could not escape the halo effect that Carnival's CCLCUK Costa Concordia tragedy has created over cruising. We did not lower our fair value estimate for Royal Caribbean when the incident occurred, but plan a decrease to bring our near-term free cash flow expectations in line with reality, considering the drag the media scrutiny has created for both Royal Caribbean and Carnival.

Masking a fourth quarter that would typically be perceived as solid is the forward forecast from the company that takes into account the depressed demand it has encountered since mid-January, when the Concordia was grounded. While the company noted that there were no material changes to cancellation activity, it conveyed that new booking activity had been affected, with North American booking volume down in the low to mid-teen percentages and European booking volume down even more significantly. On the bright side, it appears that the precipitous drop in bookings has stabilized, and management believes it can achieve yield improvement of zero to 4% on an as-reported basis for 2012.

On the cost side, distribution changes and deployment initiatives are likely to increase net cruise costs by about 300 basis points to 5%-6% in 2012 (the same changes are expect to help yields by 200 basis points during the year). Even though first-quarter earnings seem to be intact, we can see the longer-term implications for 2012 earnings and in particular summer bookings as indicated by the company's 2012 outlook for EPS of $1.90-$2.30. We expect both our $3.02 and the Street's $2.94 estimate for 2012 to be adjusted accordingly, and as we reduce our earnings estimate materially, our fair value will adjust as well.

We remain positive on the cruise industry as a whole over the longer term, as we expect the demand for cruising will handily outstrip the growth in capacity over the next five years at least. We deem it prudent to remain on the sidelines when the media has a stranglehold on an industry, particularly when we know it will take at least a few months to remove the Concordia ship from Mediterranean waters, and the spectacle will remain a sight for both cruisers and investors that will be difficult to digest over the near term. Once we trudge through what is likely to be a difficult quarter or two for both Royal Caribbean and Carnival, we think there will be a number of positive catalysts that will make these stocks compelling.

Royal Caribbean Cruises, Ltd. RCL

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
7,700	5,316	Leisure	Consumer Cyclical

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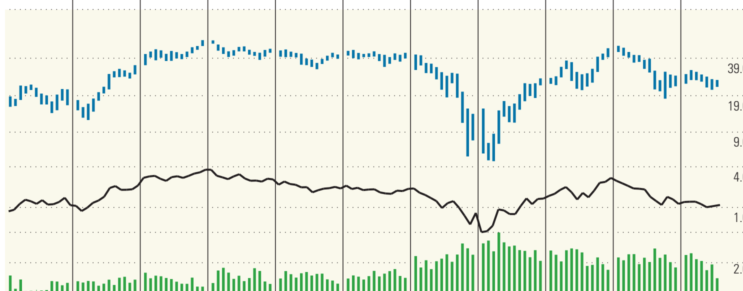
2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	
24.38	35.00	55.47	55.23	46.77	46.36	42.59	27.39	47.83	49.99	31.96	Annual Price High
14.21	12.42	34.98	38.59	32.47	33.90	5.97	5.40	21.97	18.70	22.12	Low
											Recent Splits



2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
6.3	111.4	58.0	-16.2	-6.8	4.0	-66.5	83.8	85.9	-46.9	-0.7	Total Return %
29.7	85.0	49.0	-19.2	-20.4	0.5	-28.0	60.4	73.1	-46.9	-9.0	+/- Market
2.8	77.6	17.2	-8.0	-6.2	9.9	-20.0	29.1	44.8	-32.6	-17.7	+/- Industry
3.1	1.5	1.0	1.2	1.5	1.4	4.4	—	—	0.8	1.6	Dividend Yield %
3223	6823	10676	9460	8775	9480	2926	5409	10147	5382	5316	Market Cap USD Mil

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Financials
3434	3784	4555	4903	5230	6149	6533	5890	6753	7537	7700	Revenue USD Mil
38.5	37.1	38.1	38.9	37.9	35.2	32.6	30.9	34.0	34.4	33.8	Gross Margin %
551	526	754	872	858	901	832	489	803	932	917	Oper Income USD Mil
16.0	13.9	16.5	17.8	16.4	14.7	12.7	8.3	11.9	12.4	11.9	Operating Margin %
351	281	475	716	634	603	574	162	547	607	576	Net Income USD Mil
1.79	1.42	2.26	3.26	2.94	2.82	2.68	0.75	2.51	2.77	2.63	Earnings Per Share USD
0.52	0.52	0.52	0.56	0.60	0.60	0.45	0.00	0.00	0.20	0.30	Dividends USD
196	198	210	220	216	214	213	215	218	219	219	Shares Mil
20.91	21.74	24.50	26.46	28.73	30.25	31.97	35.05	36.59	38.70	39.44	Book Value Per Share USD
870	858	1077	1111	949	1269	1071	845	1663	1456	1386	Oper Cash Flow USD Mil
-690	-1030	-631	-430	-1181	-1317	-2224	-2478	-2187	-1174	-1285	Cap Spending USD Mil
180	-172	446	681	-232	-49	-1152	-1633	-524	282	101	Free Cash Flow USD Mil

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Profitability
3.4	2.6	4.1	6.2	5.1	4.3	3.6	0.9	2.9	3.1	2.9	Return on Assets %
9.0	6.8	10.5	13.8	10.9	9.4	8.5	2.3	7.1	7.4	6.8	Return on Equity %
10.2	7.4	10.4	14.6	12.1	9.8	8.8	2.8	8.1	8.1	7.5	Net Margin %
0.33	0.35	0.39	0.42	0.42	0.43	0.42	0.34	0.36	0.38	0.39	Asset Turnover
2.6	2.7	2.5	2.0	2.2	2.2	2.4	2.4	2.5	2.4	2.3	Financial Leverage

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	03-12	Financial Health
-722	-930	-1413	-1612	-1370	-1347	-1697	-1723	-2429	-2098	-1976	Working Capital USD Mil
5322	5521	4827	3554	5040	5347	6540	7664	7951	7857	7899	Long-Term Debt USD Mil
4035	4263	4805	5554	6092	6757	6803	7500	7943	8408	8593	Total Equity USD Mil
1.32	1.30	1.00	0.64	0.83	0.79	0.96	1.02	1.00	0.93	0.92	Debt/Equity

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
9.3	24.5	24.1	14.9	14.1	15.1	5.1	33.7	18.7	8.9	9.3	Price/Earnings
—	—	—	—	—	—	—	—	—	0.5	—	P/E vs. Market
0.9	1.8	2.5	1.9	1.7	1.5	0.5	0.9	1.5	0.7	0.7	Price/Sales
0.8	1.6	2.2	1.7	1.4	1.4	0.4	0.7	1.3	0.6	0.6	Price/Book
3.8	8.0	10.6	8.6	9.2	7.2	2.7	6.4	6.2	3.7	3.9	Price/Cash Flow

Growth Rates Compound Annual

Grade: C	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	11.6	4.9	7.6	9.1
Operating Income %	16.1	3.8	1.6	7.4
Earnings/Share %	10.4	1.1	-1.2	7.7
Dividends %	—	-23.7	-19.7	-9.1
Book Value/Share %	5.3	6.6	6.2	7.1
Stock Total Return %	-30.7	18.7	-8.6	4.4
+/- Industry	-37.3	-3.1	-10.3	-1.9
+/- Market	-33.5	6.0	-6.3	2.3

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	6.8	6.9	9.8	22.8
Return on Assets %	2.9	3.0	5.0	9.3
Fixed Asset Turns	0.5	0.5	0.8	7.7
Inventory Turns	35.3	41.2	10.9	17.0
Revenue/Employee USD K	126.1	112.5*	—	1055.7
Gross Margin %	33.8	33.4	42.6	39.7
Operating Margin %	11.9	12.0	13.8	16.6
Net Margin %	7.5	7.5	9.3	11.1
Free Cash Flow/Rev %	1.3	—	8.1	0.1
R&D/Rev %	—	—	—	9.5

Financial Position

Grade: C	12-11 USD Mil	03-12 USD Mil
Cash	262	278
Inventories	145	148
Receivables	292	313
Current Assets	969	1124
Fixed Assets	16935	16950
Intangibles	747	758
Total Assets	19804	20029
Payables	305	291
Short-Term Debt	639	639
Current Liabilities	3068	3100
Long-Term Debt	7857	7899
Total Liabilities	11397	11436
Total Equity	8408	8593

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	9.3	16.3	20.0	—
Forward P/E	13.4	—	—	13.2
Price/Cash Flow	3.9	5.2	9.6	—
Price/Free Cash Flow	52.9	—	26.3	—
Dividend Yield %	1.6	—	1.9	2.0
Price/Book	0.6	0.9	1.9	—
Price/Sales	0.7	1.0	1.8	—
PEG Ratio	1.6	—	—	0.3

Quarterly Results

Revenue USD Mil	Jun 11	Sep 11	Dec 11	Mar 12
Most Recent Period	1767.9	2322.0	1775.4	1834.5
Prior Year Period	1601.7	2060.7	1604.5	1672.0

Rev Growth %	Jun 11	Sep 11	Dec 11	Mar 12
Most Recent Period	10.4	12.7	10.7	9.7
Prior Year Period	18.7	16.9	10.5	12.5

Earnings Per Share USD	Jun 11	Sep 11	Dec 11	Mar 12
Most Recent Period	0.43	1.82	0.17	0.21
Prior Year Period	0.28	1.64	0.20	0.42

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Royal Caribbean Crui	5316	7700	9.3	6.8
Carnival Corporation	26703	15874	18.0	6.1

Major Fund Holders

	% of shares
	—
	—
	—

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

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

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- 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.

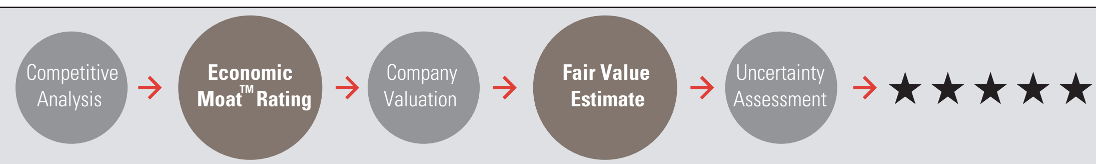
Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely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

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

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.