MORNINGSTAR®

Research Highlights

A weekly summary of our best ideas and developments in the companies we cover.

Morningstar Equity Research
July 30-Aug. 3, 2018

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Interactive web-based models are available for our Best Ideas at Trefis.

Kion Group: Market Overshoots on Margin Concerns

Kion Group shares are down 20% year to date, which we see as an opportunity, with shares now trading 35% below our EUR 90 fair value estimate. We disagree with the pessimists on three points. First, we believe some analysts' valuations are based on near-term enterprise value/EBITDA multiples. On the whole, we prefer our DCF approach, particularly for companies like Kion, where "normalized" margin and cash flow generation is a few years away.

Second, we believe bears have overplayed near-term weakness in margins from factors, such as raw material price and wage increases, that have plagued other capital goods peers this year. These scenarios ignore mitigating factors such as annual price increases, operating leverage in the warehouse equipment division, and our estimate of roughly 40% of the employee count on flexible contracts.

Finally, we think detractors on the stock have glossed over the upsurge in the company's warehouse automation equipment orders, which we find essential to the long-term fundamentals.

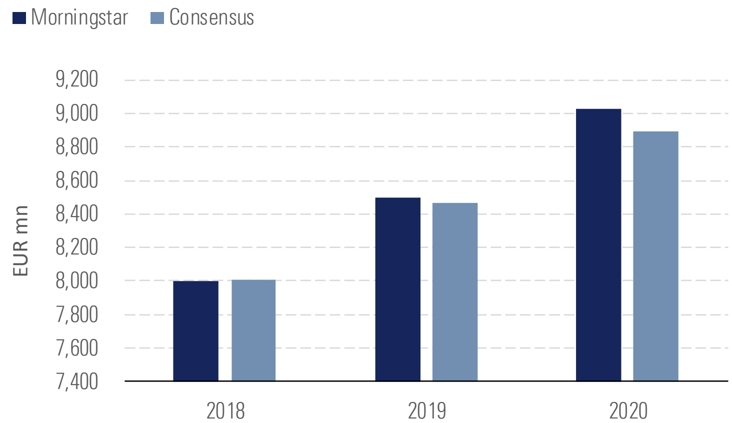
- 2018 margin pressures include one-off effects, like raw material price inflation, that should be mitigated by operating leverage and price increases
- Our demand thesis for the company's warehouse equipment is starting to play out with a nearly 40% rise in first-half 2018 orders. Recent data points to a continued boom in warehouse space.
- Customer-required specificity and a large reference project base underpin Kion's narrow moat.

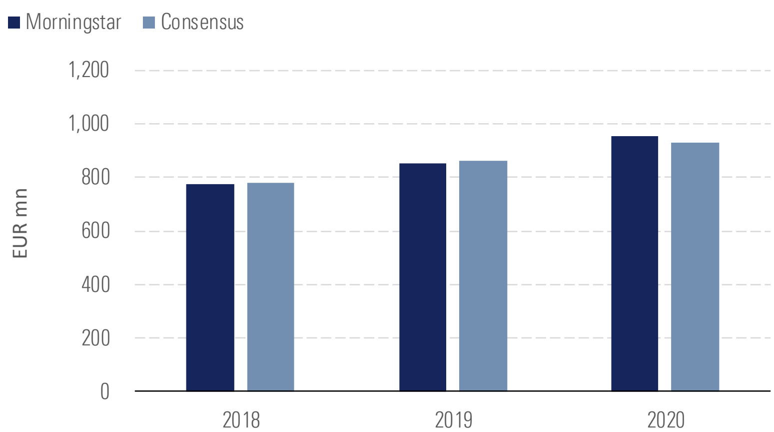
Valuing Kion on Near-Term Multiples Ignores Long-Term Shift in Warehouse Automation

We believe some of our more pessimistic peers value Kion Group on an EV/EBITDA multiple. On the whole, we view discounting future cash flows as a superior valuation method, and this is especially true for Kion, with midcycle cash flows achieved in the medium term. Our EUR 90 valuation is higher than the consensus EUR 75, which we believe is due to this difference in approach, as our near-term forecasts are not far off from consensus (Exhibit 1).

Roughly one third of Kion's business comes from its warehouse equipment division, known as SCS, which we believe is in the early stages of growth from the long-term structural shift toward automating warehouse operations. This means that growth levels for Kion at the group level, as well as EBIT margins in the near term, do not reflect a mature or midcycle business. This begs for a multiyear valuation, and moreover, we do not believe it makes sense to value Kion relative to the average European capital goods company multiple, which is weighted toward more mature industries like compressors and ball bearings.

Exhibit 1 Our Near-Term Revenue (top) and EBIT (bottom) Forecasts Are Not Far From Consensus





Sources for both charts above: Morningstar Research Services LLC, Capital IQ

Built into our DCF model is an 8% weighted average cost of capital and forecasts for 6% medium-term revenue growth and modest annual EBIT margin expansion, as we believe the business will need to invest in staff, research and development, and other operating expenditures to support our assumed revenue growth. As revenue growth starts to slow, we expect the company to reach management's 12% target.

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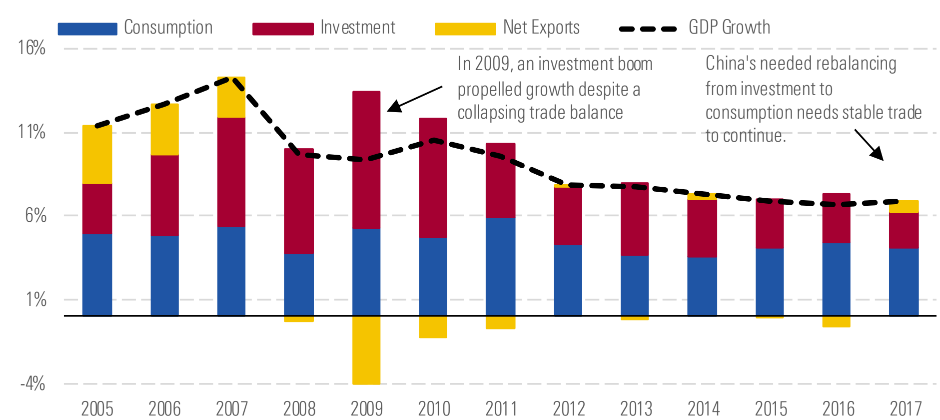
Trade Tensions Create a Cliffhanger in China's Economy

China has continued to rebalance toward a more sustainable, consumer-led mix in the second quarter but is not yet deleveraging. This process remains slow, as the Chinese consumer is becoming challenged with higher levels of household debt. Trade war tensions have escalated, as U.S. President Donald Trump appears determined to shift the existing equilibrium toward a more favorable outcome for the United States even if the U.S. must incur substantial short-term economic cost and damaged relationships with allies.

In turn, China has limited options to prevent a sharp and unwanted slowdown in GDP growth given its debt load. The biggest point in China's favor is President Xi Jinping's tight control within his country and ability to take a longer-term view measured in decades. We don't think China can meet U.S. demands regarding a significant reduction in the trade deficit, suggesting face-saving measures are needed to prevent greater long-term damage to both economies as well as trimming global GDP growth rates by 0.5%.

- ► Fixed-asset investment continues its long-term decline. However, a rebound in private-sector spending speaks to a rebalancing toward a more sustainable mix and improved capital/output ratio.
- ► Although headline retail sales growth looks weak, consumer expenditure appears to have rebounded, as confirmed by consumer goods volume growth.
- ► Shadow banking growth has collapsed amid tighter regulations, yet loosening reserve ratio requirements point to government concerns around slowing credit growth's impact on GDP growth.
- ► Our highlighted China stock ideas should remain resilient in the face of escalating trade tensions.

Exhibit 1 Unlike in 2009, China Can't Afford Another Major Slowdown in Trade
China Official Real GDP Growth Contribution by Expenditure



Source: Morningstar, China National Bureau of Statistics

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Raising Long-Term Nitrogen Price Forecast

We've taken a fresh look at both our near-term and long-term nitrogen price assumptions and are increasing our near-term urea price forecast by $10 per ton, to $240 from $230. Increased anthracite coal prices in China, which have resulted in lower production and lower exports to the U.S., are driving our near-term price forecast. We think this dynamic will continue to support nitrogen prices through the remainder of 2018 and into 2019.

Separately, we've also reviewed our long-term price forecast and are increasing our 2025 urea price forecast to $240 per ton in 2018 real terms, up from $220. Our forecast for a higher spread between natural gas prices in the U.S. versus prices in Europe and Asia is driving our change. After updating our cost curve for the increased differentials, we now forecast nitrogen production from European natural gas feedstock will become the long-term marginal cost of production.

Previously, we had forecast that nitrogen production from Chinese coal would represent the marginal cost of production. However, many of the older, high-cost Chinese coal plants will be shut and replaced with new, lower-cost production. Over time, this will allow Chinese producers that export nitrogen to the U.S. to produce nitrogen at a lower cost than European producers who use natural gas, thereby displacing them on the cost curve.

As a result of our nitrogen price updates, our CF Industries fair value estimate increases to $45 per share from $30. Additionally, our fair value estimates for Nutrien increase to $64 and CAD 83.

CF Industries ★★★★

CF Industries is the largest nitrogen fertilizer producer in North America, with production based in both the United States and Canada. CF's plants, which benefit from low-cost North American natural gas, are connected to its main customers in the U.S. Corn Belt by an extensive distribution network of pipelines, rail, and barge, giving the company a transportation cost advantage over foreign competition without pipeline access. As one of the largest nitrogen fertilizer producers in North America, CF's sales and profits are largely tied to U.S. corn planted acreage. Nitrogen fertilizers are key to achieving higher yields in corn, as the crop, unlike soybeans, does not produce its own nitrogen. That said, corn planted acres and prices have since declined in recent years, weighing on CF's profits.

CF recently completed capacity expansions to its Donaldsonville, Louisiana, and Port Neal, Iowa, nitrogen plants. The increased nitrogen production volumes going forward should give the company the capacity to meet the minimum volumes of its fertilizer contracts, while still retaining additional capacity to produce higher-margin industrial products. Donaldsonville’s seaborne location also allows CF to export more fertilizer products and take advantage of nitrogen demand in South America, a region that imports nearly all of its nitrogen fertilizers.

Bulls Say

- High shipping and storage costs for importers of nitrogen fertilizer limit the competition CF faces in North American markets from outside regions with low natural gas costs.

- Using low-cost natural gas as a feedstock, CF's nitrogen operations currently sit at the low end of the global nitrogen cost curve.
- Access to pipelines connecting the company's nitrogen facilities in Louisiana, Iowa, and Oklahoma to the Midwest gives CF a transportation cost advantage.

Bears Say

- Soybean, which does not require nitrogen fertilizer, has been stealing share of planted acres from corn in North America, hurting nitrogen fertilizer demand.
- In nitrogen, CF competes with many companies that are state-owned or government-subsidized. Government-controlled firms are more likely to produce quantities in excess of demand, disrupting supply/demand balances.
- As the world's largest consumer of fertilizers, China is expected to expand its fertilizer production capacity, which could put downward pressure on fertilizer prices.

Nutrien ★★★

Nutrien, the world’s largest crop nutrient company, was formed in early 2018 as a result of the merger between Potash Corporation of Saskatchewan and Agrium.

The company is the largest agricultural retailer in North America and Australia with more than 1,400 locations. Its retail centers sell fertilizers, crop chemicals, and seeds directly to farmers. In the highly fragmented farm retail industry, Nutrien is pursuing an acquisition strategy to expand its retail store base, which should improve bargaining power with suppliers. The company also benefits from selling proprietary and private-label products at its newly acquired stores. We expect this segment, which accounted for roughly two thirds of pro forma gross profit in 2016, to generate relatively steady cash flows.

In addition to its retail operations, Nutrien produces all three primary crop nutrients. With over 20% market share, Nutrien is the world’s largest producer of potash by capacity. Its Canadian mines mostly sit on the lower half of the cost curve and have generated profits even when prices are below the marginal cost of production.

By contrast, Nutrien currently sits on the high end of the phosphate fertilizer cost curve, largely because the legacy Agrium operations lack phosphate rock resources and instead buy the input from industry giant OCP in Morocco. Once the OCP supply contract expires in 2018, those operations will source phosphate rock from legacy PotashCorp assets, which should lower the firm’s position on the cost curve slightly below the marginal cost of production.

Bulls Say

- Declining arable land per person will force growers to be more productive and should drive growth in a variety of crop inputs.

- Potash application rates in China and India lag scientifically recommended levels. With these two countries working to secure food supply, increasing potash application is a relatively pain-free way to raise crop yields and food production.
- The retail agriculture market is very fragmented, leaving Nutrien room to steadily snap up smaller competitors and increase its share lead and bargaining power with suppliers.

Bears Say

- Volatile pricing and demand for crop nutrients have characterized Nutrien's business during the past few years, highlighting the cyclical nature of the company's cash flows.
- New greenfield potash mines from K+S and EuroChem combined with Uralkali's continued volume-over-price strategy threaten to drag down potash prices.
- Through subsidies and state-run companies, governments influence about half of the nitrogen and phosphate markets worldwide.

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Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Basic Materials								
Cameco (CCJ)	★★★★	$17	$11.11	High	Narrow	0.65	4.30	Inton
Compass Minerals International (CMP)	★★★★	$83	$66.6	High	Wide	0.80	2.25	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$204.76	High	Narrow	0.77	12.90	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 230	High	Narrow	0.64	22.82	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 69.25	Medium	Narrow	0.68	1417.93	Baker
Comcast (CMCSA)	★★★★	$42	$34.64	Medium	Wide	0.82	158.72	Macker
Telefonica (TEF)	★★★★★	$13	$7.62	High	Narrow	0.59	39.57	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.82	Medium	Narrow	0.64	33.54	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$157	$143.26	Medium	Narrow	0.91	10.61	Akbari
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 81.18	High	Narrow	0.69	52.81	Hilgert
Expedia Group (EXPE)	★★★★	$185	$132.85	High	Narrow	0.72	19.85	Wasiolek
General Motors (GM)	★★★★	$45	$36.62	High	None	0.81	51.67	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 5.34	High	None	0.40	74.17	Su
Hanesbrands (HBI)	★★★★★	$29	$18.28	Medium	Narrow	0.63	6.59	Hottovy
InvoCare (IVC)	★★★★	AUD 17	AUD 14.46	Medium	Wide	0.85	1.59	Ragonese
Mattel (MAT)	★★★★	$21.5	$15.96	High	Narrow	0.74	5.49	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$49.68	High	Narrow	0.72	11.16	Katz
Walt Disney (DIS)	★★★★	$130	$112.75	Medium	Wide	0.87	167.63	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1166.5	Medium	Narrow	0.78	14.72	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★	AUD 4	AUD 2.42	High	None	0.61	1.10	James
General Mills (GIS)	★★★★★	$59	$45.74	Low	Wide	0.78	27.14	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2908.5	Low	Wide	0.79	27.74	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8165	Low	Wide	0.93	3979.79	Wei
Mondelez International (MDLZ)	★★★★	$51	$43.16	Medium	Wide	0.85	63.30	Lash
PepsiCo (PEP)	★★★★	$123	$114.69	Low	Wide	0.93	162.21	Vora
Procter & Gamble (PG)	★★★★	$98	$82	Low	Wide	0.84	204.84	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6800	Low	Wide	0.93	48.05	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$13.11	Very High	None	0.62	16.11	Gemino
Enbridge (ENB)	★★★★	$64	$46.19	Medium	Wide	0.72	78.74	Gemino
Enterprise Products Partners (EPD)	★★★★	$35.5	$29.2	Low	Wide	0.82	63.44	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$68.51	Low	None	0.88	285.67	Good
Total (TOT)	★★★★	$74	$63.8	Medium	None	0.86	167.58	Good
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.53	High	Narrow	0.84	1227.42	Tan
American International Group (AIG)	★★★★	$76	$55.16	Medium	None	0.73	49.16	Horn
Capital One Financial (COF)	★★★★	$127	$95.77	Medium	Narrow	0.75	45.82	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 15.76	High	Narrow	0.72	40.19	Scholtz
Invesco (IVZ)	★★★★★	$38	$24.96	Medium	Narrow	0.66	10.25	Warren

Source: Morningstar. As of Aug. 3, 2018

Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Financial Services (cont.)								
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 693.1	Medium	None	0.79	9064.84	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 8.96	Medium	Narrow	0.81	2.51	Likos
QBE Insurance Group (QBE)	★★★★	AUD 12	AUD 10.34	High	None	0.86	14.04	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 28.91	Medium	Wide	0.83	97.89	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$263	$184.28	Medium	Wide	0.70	62.48	Waterhouse
McKesson (MCK)	★★★★★	$210	$123.99	Medium	Wide	0.59	24.77	Lekraj
Medtronic (MDT)	★★★★	$105	$89.89	Medium	Wide	0.86	121.51	Wang
Ramsay Health Care (RHC)	★★★★★	AUD 82	AUD 56.58	Medium	Narrow	0.69	11.43	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 244.8	Low	Wide	0.73	209.47	Andersen
Shire (SHP)	★★★★	GBX 4990	GBX 4397	Medium	Narrow	0.88	40.21	Andersen
Industrials								
Allegion (ALLE)	★★★★	$91	$81.2	Medium	Wide	0.89	7.71	Bernard
Anixter International (AXE)	★★★★★	$107	$71.3	Medium	Narrow	0.67	2.39	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 36.95	Medium	Narrow	0.64	46.63	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.91	Medium	Wide	0.88	15.78	Fleck
CK Hutchison Holdings (1)	★★★★★	HKD 118	HKD 84	Medium	None	0.71	324.04	Tan
G4S (GFS)	★★★★	GBX 337	GBX 271.7	Medium	None	0.81	4.22	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 32.95	Medium	Wide	0.70	5.95	Molina
General Dynamics (GD)	★★★	$218	$194.94	Medium	Wide	0.89	57.76	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 217	MXN 181.93	High	Wide	0.84	102.06	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.8	HKD 3.85	High	None	0.57	32.75	Song
Johnson Controls International (JCI)	★★★★	$53	$37.81	High	Narrow	0.71	34.97	Bernard
KION GROUP (KGX)	★★★★★	EUR 90	EUR 57.82	Medium	Narrow	0.64	6.83	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 37.68	Medium	Narrow	0.90	35.10	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 91.68	Medium	Narrow	NA	13.60	Field
Stericycle (SRCL)	★★★★	$86	$70.97	High	Narrow	0.83	6.10	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.8	AUD 2.29	Medium	None	0.82	1.33	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 118.9	Medium	Narrow	0.78	344.45	Zhong
Welltower (WELL)	★★★★	$74	$63.17	High	None	0.85	23.50	Brown
Technology								
Intel (INTC)	★★★★	$65	$49.48	Medium	Wide	0.76	228.15	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$94.61	Medium	Wide	0.84	22.27	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 3.13	Medium	Narrow	0.82	1.88	James
ServiceNow (NOW)	★★★★	$221	$182.84	Medium	Wide	0.83	32.30	Fitzsimmons
Synaptics (SYNA)	★★★★	$64	$47.06	Very High	None	0.74	1.63	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 11640	High	None	0.93	1469.49	Ito
Tencent Holdings (700)	★★★★★	HKD 641	HKD 349.8	High	Wide	0.55	3330.88	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$71.14	Low	Wide	0.85	46.51	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.49	Medium	None	0.79	45.70	Fulop
FirstEnergy (FE)	★★★★	$40	$36.42	Low	Narrow	0.91	17.70	Fishman
SCANA (SCG)	★★★★	$56	$41.34	Medium	Narrow	0.74	5.90	Miller

Source: Morningstar. As of Aug. 3, 2018

Highlighted Stocks

Wesco International WCC

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Industrials	Stable	USD	86	59.05	Medium	Narrow	0.69	2.72

Source: Morningstar. As of Aug. 3, 2018

We continue to be pleased with Wesco's strong, broad-based organic revenue growth, which has persisted over the last four quarters.

Analyst Note, Aug. 2, 2018
Wesco turned in another solid quarterly performance, in our view. The narrow-moat industrial distributor's second-quarter revenue grew over 10% (9% organic) year over year to $2.1 billion. Excluding a 20-basis-point unfavorable impact from a $2.5 million bad debt charge, operating margin expanded 20 basis points to 4.5% (flat year over year on a GAAP basis). GAAP EPS increased nearly 20% to $1.22, driven by a 10% increase in GAAP operating income, a lower effective tax rate, and a reduced share count versus the year-ago quarter. Wesco's second-quarter EPS missed the consensus estimate by $0.01 on in-line revenue.

We continue to be pleased with Wesco's strong, broad-based organic revenue growth, which has persisted over the last four quarters. In our view, this trend is indicative of both healthy end market demand and Wesco's solid execution. We've increased our fair value estimate to $86 per share from $84 previously due to the time value of money since our last update. Our fair value estimate continues to assume that Wesco's normalized operating margin and return on invested capital (excluding goodwill) is 5% and 15%, respectively, versus a 4.2% operating margin and a 13.4% ROIC (excluding goodwill) in 2017.

In terms of organic revenue growth by end market, utility grew 19% year over year, commercial, institutional, and government grew over 9%, construction grew 8%, and industrial grew 6%. All four of Wesco's end markets have had at least four consecutive quarters of positive organic growth. Based on a strong first-half performance and positive outlook, management raised its full-year revenue growth guidance to 6% to 9% from 5% to 8% previously.

In addition to updating sales growth guidance, management also updated its operating margin guidance to 4.2%-4.5% from 4.2%-4.6% previously and its EPS guidance to $4.60-$5 from $4.50-$5 previously. Based on our modeling, this guidance appears to be reasonable.

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Pilgrim's Pride PPC

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Consumer	Stable	USD	31.50	18.20	High	None	0.58	4.36

Source: Morningstar. As of Aug. 3, 2018

Despite the valuation cut, we believe the shares are attractive, as we expect near-term headwinds to yield to opportunities borne of Pilgrim's broad portfolio and Mexican unit.

Analyst Note, Aug. 2, 2018
While we had tempered our near-term targets for no-moat Pilgrim's Pride, its soft second-quarter results lead us to plan a mid-single-digit percentage cut to our $31.50 per share valuation. However, the results do not materially alter our 10-year outlook for 3% sales growth and 11% adjusted EBITDA margins on average. Despite the valuation cut, we believe the shares are attractive, as we expect near-term headwinds to yield to opportunities borne of Pilgrim's broad portfolio and Mexican unit.

Year to date, Pilgrim’s sales grew 6.7%, against a nearly 320-basis-point adjusted EBITDA margin dip to 9.8% compared with our 220-basis-point and 10.7% full-year profitability forecast. Management cited low commodity deboned large bird prices, with demand pressured as other meats received greater attention in retail and food-service promotional activity.

The results conform to our view that Pilgrim's returns are at the mercy of exogenous factors, leading to our no-moat rating. While we applaud management's diversification efforts (across bird sizes, contract structures, and geographies) and specialty product focus, factors outside its control still dictate profitability. On the cost side, feed accounts for 30%-40% of Pilgrim's cost of goods, while it also has little control over demand, as shown by second-quarter price pressure from other proteins, particularly pork, as trade barriers led to domestic oversupply. As such, we question Pilgrim’s long-term ability to outearn its cost of capital.

Still, we are encouraged by the firm’s disciplined, customer-led efforts to grow in more differentiated segments, including organic, no-antibiotic, and prepared items. Pilgrim's prepared foods success in Mexico is particularly striking, reaching a 35% market share. We expect Pilgrim's reputation for reliability and food safety, as well as its local market production, to propel results there, with Mexico serving as its vanguard for growth given market undersupply and rising incomes.

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Incyte INCY

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Healthcare	Positive	USD	97	63.04	High	Narrow	0.65	13.70

Source: Morningstar. As of Aug. 3, 2018

We continue to believe that the market is overreacting to first-quarter disappointments, including the failed IDO inhibitor trials and tempered baricitinib outlook, and undervaluing Incyte's Jakafi and pipeline opportunities.

Analyst Note, July 31, 2018

Narrow-moat Incyte reported a strong second quarter, with Jakafi posting 25% year-over-year revenue growth in the U.S. and Iclusig royalties up 27%. Jakafi sales were slightly above of our expectations, but we are maintaining our full-year Jakafi outlook, which is on the lower end of management guidance, and reaffirming our fair value estimate of $97 per share. We continue to believe that the market is overreacting to first-quarter disappointments, including the failed IDO inhibitor trials and tempered baricitinib outlook, and undervaluing Incyte's Jakafi and pipeline opportunities.

The cash-generating Jakafi franchise underpins our narrow moat rating as we believe Incyte's entrenched position in the myeloproliferative neoplasm market and the future opportunities for expansion will allow the firm to continue earning excess returns. Incyte plans to file for Jakafi label expansion in steroid-refractory acute graft-versus-host-disease, or GVHD, next quarter, and the firm is mobilizing its salesforce in preparation for launch in the U.S., leaning on its existing relationships with both U.S. payers and physicians in transplant centers who treat myelofibrosis. We expect the launch in second-line acute GVHD to expand the eligible patient population for Jakafi by a couple thousand, and there are further opportunities in chronic GVHD and treatment-naïve patients on the horizon.

Incyte boasts a healthy pipeline in oncology, inflammation, and autoimmune disease, with near-term catalysts including data readouts for ruxolitinib cream for atopic dermatitis and for FGFR inhibitor (pemigatinib) in cholangiocarcinoma and bladder cancer before the end of the year. The recent restrictions on the use of PD-1 inhibitors in bladder cancer patients with low PD-L1 expression carve out nice potential for Incyte's FGFR inhibitor, in our opinion. However, we expect the immuno-oncology market to remain highly competitive and highlight the importance of Incyte's broad pipeline.

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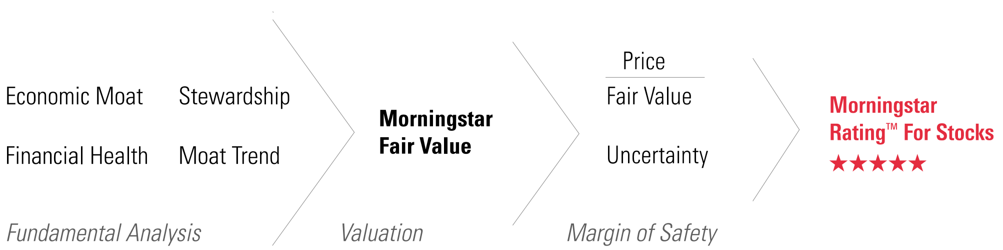
Research Methodology for Valuing Companies

Overview
At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Morningstar Research Methodology



Source: Morningstar.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate, and (4) the current market price. This process ultimately culminates in our single-point star rating.

Economic Moat
The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward their cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger, stable where we don't anticipate changes to competitive advantages over the next several years, or negative where we see signs of deterioration.

Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last 5 to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested (RONIC)—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market value weights.

Uncertainty Around That Fair Value Estimate

Morningstar's uncertainty rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The uncertainty rating represents the analysts' ability to bound the estimated value of the shares in a company around the fair value estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

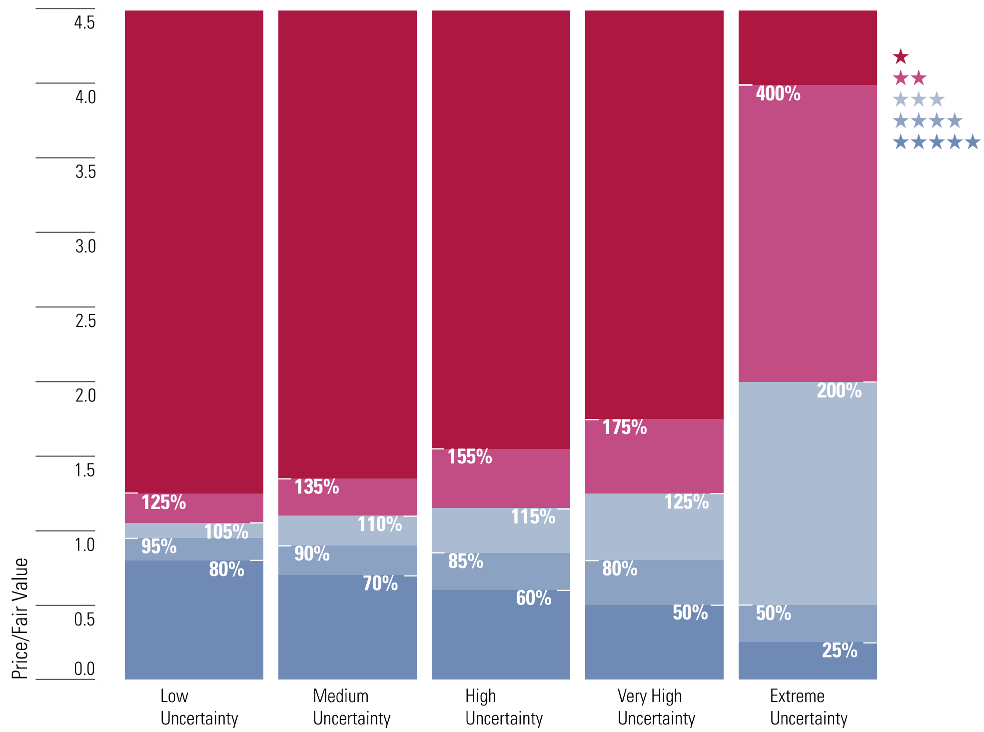
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty regarding the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

- Low: Margin of safety for 5-star rating is a 20% discount and for 1-star rating is a 25% premium.
- Medium: Margin of safety for 5-star rating is a 30% discount and for 1-star rating is a 35% premium.
- High: Margin of safety for 5-star rating is a 40% discount and for 1-star rating is a 55% premium.
- Very high: Margin of safety for 5-star rating is a 50% discount and for 1-star rating is a 75% premium.
- Extreme: Margin of safety for 5-star rating is a 75% discount and for 1-star rating is a 300% premium.

Morningstar Equity Research Star Rating Methodology



Market Price

The market prices used in this analysis and noted in the report come from the exchange on which the stock is listed, which we believe is a reliable source.

For more details about our methodology, please go to http://global.morningstar.com/equitydisclosures.

Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically recalculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true, the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience, and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to capital loss.

Risk Warning

Please note that investments in securities are subject to market and other risks, and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in the future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's uncertainty rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

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