Research Highlights

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

Morningstar Equity Research
Oct. 22-26, 2018

Contents

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Clear Skies for Salesforce in CRM and Beyond

We came away from Salesforce.com's Dreamforce expo and fiscal 2019 analyst day with renewed confidence in the firm's software-as-a-service leadership, our wide moat and positive moat trend ratings, and revenue and margin expansion assumptions for the business. We believe the firm's top line will benefit from aggregate customer relationship management strength, multicloud expansion (where Salesforce cross-sells into its current customer base), and geographic expansion into Europe, the Middle East, Africa, and Asia-Pacific. Salesforce's Dreamforce announcements, such as its partnership with Apple, Customer 360, and Einstein Voice, cemented our assumptions.

Dreamforce's fourth large focus was MuleSoft, which was acquired for $6.5 billion in March 2018. We think MuleSoft enhances Salesforce's moat, as it is the glue behind enterprise customers' IT systems, and can ease transitions to cloud applications, potentially serving as a tailwind for the rest of Salesforce's SaaS application businesses.

In terms of the bottom line, we think the SaaS business model understates Salesforce's long-term profit potential, as there is a mismatch between costs and revenue recognition. Concurrently, as secular tailwinds propel the aggregate CRM market, Salesforce has invested in headcount and new products to drive revenue growth while the industry is still in land-grab mode. Chasing this revenue growth has been to the detriment of GAAP operating margins, but, longer term, we see significant potential for margin expansion as Salesforce matures. Combined with a recent market sell-off in high-growth software names, we see an attractive margin of safety for investors today.

We remain bullish on Salesforce because of its ability to cross-sell further into its current customer base, secular tailwinds in customer relationship management, and margin expansion opportunities. New product announcements at Dreamforce and a focus on the recently acquired MuleSoft give us confidence that Salesforce's growth runway remains robust.

- We continue to like wide-moat Salesforce.com, largely because of its exposure to the high-growth CRM space, its acquisition of MuleSoft, and its incremental investments in artificial intelligence.
- We believe that Salesforce warrants a wide moat and positive moat trend rating, thanks to investments in integration, whether Customer 360 or MuleSoft, as well as artificial intelligence. Salesforce continues to expand its SaaS and platform-as-a-service offerings, and there is room for customer multicloud expansion, as customers purchase more than one of Salesforce's products. As customers become multicloud, it increases the number of integration points, which makes replacing Salesforce with an

alternative vendor time-consuming and expensive. Customer 360 represents Salesforce's investments to ensure that adding another Salesforce module is an easy and natural extension for current customers.

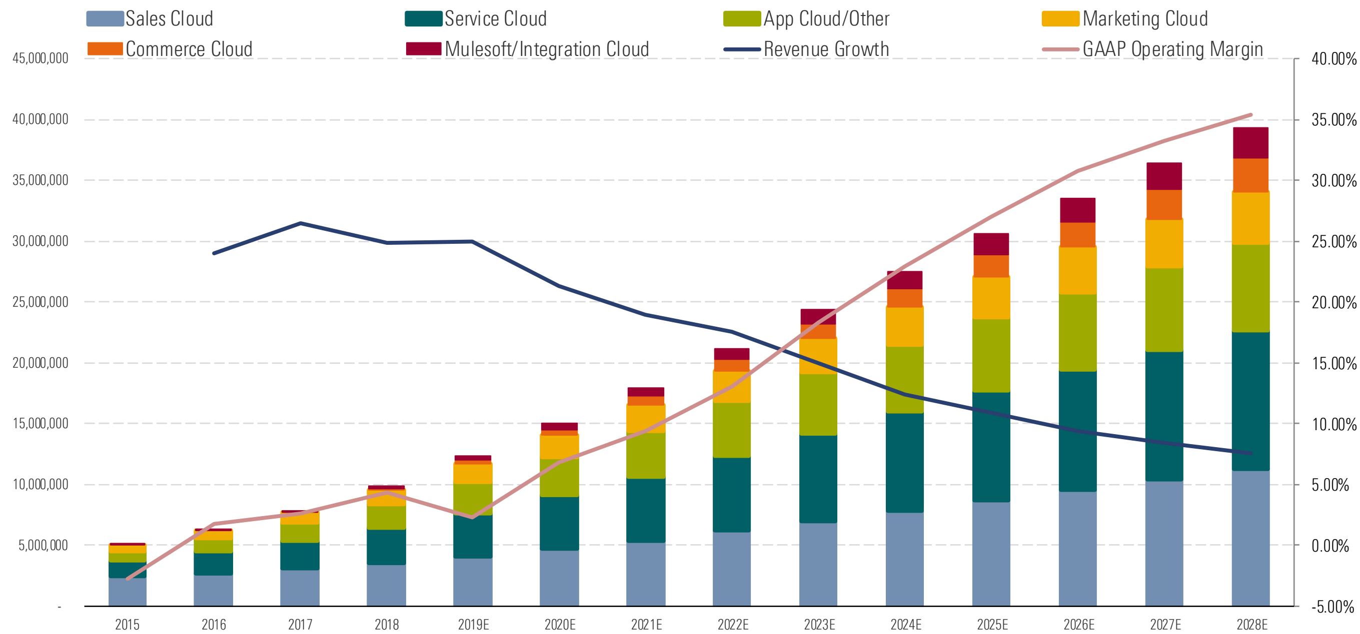
- Aggregate CRM spending is expected to outpace all other application software spending over the next five years. We believe that aggregate CRM strength, multicloud expansion potential, and geographic penetration in EMEA and APAC will allow Salesforce to achieve its $21 billion-$23 billion revenue target by fiscal 2022.
- We believe that the economics of SaaS business models likely understate the long-term GAAP operating profit potential for SaaS leaders like Salesforce. Instead, in the near term, while SaaS providers are mostly in land-grab mode, we view the lifetime value/cost of customer acquisition ratio, or LTV/CAC, as an important metric to gauging customer stickiness and wise (or unwise) sales and marketing investments.
- We think midcycle GAAP operating margins can expand significantly as Salesforce matures and revenue growth slows. It may take a couple of years for Salesforce or another pure-play cloud peer to break even on a deal. However, we believe steady-state revenue extraction and margins are higher under the SaaS model.
- The largest product announcements at Dreamforce were the Apple-CRM partnership, Einstein Voice and Analytics, and Customer 360. In addition, a large focus of Dreamforce was MuleSoft, which Salesforce acquired for nearly $6.5 billion. We believe MuleSoft enhances Salesforce's moat and remains integral to its long-term growth story.
- MuleSoft's Anypoint Platform allows Salesforce to become the backbone of an enterprise's IT ecosystem, enhancing switching costs. Secondly, because MuleSoft eases the burden of cloud migrations, it can accelerate enterprises' adoption of Salesforce's cloud applications. MuleSoft's market grew by 72% in 2017, according to Gartner, up from 61% in 2016, and we forecast solid growth ahead. We think MuleSoft can surpass $1 billion in revenue by calendar 2021.
- With our fair value estimate of $180 per share, Salesforce is approximately 29% undervalued. The recent market sell-off in high-growth software names is providing investors with an opportunity, in our view.

Exhibit 1 Our Salesforce Fiscal 2028 Segment Assumptions: Solid Strength Across Salesforce's Different Businesses

	Breakdown of Salesforce's Subscription Clouds				
	Moat	**Source**	**% of Subscription Revenue**	**5-year CAGR**	**10-year CAGR**
Sales Cloud	Wide	Switching Costs	33.7% (in 2018) 27.4% (in 2028)	14.4%	12.2%
Service Cloud	Wide	Switching Costs	27.3% (in 2018) 27.8% (in 2028)	20.2%	14.8%
Marketing Cloud	Wide	Switching Costs	11.7% (in 2018) 10.3% (in 2028)	18.2%	13.1%
Commerce Cloud	Wide	Switching Costs	1.1% (in 2018 By Our Estimates) 6.7% (in 2028)	58.2%	36.7%
Application Cloud/Other	Wide	Switching Costs Network Effect	18.3% (in 2018) 17.8% (in 2028)	21.2%	14.2%
MuleSoft/Integration Cloud	Wide	Switching Costs	1.8% (in 2018 Using Restated Numbers) 6.0% (in 2028)	43.5%	29.2%

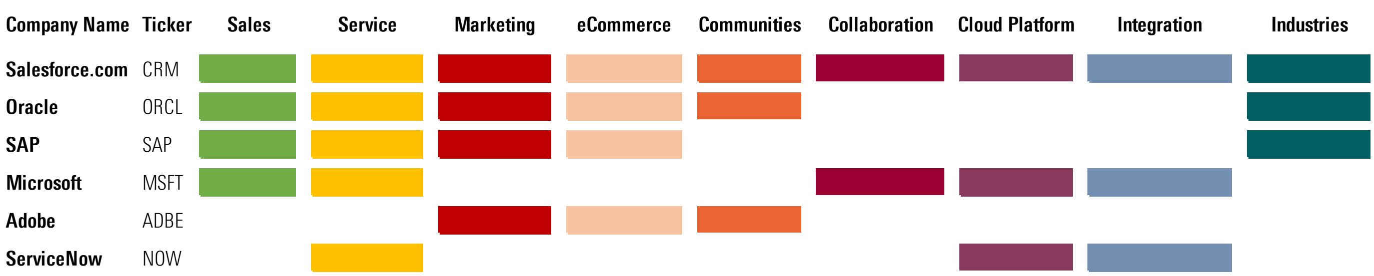
Source: Salesforce.com financial filings and Morningstar projections

Exhibit 2 Our Assumptions for Wide-Moat Salesforce: An Inverse Relationship Between Revenue Growth and Margins



Source: Salesforce.com financial filings and Morningstar projections

Exhibit 3 Salesforce's Product Breadth Trounces the Competition



Source: Salesforce.com 2019 financial analyst day

Medtronic's Embrace of Value-Based Payments Reinforces Its Wide Moat

Despite the Republican Party's persistent efforts to roll back the Affordable Care Act, we think payer and provider appetite for more sharing of the financial risk is unlikely to dissipate. Even though Medicare, under the Trump administration, has stepped back from its position as a key adopter of value-based payments, the private payers and provider systems have already embraced this new normal.

We contend that Medtronic is particularly well-positioned to take advantage of new opportunities in risk-based contracting with hospitals and believe pursuing this strategy should help reinforce Medtronic's already-wide economic moat by fending off competitive forces. Medtronic's risk-sharing contracts raise the financial risk for providers if they choose competitive products and end up incurring additional costs due to complications or unfavorable patient outcomes.

Although the adoption of risk-based contracting by manufacturers is still in its nascent phase and this strategy has yet to materially affect Medtronic's overall financial performance, we expect this approach will gain steam and contribute substantially over the long term. We still think Medtronic's shares are relatively undervalued, as it is challenging for investors to understand how the firm's value-based payment strategy will translate into financial results

- After having financial risk shoved onto them, healthcare-services providers have, in turn, become interested in shifting some of that risk onto their vendors, including medical device makers.
- Medical device manufacturers, compared with biopharma companies, are in a strong position to pursue risk-based contracting thanks to fewer issues with patient compliance, greater expertise with post-market data collection, and a history of close collaboration with practitioners.
- Medtronic has aggressively and creatively pursued risk-based contracting, thereby leveraging its broad portfolio and deep experience with clinical trials.
- We estimate that between 4% and 6% of Medtronic's total revenue is currently under value-based contracts, including 30% of its U.S. traditional cardiac rhythm management business.

Debbie S. Wang | debbie.wang@morningstar.com

Japanese Resorts on the Horizon

As Japan moves toward gaming with the July passing of the Implementation Bill, we think investors can benefit from understanding which operators are best positioned to win integrated resort licenses, or IRs, in 2020 that represent a total sales opportunity of $26 billion in 2026 (above the 2024 $21 billion forecast laid out in our 2017 Observer The Rising Sun Will Shine Bright on Japanese Integrated Resorts.)

We contend that IRs will open in two urban sites (Osaka and Yokohama) but now in just one regional area (Hokkaido) versus two before (Nagasaki also), as Japan's Implementation Bill guided for no more than three initial IRs. We now expect the first IRs to open in 2025 versus 2024 earlier, due to a slightly slower political process. Still, the IR opportunity remains supportive of brand intangible advantages with ROICs near 20% (near our prior forecast), as one less rural license is offset by resort(s) larger than those found in other gaming jurisdictions, also aided by our intact and differentiated view that factors in Japan's favorable demographics (population density, incomes, and propensity to gamble).

We still model narrow-moat Las Vegas Sands and no-moat MGM Resorts to receive the two urban concessions with the former winning the larger Osaka opportunity (due to its strong experience across Singapore, Vegas, and Macau) and the latter handed the Yokohama concession (driven by a leading Vegas presence and partner involvement). We see an attractive margin of safety in both Las Vegas Sands (23% discount to our $72 valuation) and MGM Resorts (29% discount to our $37.50 valuation), which we believe offers investors an opportunity to participate in the world's next large gaming market.

- We assume an Osaka IR generates 2025 sales of $12.8 billion (prior 2024 forecast $8.7 billion) and 20% ROIC (17%), driven by continued political support, favorable demographics, and an enormous 173-acre development site that we believe will produce a casino 40% larger than Marina Bay Sands in Singapore.
- Due to political uncertainty, we see a Yokohama IR opening later in 2026. But the opportunity remains large with $11.4 billion in 2026 sales (prior 2024 forecast $11.3 billion) and 21% ROIC (20%), despite the chance of a smaller development area in Minata Mirai versus the larger site at Yokohama Pier.

Dan Wasiolek | dan.wasiolek@morningstar.com

Best Ideas

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)	★★★★★	$19.5	$11	High	Narrow	0.56	4.30	Inton
Compass Minerals International (CMP)	★★★★	$81	$47.95	High	Wide	0.59	1.62	Goldstein
Martin Marietta Materials (MLM)	★★★★	$260	$162	High	Narrow	0.62	10.21	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 240.55	High	Narrow	0.67	24.82	C. Nichols
China Mobile (941)	★★★★	HKD 97	HKD 73.05	Medium	Narrow	0.75	1517.23	Baker
Comcast (CMCSA)	★★★★	$42	$35.84	Medium	Wide	0.85	163.05	Macker
Telefonica (TEF)	★★★★★	$13	$6.84	High	Narrow	0.53	35.56	C. Nichols
Telstra (TLS)	★★★★	AUD 4.4	AUD 3.05	Medium	Narrow	0.69	36.27	Han
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	$240	$144.6	High	Wide	0.60	359.07	Hottovy
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 74.5	High	Narrow	0.64	47.27	Hilgert
Expedia Group (EXPE)	★★★★	$185	$117.57	High	Narrow	0.64	17.54	Wasiolek
General Motors (GM)	★★★★	$45	$32	High	None	0.71	45.15	Whiston
Hanesbrands (HBI)	★★★★★	$27	$16.86	Medium	Narrow	0.62	6.08	Hottovy
InvoCare (IVC)	★★★★	AUD 16	AUD 12.35	Medium	Wide	0.77	1.36	Ragonese
Mattel (MAT)	★★★★	$21.5	$13.84	High	Narrow	0.64	4.78	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$45.43	High	Narrow	0.66	9.98	Katz
Walt Disney (DIS)	★★★★	$130	$114.16	Medium	Wide	0.88	165.99	Macker
WPP (WPP)	★★★★★	GBX 1450	GBX 910.8	Medium	Narrow	0.63	11.49	Mogharabi
Consumer Defensive								
A2 Milk (ATM)	★★★★	AUD 14.6	AUD 9.86	High	Narrow	0.68	7.25	Fleck
G8 Education (GEM)	★★★★★	AUD 3.5	AUD 1.91	High	None	0.55	0.87	James
General Mills (GIS)	★★★★★	$58	$44.47	Low	Wide	0.77	26.72	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2743.5	Low	Wide	0.74	25.23	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7261	Low	Wide	0.83	3539.16	Wei
Mondelez International (MDLZ)	★★★★	$52	$41	Medium	Wide	0.79	60.60	Lash
PepsiCo (PEP)	★★★★	$122	$112.85	Low	Wide	0.93	159.45	Vora
Procter & Gamble (PG)	★★★★	$97	$89	Low	Wide	0.92	221.74	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6747	Low	Wide	0.92	47.58	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$11.1	Very High	None	0.53	13.38	Gemino
Enbridge (ENB)	★★★★★	$64	$40.79	Medium	Wide	0.64	70.99	Gemino
Enterprise Products Partners (EPD)	★★★★★	$35.5	$26.84	Low	Wide	0.76	58.40	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$83	$64.05	Medium	Narrow	0.77	260.66	Good
Total (TOT)	★★★★	$77	$58.17	Medium	None	0.76	152.23	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 33.26	High	None	0.72	31.14	Taylor

Source: Morningstar. As of Oct. 26, 2018

Best Ideas

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Financial Services								
Agricultural Bank of China (601288)	★★★	CNY 4.2	CNY 3.91	High	Narrow	0.93	1341.08	Tan
American International Group (AIG)	★★★★★	$76	$42.38	Medium	None	0.56	37.52	Horn
BlackRock (BLK)	★★★★★	$580	$391.96	Medium	Wide	0.68	60.88	Warren
Capital One Financial (COF)	★★★★	$127	$88.27	Medium	Narrow	0.70	41.81	Plunkett
Credit Suisse Group (CSGN)	★★★★★	CHF 22	CHF 12.48	High	Narrow	0.57	31.84	Scholtz
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 797	JPY 653.1	Medium	None	0.82	8503.76	Makdad
Pendal Group (PDL)	★★★★	AUD 11	AUD 7.99	Medium	Narrow	0.73	2.24	Likos
Westpac Banking (WBC)	★★★★	AUD 35	AUD 25.96	Medium	Wide	0.74	87.90	Ellis
Healthcare								
Allergan (AGN)	★★★★	$263	$180.29	Medium	Wide	0.69	61.20	Waterhouse
McKesson (MCK)	★★★★★	$210	$121.99	Medium	Wide	0.58	23.83	Lekraj
Medtronic (MDT)	★★★★	$110	$91.76	Medium	Wide	0.83	123.77	Wang
Ramsay Health Care (RHC)	★★★★	AUD 65	AUD 54	Medium	Narrow	0.83	10.91	James
Roche Holding (ROG)	★★★★★	CHF 333	CHF 233.65	Low	Wide	0.70	199.60	Andersen
Industrials								
Anixter International (AXE)	★★★★★	$107	$64.74	Medium	Narrow	0.61	2.17	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 40.3	Medium	Narrow	0.69	50.86	Song
CK Hutchison Holdings (1)	★★★★★	HKD 118	HKD 78	Medium	None	0.66	300.79	Tan
G4S (GFS)	★★★★★	GBX 337	GBX 214.9	Medium	None	0.64	3.33	Field
GEA Group (G1A)	★★★★★	EUR 45	EUR 26.04	Medium	Wide	0.58	4.54	Molina
General Dynamics (GD)	★★★★	$216	$170.6	Medium	Wide	0.79	50.52	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★	MXN 221	MXN 184.86	High	Wide	0.84	103.91	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.3	HKD 2.87	High	None	0.46	20.33	Song
Johnson Controls International (JCI)	★★★★	$53	$32.1	High	Narrow	0.61	29.69	Bernard
Kion Group (KGX)	★★★★★	EUR 90	EUR 46.65	Medium	Narrow	0.52	4.87	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 31.92	Medium	Narrow	0.76	29.73	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 87.52	Medium	Narrow	0.80	12.37	Field
Stericycle (SRCL)	★★★★★	$86	$49.52	High	Narrow	NA	4.25	Young
Real Estate								
Aveo Group (AOG)	★★★★★	AUD 2.8	AUD 1.86	Medium	None	0.66	1.08	Sherlock
Sun Hung Kai Properties (16)	★★★★★	HKD 153	HKD 102.6	Medium	Narrow	0.67	297.23	Zhong
Welltower (WELL)	★★★★	$72	$66.28	Medium	None	0.92	24.66	Brown
Technology								
Intel (INTC)	★★★★★	$65	$44.31	Medium	Wide	0.68	204.31	Davuluri
Microchip Technology (MCHP)	★★★★★	$112	$62.51	Medium	Wide	0.56	14.72	Colello
Murata Manufacturing (6981)	★★★★	JPY 24000	JPY 15575	High	Narrow	0.65	3321.39	Ito
MYOB Group (MYO)	★★★	AUD 3.82	AUD 3.41	Medium	Narrow	0.89	2.04	James
Synaptics (SYNA)	★★★★	$64	$36.96	Very High	None	0.58	1.29	Davuluri
Tencent Holdings (700)	★★★★★	HKD 590	HKD 260	High	Wide	0.44	2475.26	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$72.73	Low	Wide	0.87	47.55	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.43	Medium	None	0.78	44.53	Fulop
FirstEnergy (FE)	★★★★	$41	$37.89	Low	Narrow	0.92	19.38	Fishman
Scana (SCG)	★★★★★	$56	$37.37	Medium	Narrow	0.67	5.33	Miller

Source: Morningstar. As of Oct. 26, 2018

Highlighted Stocks

Livent LTHM

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Basic Materials	Stable	USD	18	15.73	Very High	Narrow	0.87	2.17

Source: Morningstar. As of Oct. 26, 2018

Livent's narrow moat is based on the firm's cost-advantaged lithium carbonate production.

Analyst Note, Oct. 22, 2018
We are initiating coverage of Livent, the lithium business recently spun off from FMC, with a narrow economic moat and stable trend ratings. With shares trading below our $18 per share fair value estimate, we view shares as slightly undervalued.

Livent's narrow moat is based on the firm's cost-advantaged lithium carbonate production. Livent's lithium carbonate is produced from its low-cost brine operations at the Salar del Hombre Muerto in Argentina. Because of a higher concentration of lithium in its brine that is extracted from the ground, Livent's operations sit near the bottom of the lithium carbonate cost curve, well below our $12,000 per metric ton long-term price forecast.

In the coming years, Livent plans to nearly triple its lithium carbonate production from 21,000 metric tons on an LCE basis in 2018 to 60,000 metric tons by 2025. Because of higher lithium prices and its low-cost carbonate production expansions, Livent should generate EBITDA margins above 40% in a midcycle environment. This sits above the 36% margin generated in 2017 on a pro forma basis. Livent will also grow its lithium hydroxide capacity from 18,500 metric tons in 2018 to 55,000 metric tons by 2025. Although we think the increased hydroxide capacity will be a profitable endeavor, we contend that incremental economic profits will be mainly derived from its low-cost carbonate production rather than the conversion of carbonate to hydroxide.

FMC still retains an 84.25% equity ownership stake in Livent. However, FMC has indicated that it will look to divest the remaining equity stake as early as 2019, depending on prevailing market conditions.

As a pure-play lithium producer, Livent is well-positioned to benefit from growing electric vehicle adoption. Using a regional buildup, we forecast that EVs will make up 15% of global light-vehicle sales in 2028, above the 11% consensus forecast.

Seth Goldstein, CFA | seth.goldstein@morningstar.com

Imax IMAX

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	30	20.08	High	Narrow	0.67	1.23

Source: Morningstar. As of Oct. 26, 2018

With shares trading in 4-star territory, the stock may offer an attractive entry point to investors.

Analyst Note, Oct. 25, 2018
Imax reported a strong third quarter as the firm beat consensus projections for the top line and met Street expectations for adjusted EBITDA. The firm reported IMAX box office grosses of $207 million in the third quarter, down 6% year over year on a tough comp. Despite the overall decline, the China market continues to expand with box grosses up 29% in the quarter. Imax signed agreements covering 25 new theaters, along with 12 upgrade signings during the quarter and ended the quarter with a backlog of 635 new theaters versus 545 a year ago. There is no change to our narrow moat rating or to our $30 fair value estimate. With shares trading in 4-star territory, the stock may offer an attractive entry point to investors.

Total revenue for the third quarter came in at $82 million, down 17% versus the same quarter last year. The third quarter of 2017 benefited from *Dunkirk*, *Spiderman: Homecoming*, and *It*, all of which played strongly on Imax screens. China continued to bounce back with 29% box office growth in the quarter and is now up 18% year to date versus 2017. We note that the growth in U.S. box office for the firm continues to outpace the total box office growth as Imax box office improved 14% in the first nine months of the year versus 9% for overall box office in U.S. We believe that the faster growth in Imax grosses can be partially attributed to the changes in slate programming implemented last year that included day-parting theaters and a quicker hook for underperforming films. Adjusted EBITDA margin for the quarter fell by 360 basis points to 31.4%, as the decreased revenue more than offset improved cost controls.

While MoviePass received a lot of publicity for bringing the one price for all you watch model for the movie business, the firm has largely flamed out. However, reduced versions of the model have been introduced by specific movie theater chains including AMC Entertainment. The AMC version, Stubs A-List, lets subscribers watch up to 3 movies a week for $19.95 per month. While the price is double the old MoviePass price, subscribers can watch movies on premium large-format screens including Imax. AMC has already signed up over 400,000 movie goers with many taking advantage of the ability to watch Imax films. Management believes that the percentage of A-List users that attend Imax screening is up to three times higher than the standard AMC customer. While the product is in the early stages, we believe that A-List and products from competitors could drive increased attendance at the movies. However, the revenue split between the studio, exhibitors, and Imax for these products could become contentious in the future if the subscribers start to compose a large percentage of viewers.

Neil Macker, CFA | neil.macker@morningstar.com

Scana SCG

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Utilities	Stable	USD	56	36.51	Medium	Narrow	0.65	5.33

Source: Morningstar. As of Oct. 26, 2018

Earnings through the first nine months are running ahead of our forecast due to favorable weather and customer growth.

Analyst Note, Oct. 25, 2018

We are reaffirming our $56 per share fair value estimate for Scana after the company reported earning $0.47 per share in the third quarter, down from $1.16 per share on an adjusted basis in the third quarter of 2017. We continue to believe Scana offers the most attractive risk-reward opportunity in the utilities sector with the stock trading at a 33% discount to our fair value estimate and a 29% discount to the implied value of Dominion Energy's proposed acquisition terms as of late October.

The impact from South Carolina Act 258 and subsequent regulatory approval of a 15% rate cut reduced earnings $0.56 per share in the quarter, in line with our expectations. We estimate the nine-month impact starting from the April 1 implementation could reduce 2018 earnings as much as $1.45 per share. We previously reduced our fair value estimate in June when the legislation passed to reflect these lost earnings. The rate cut expires when state regulators rule on long-term rate recovery for the abandoned V.C. Summer new nuclear project, likely by year-end.

Earnings through the first nine months are running ahead of our forecast due to favorable weather and customer growth. Management has not provided earnings guidance. Electric customer growth continues to top 1% and gas customer growth remains near 3%, among the highest in the industry. We expect this growth potential is one reason Dominion has offered substantial customer rate concessions as part of its acquisition proposal.

Our fair value estimate continues to include a 75% probability that regulators approve Dominion's all-stock acquisition and customer rate adjustment proposal. This results in a $1 per share uplift to our stand-alone fair value estimate based on our $84 per share Dominion fair value estimate. Regulatory hearings related to the acquisition and customer rates begin Nov. 1 with a required ruling by Dec. 21.

Travis Miller | travis.miller@morningstar.com

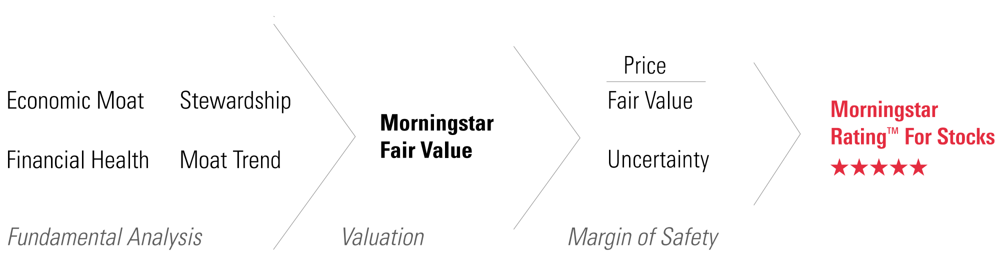
Research Methodology for Valuing Companies

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.

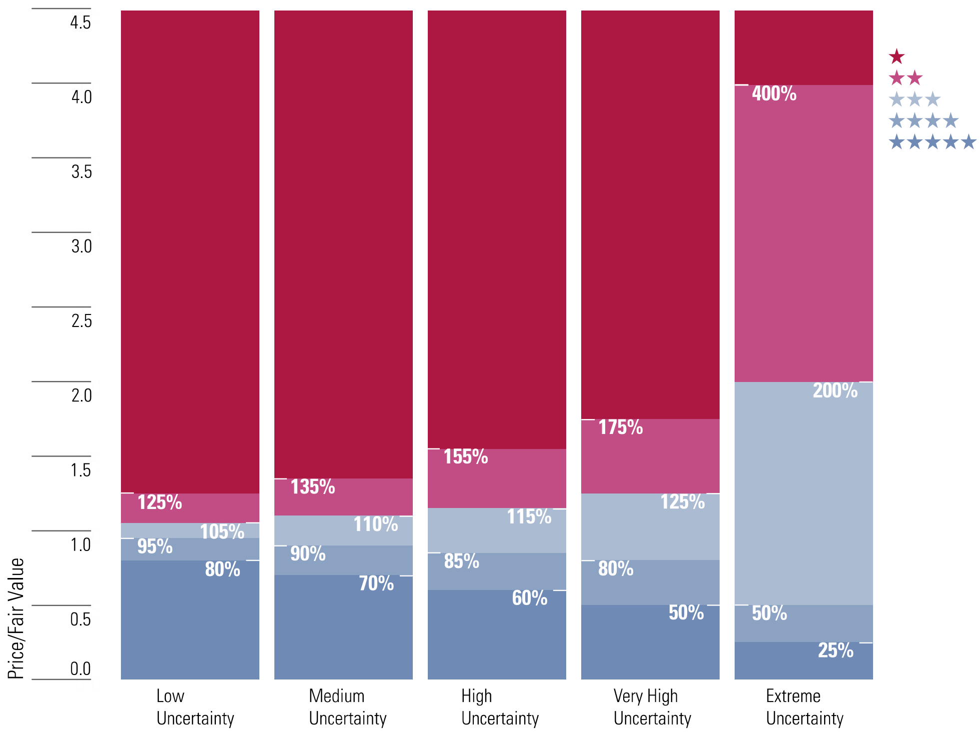
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than 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.

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+1 312 696-6869
equitysupport@morningstar.com

MORNINGSTAR®

22 West Washington Street
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