Research Highlights

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

Morningstar Equity Research
July 9-13, 2018

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

Rising Input Costs Won't Put Off Homebuilders Anytime Soon

Although rising labor costs and elevated material prices have made headlines since the start of the year, we remain optimistic about homebuilders' profitability and their willingness to ramp up new-home construction.

The two largest sources of input cost inflation have been labor and wood products over the trailing year. Lumber prices are up a substantial 30% between the first quarter of 2018 and the first quarter of 2017. Weekly labor costs are up a more modest but still meaningful 4%. In aggregate, we think the cost of building a new home is up roughly 4.5% through the first quarter. That's still far less than the nearly 7% climb in the average new-home sale price per square foot. Healthy margins should keep homebuilders hard at work through the remainder of the year. As homebuilders continue to better hone production to cater to their shifting customer base, we think additional demand will beget a sustained investment in supply.

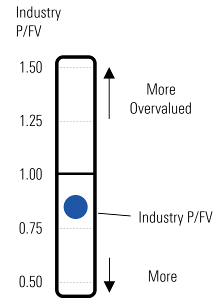
Building activity has remained solid throughout the first five months of 2018. Seasonally adjusted starts have averaged nearly a 1.32 million-unit pace, up more than 10% from last year. A long-awaited rebound in multifamily activity has supported a strong start to the year, but we expect that to moderate somewhat as the year goes on. We still expect 1.3 million total starts in 2018, up 8% from 1.20 million in 2017, as homebuilders work through sizable backlogs. Over the long run, we expect starts to peak at roughly 1.9 million units in 2021 before returning to a more sustainable 1.5 million-unit pace by 2027.

The second quarter finally presented some compelling buying opportunities for investors looking to capitalize on a strengthening housing market. Homebuilders such as Lennar and Toll Brothers trade in 4-star territory following concerns about the effects of higher interest rates and rising input costs on the bottom line.

A combination of declining existing-home vacancies and still-compelling monthly ownership costs leads us to believe these fears are exaggerated. In contrast, wood product valuations look very rich, following commodity price spikes during the first five months of this year. Lastly, soft goods companies have largely grown fully valued over the trailing six months, but for investors who are looking for possible upside in that sector, Williams-Sonoma still trades roughly 10% below our fair value estimate.

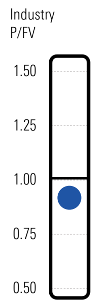
Exhibit 1 Housing-Related Industry Valuations and Top Picks

Legend



Morningstar Best Idea

Homebuilders and Building Materials



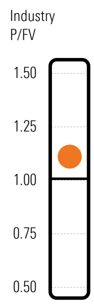
Industry Outlook

Homebuilders and building materials companies will benefit from surging home construction over the next several years. Although we expect homebuilders to post strong growth through 2021, profitability will be constrained by elevated land, labor, and material costs. Many builders have shifted their strategy toward buying shorter-duration land parcels and building faster-turning products, which should help improve returns on capital. We expect many building materials companies to benefit from increased volume and rising prices. For more, see Page 14.

Industry Top Pick	Rating	P/FV	Moat	Uncertainty
Lennar (LEN)	★★★★	0.72	None	High

We see about a 6% upside to Lennar's current valuation; however, this upside is entirely driven by potential synergies from the proposed merger with CalAtlantic which was announced on Oct. 30, 2017. The combined entity will likely surpass D.R. Horton as the largest homebuilder in the U.S. Based on our analysis, value creation for Lennar shareholders will primarily be driven by Lennar's ability to realize cost and selling efficiency synergies. Management noted that it is targeting $115 million in cost synergies in fiscal 2018 and $380 million in run-rate cost synergies in fiscal 2019.

Home Goods and Repair



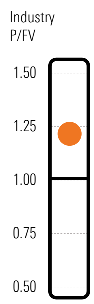
Industry Outlook

Increased household formation bodes well for businesses catering to home improvement and furnishing demand. As housing turnover picks up, so too should repair and activity. This benefits not only home improvement operators like Home Depot and Lowe's, but also furnishing and soft goods companies as consumers fit their new living arrangements to their preferences. For more, see Page 20.

Industry Top Pick	Rating	P/FV	Moat	Uncertainty
Williams-Sonoma (WSM)	★★★	0.90	Narrow	Medium

We think Williams-Sonoma has a competitive edge. While home furnishing peers have forced an increasingly promotional environment, pressuring the ability to grow gross margins, we still contend Williams-Sonoma is better positioned than peers to meet consumer demand, thanks to its robust trove of consumer analytics that allows the company to forecast unit demand on a more localized level. While some pricing pressure could persist, we believe Williams-Sonoma's evolving real estate strategy, supply chain optimization, and still-growing global reach will help returns on invested capital rise to 17% over the next five years (versus our cost of capital of 9%).

Wood Products



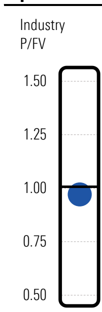
Industry Outlook

New residential construction is the single-largest demand source for lumber and panel products. Rising household formation will push North American mills to the brink by 2020. As higher-cost supply is restarted, we expect lumber, panel, and timber prices to rise meaningfully in the coming decade. For more, see Page 11 of this report, and refer to our recently published piece "Lumber Companies Poised to Profit as Millennials Form Households".

Industry Top Pick	Rating	P/FV	Moat	Uncertainty
Canfor (CFP.TO)	★★★	1.07	None	High

Transportation issues and tariffs have spurred lumber prices and Canfor's share price over the past year. While the company trades near our fair value today, a short-term lumber price decline could present a buying opportunity. New home construction is the key driver of lumber demand. As millennials put down roots, forming households, construction will favor lumber-intensive single-family homes. Rising lumber demand will strain supply, driving prices higher to incentivize capacity growth. Canfor has the added benefit of a pipeline of growth projects in the U.S. South, lifting capacity by up to 600mmbf through 2020. Together, these factors will nearly double EBITDA between 2016 and 2021.

Apartment REITs



Industry Outlook

While apartments are currently working through high levels of supply that have decelerated rent growth in all major markets over the past two years, we believe that rising construction costs are starting to limit the number of new projects and will lead to falling rates of supply growth over the next few years. The extended economic cycle and current demographic trends that favor renting over owning should persist and support low but steady internal growth for a few more years. Unfortunately, we see the high construction costs also negatively impacting the REITs' ability to create value from development, a major driver of growth to this point in the current economic cycle.

Industry Top Pick	Rating	P/FV	Moat	Uncertainty
Essex Property Trust (ESS)	★★★	0.93	None	Medium

Essex Property Trust's portfolio is the most geographically concentrated apartment REIT with all of its assets located in Seattle and the major metropolitan cities of California. The tech industry continues to support strong job and income growth in these markets and supply hasn't been as high as the East Coast markets, which drives our assumption that the company will maintain high occupancy and produce above-average rent growth over the next few years. While we believe the company should see solid internal operating growth, management's ability to generate accretive external growth will be limited as rising construction costs are reducing the company's opportunistic development pipeline.

Source: Morningstar Research Services LLC. Data as of July 9, 2018.

Credit Bureaus Have Wide Moats That Can't Be Breached

Equifax's massive data breach last year has drawn a fair amount of unfavorable attention to the credit bureau industry. While uncertainty around this issue persists, we think Equifax's results since the breach, first reported in September 2017, have been about as good as can be expected, due in large part to the wide economic moat the firm and its peers—Experian and TransUnion—enjoy.

Going forward, we believe these companies have meaningful opportunities to expand without diluting the moats around their legacy operations. We view the growth of the middle class in emerging markets to be the most value-creative long-term growth opportunity for the industry as the companies tap this secular trend to replicate their business model internationally. Additionally, selling credit data and related services directly to consumers is a natural extension of the credit bureau business model, and while new entrants have appeared, we think the credit bureaus will retain control of this market given that they control the credit data. Finally, we believe the credit bureaus have been relatively disciplined in entering new verticals that play to their strengths.

Overall, we see Experian as the stalwart in the industry and expect it to rebound from recent headwinds. TransUnion is the smallest but most aggressive player and has the best growth prospects. Equifax currently trades at a modest discount to our fair value estimate and could be tempting for investors willing to wait out the impact of the breach.

- ► While Experian has historically been the leader, with the most complete footprint in international markets, TransUnion has a commanding market share in India—a market that could ultimately rival the U.S. in revenue potential.
- ► In the consumer segment, TransUnion's decision to partner with new entrants such as Credit Karma gives it the best near-term outlook. Experian's leading position has been threatened, but we believe its strategy to compete instead of partner offers the potential to unlock the most long-term value. Equifax's damaged brand leaves it in the weakest position.
- ► We think the credit bureaus have largely been disciplined in entering new verticals, and Equifax's employment verification business looks as moaty as its legacy operations.

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New Regulatory Proposals Will Change Stress-Test Landscape

We see capital returns increasing over the medium term, as the banking industry begins to shed excess capital and proposed regulations go into effect. While these regulations generally are more numerically punitive toward the largest banks, and even some regional banks, we argue that they may still encourage more aggressive capital returns due to removing the pass/fail nature of the tests. This is good for returning money to shareholders and raising ROEs through lower capital levels, but there is also arguably a trade-off between the safety of the U.S. banking system and overall levels of capital supporting that system. This is something to watch because we see competition increasing throughout the industry.

In this piece we take an in-depth look at the Federal Reserve's 2018 Comprehensive Capital Analysis and Review test results and how the proposed Stress Buffer regulations and Act S.2115 will affect the industry, future stress tests, and future returns. We show who is best positioned to improve returns via reducing capital levels, and who has been approved to return the most relative capital over the next four quarters. Among the banks, we estimate that Fifth Third, Huntington Bancshares, and Wells Fargo have the highest potential to increase ROEs from excess capital returns.

- We project that Huntington Bancshares, Fifth Third, and Wells Fargo have the most room to improve returns on equity via returning excess capital under the Stress Capital Buffer and Stress Leverage Buffer proposals, with each able to improve ROEs by over 300 basis points if they shed the vast majority of their excess capital.
- We calculate that Citigroup, Regions Financial, Wells Fargo, and Fifth Third are all approved to "pay out" (dividends plus share buybacks) over 10% of their current market caps. This is especially relevant for Wells Fargo, which is trading at the largest discount to our fair value estimate.
- We estimate that potential new regulatory changes, the stress buffer proposals, would have a mixed effect on the banks we cover. Banks will be able to maintain higher capital levels through the stress test; however, higher minimum requirements will more than outweigh this for many of them.
- We see these latest regulatory proposals generally benefiting the midsize regional banks we cover, while being more punitive to the big four and some of the larger regionals. This is in line with the generally accepted guidance from the U.S. Federal Reserve; however, we also calculate that Wells Fargo may have some of the most room to return excess capital, which we think may not be well understood by the market.
- We also show that, counterintuitively, the regionals with the smallest deteriorations to their stressed common equity Tier 1 ratios will also be penalized, due to the proposed 2.5% Stress Capital Buffer floor. This would have hurt U.S. Bancorp, Huntington, BB&T, American Express, and Northern Trust based on 2018 results.
- We project that, based on first-quarter 2018 capital levels, Goldman Sachs and State Street would have had below the minimum capital requirement under the new Stress Capital Buffer proposal.
- The new stress-test proposals will institute minimum capital levels that must be met all year, but these proposals will also take away the "one-time pass/fail" nature of the current stress tests. This should make it easier for these banks to more aggressively target the lowest possible capital levels attainable,

as the pressure to avoid the consequences of failure of the current CCAR tests will be removed and the minimum capital levels they are aiming for will be known all year.

- The normalized dividend payout ratio for the banks we cover should stay steady at roughly 30% in 2018, while approved share buybacks could approach 69%, leading to a total approved payout ratio of nearly 100% for the group as a whole. Many banks are approved to return well over 100% of their likely income over the next four quarters, including Citigroup, Wells Fargo, SunTrust, Fifth Third, Regions Financial, M&T Bank, and Huntington.

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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	$10.88	High	Narrow	0.64	4.30	Inton
Compass Minerals International (CMP)	★★★★	$83	$65.8	High	Wide	0.79	2.23	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$225.69	High	Narrow	0.85	14.21	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 223.65	High	Narrow	0.62	22.19	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 69	Medium	Narrow	0.68	1412.81	Baker
Comcast (CMCSA)	★★★★	$42	$34.55	Medium	Wide	0.82	158.99	Macker
Telefonica (TEF)	★★★★★	$13	$7.56	High	Narrow	0.58	39.28	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.75	Medium	Narrow	0.63	32.71	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$157	$138.79	Medium	Narrow	0.88	10.27	Akbari
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 79.37	High	Narrow	0.68	51.64	Hilgert
Expedia Group (EXPE)	★★★★	$180	$127.37	High	Narrow	0.71	19.12	Wasiolek
General Motors (GM)	★★★★	$56	$39.27	High	None	0.70	55.35	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 5.29	High	None	0.39	84.56	Hu
Hanesbrands (HBI)	★★★★	$29	$21.66	Medium	Narrow	0.75	7.81	Hottovy
InvoCare (IVC)	★★★★	AUD 15.5	AUD 14.09	Medium	Wide	0.91	1.55	Ragonese
Mattel (MAT)	★★★★	$21.5	$17.21	High	Narrow	0.80	5.92	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$47.96	High	Narrow	0.70	10.78	Katz
Walt Disney (DIS)	★★★★	$130	$108.25	Medium	Wide	0.83	160.94	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1226	Medium	Narrow	0.82	15.47	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★	AUD 4	AUD 2.38	High	None	0.60	1.08	James
General Mills (GIS)	★★★★★	$59	$44.58	Low	Wide	0.76	26.45	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2902.5	Low	Wide	0.74	27.68	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8329	Low	Wide	0.95	4059.73	Wei
Mondelez International (MDLZ)	★★★★	$51	$42.45	Medium	Wide	0.83	62.62	Lash
PepsiCo (PEP)	★★★★	$123	$111.53	Low	Wide	0.91	157.74	Vora
Procter & Gamble (PG)	★★★★★	$98	$78.89	Low	Wide	0.81	198.38	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6497	Low	Wide	0.89	45.90	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$14	Very High	None	0.67	17.20	Gemino
Enbridge (ENB)	★★★★	$64	$47.12	Medium	Wide	0.74	80.33	Gemino
Enterprise Products Partners (EPD)	★★★★	$32.5	$28.24	Low	Wide	0.87	61.36	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$73.08	Low	None	0.94	294.83	Good
Total (TOT)	★★★★	$74	$62.24	Medium	None	0.84	162.65	Good
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.5	High	Narrow	0.83	1213.43	Tan
American International Group (AIG)	★★★★	$76	$54.3	Medium	None	0.71	48.74	Horn
Capital One Financial (COF)	★★★★	$123	$95.24	Medium	Narrow	0.77	46.33	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 14.87	High	Narrow	0.68	37.76	Scholtz
Invesco (IVZ)	★★★★★	$40	$26.04	Medium	Narrow	0.65	10.70	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 638.3	Medium	None	0.73	8374.21	Wu
QBE Insurance Group (QBE)	★★★★	AUD 12	AUD 9.79	High	None	0.82	13.29	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 29.6	Medium	Wide	0.85	100.23	Ellis

Source: Morningstar. As of July 13, 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
Healthcare								
Allergan (AGN)	★★★★★	$263	$176.52	Medium	Wide	0.67	59.85	Waterhouse
McKesson (MCK)	★★★★★	$210	$135.98	Medium	Wide	0.65	27.44	Lekraj
Medtronic (MDT)	★★★★	$105	$87.87	Medium	Wide	0.84	118.77	Wang
Ramsay Health Care (RHC)	★★★★★	AUD 82	AUD 54.62	Medium	Narrow	0.67	11.04	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 232.7	Low	Wide	0.69	199.51	Andersen
Shire (SHP)	★★★★	GBX 4890	GBX 4336	Medium	Narrow	0.89	39.63	Andersen
Industrials								
Allegion (ALLE)	★★★★	$91	$79.08	Medium	Wide	0.87	7.51	Bernard
Anixter International (AXE)	★★★★★	$107	$64.4	Medium	Narrow	0.60	2.15	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 37.85	Medium	Narrow	0.65	47.77	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.41	Medium	Wide	0.84	14.97	Fleck
CK Hutchison Holdings (1)	★★★★★	HKD 125	HKD 84.2	Medium	None	0.67	324.82	Tan
G4S (GFS)	★★★★	GBX 337	GBX 273.6	Medium	None	0.81	4.25	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 28.6	Medium	Wide	0.61	5.16	Molina
Grupo Aeroportuario del Pacifico (GAP B)	★★★	MXN 217	MXN 188.04	High	Wide	0.87	105.49	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.08	High	None	0.60	33.85	Song
Johnson Controls International (JCI)	★★★★	$53	$34.74	High	Narrow	0.66	32.18	Bernard
KION GROUP (KGX)	★★★★	EUR 90	EUR 62	Medium	Narrow	0.69	7.32	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 37.14	Medium	Narrow	0.88	35.30	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 90.9	Medium	Narrow	0.83	13.48	Field
Stericycle (SRCL)	★★★★	$86	$68.35	High	Narrow	0.79	5.85	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.8	AUD 2.32	Medium	None	0.83	1.35	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 118	Medium	Narrow	NA	341.84	Zhong
Welltower (WELL)	★★★★	$74	$63.16	High	None	0.85	23.49	Brown
Technology								
Intel (INTC)	★★★★	$62	$52.35	Medium	Wide	0.84	243.95	Davuluri
KLA-Tencor (KLAC)	★★★★	$125	$104.55	High	Wide	0.84	16.27	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$94.28	Medium	Wide	0.84	22.20	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 3.04	Medium	Narrow	0.80	1.82	James
Qualcomm (QCOM)	★★★★	$75	$58.32	High	Narrow	0.78	86.48	Davuluri
Synaptics (SYNA)	★★★★	$64	$50.53	Very High	None	0.79	1.75	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 11760	High	None	0.94	1484.64	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 381	High	Wide	0.59	3620.72	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$70.06	Low	Wide	0.83	45.74	Fishman
FirstEnergy (FE)	★★★★	$40	$35.65	Low	Narrow	0.89	17.00	Fishman
Gas Natural SDG (NTGY)	★★★	EUR 23.5	EUR 23.42	Medium	Narrow	1.00	23.42	Fulop
SCANA (SCG)	★★★★★	$56	$38.84	Medium	Narrow	0.69	5.54	Miller

Source: Morningstar. As of July 13, 2018

Highlighted Stocks

Delta Air Lines DAL

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Industrials	Stable	USD	60	50.82	High	None	0.85	35.07

Source: Morningstar. As of July 13, 2018

While we acknowledge the high uncertainty embedded in airline earnings, heightened oil fears have created pockets of opportunity for investors.

Analyst Note, July 12, 2018

After adjusting our assumptions for management's updated guidance, we have lowered our fair value estimate for Delta Air Lines to $60 from $62. The carrier turned in second-quarter earnings below guidance due to rising fuel prices. Domestic revenue proved robust, despite a pre-earnings warning from American Airlines. Delta's transatlantic routes offered the most top-line support, growing at 13.9%, on 2.4% capacity growth. Passenger revenue improved in all but one geography, Latin America. Excluding refinery sales, total unit revenue climbed 5.9%.

Over the three-month period ending in June, Delta expanded domestic and Atlantic route capacity while withdrawing seats from Latin American and Pacific routes. Despite retracting from Pacific markets, Delta recorded passenger revenue growth of 8% year over year, thanks in part to yields rising 8%. Altogether, Delta expanded capacity by 3.5%, which fell in line with the 3.5% guided in the first quarter.

Delta costs per unit excluding fuel and special items were nearly on par with guidance. The second quarter saw a 3% rise in unit costs over last year. Fuel concerns continue to hinder margin growth, and fears have bled into management's year-end projections. For the quarter, Delta's EPS came in lower than guided at $1.47, and the carrier now expects year-end EPS between $5.35 and $5.70.

While Delta anticipates additional capacity expansion, commodity price inflation has curtailed expansion plans. Management now believes containing fuel costs and improving margins will require lower capacity expansion for the fall schedule. Third-quarter capacity guidance was cut 50 to 100 basis points, leaving growth at 3%.

Oversupply fears have left investors skittish and placed airline shares under duress. And, in lieu of rising oil prices, carriers will need to show investors they've learned from prior periods that overexpansion usually ends in tears. While we acknowledge the high uncertainty embedded in airline earnings, heightened oil fears have created pockets of opportunity for investors. After lowering our fair value from $62 to $60, Delta shares offer considerable upside.

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McDonald's MCD

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Negative	USD	190	158.47	Medium	Wide	0.83	129.94

Source: Morningstar. As of July 13, 2018

Foodborne illnesses have always been a risk for restaurant operators, but we believe the impact has been magnified in recent years.

Analyst Note, July 13, 2018
McDonald's is looking at a potential food safety issue following an investigation by the Illinois Department of Public Health linking McDonald's salads to more than 100 cases of cyclosporiasis in Illinois and Iowa. McDonald's has voluntarily pulled salads at 3,000 of its U.S. restaurants in the Midwest and its distribution centers until it can switch to another lettuce supplier.

Foodborne illnesses have always been a risk for restaurant operators, but we believe the impact has been magnified in recent years, evidenced by depressed results at Chipotle following a 2015 E. coli outbreak and Yum China following concerns about a poultry supplier (2012) and food handling at one of its suppliers (2014). We believe recent food safety issues have had a more pronounced impact on restaurant companies because of consumers' heightened concerns about where their food comes from and because of the speed with which news spreads through social media.

It's unclear what, if any, effect this incident will have on McDonald's results. Looking at recent food safety scares in the restaurant industry, we believe the impact comes down to two primary factors: the severity/magnitude of the outbreak and the company's transparency. While it's reasonable to assume more cyclosporiasis cases will be reported, McDonald's appears to have identified the affected lettuce blend and taken other precautions to prevent any additional outbreaks (which did not require store closures).

Assuming McDonald's can communicate how the affected lettuce made it into its supply chain—something absent in the Chipotle situation—and outline future preventative measures, we believe the impact will be mild. There is no change to our $190 fair value estimate or our wide moat rating, and we view shares as undervalued at current levels.

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Synchrony Financial SYF

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Financial	Stable	USD	41.50	32.44	Medium	Narrow	0.78	24.88

Source: Morningstar. As of July 13, 2018

Walmart is in a position of strength in this negotiation and can likely extract much better terms from Synchrony.

Analyst Note, July 12, 2018

Narrow-moat Synchrony fell over 5% after reports that Walmart, one of its largest retail partners, was weighing a bid from Capital One for its retail credit card portfolio. It should not come as a surprise to anyone that Walmart evaluates the bids of other suitors for its private-label credit card business. These agreements will typically last at least five to 10 years and are usually put out to bid toward the end of each contract. When it comes to private-label credit cards, renegotiations are more like auctions, which almost always come down to what percentage of revenue the credit card company is willing to share with the retailer. Historically, Capital One is one of the most price-sensitive when it comes to acquiring new retail card portfolios, which is why we're skeptical that it will be the ultimate suitor. Given the importance of Walmart, Synchrony will likely make a significant offer to retain the business. For now, we'll be maintaining our fair value estimate of $41.50 per share as we gather more information.

However, Capital One's more recent comments from the end of May at Bernstein's conference strike us as an important departure in language. Previously, when asked about acquiring these partnerships, CEO Richard Fairbank almost always complained about the price to win new partners and being forced to walk away from deals. In May, Fairbank added this caveat, "... investing in those partnerships is an important form of diversification for ourselves and allows us to take a lot of the technology that we have built in the card business and let some of our clients draft off that as they themselves have, in some cases, an almost existential challenge on the digital revolution." This would certainly align with the Bloomberg report that Walmart "is seeking a partner that supports its aspirations for Walmart Pay." As we have said many times, Capital One is likely the most technologically advanced bank we cover.

We also have to wonder whether this story was leaked in order to pressure Synchrony into sweetening its offer. Walmart accounts for more than 10% of Synchrony's receivables, but even more worrisome, Sam's Club accounts for close to another 10% and negotiates separately from its parent and likely wouldn't be renegotiated for at least another year. We have to assume that if Synchrony were to lose Walmart, it would eventually lose Sam's Club. Combined, these two entities account for more than 20% of Synchrony's loans. Walmart is in a position of strength in this negotiation and can likely extract much better terms from Synchrony than it can from Capital One, because the cost of losing this business is so great for Synchrony. That's ultimately why we speculate that Walmart's credit card business will remain with Synchrony.

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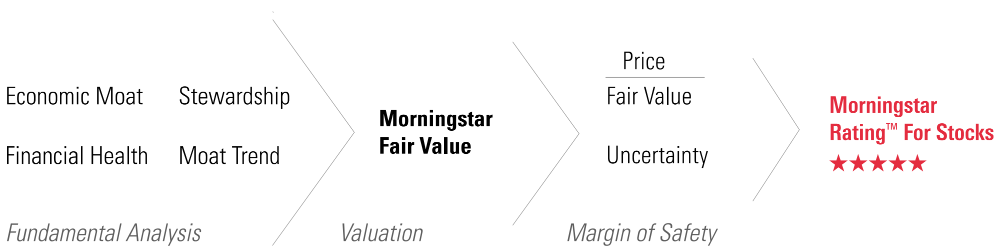
Research Methodology for Valuing Companies

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.

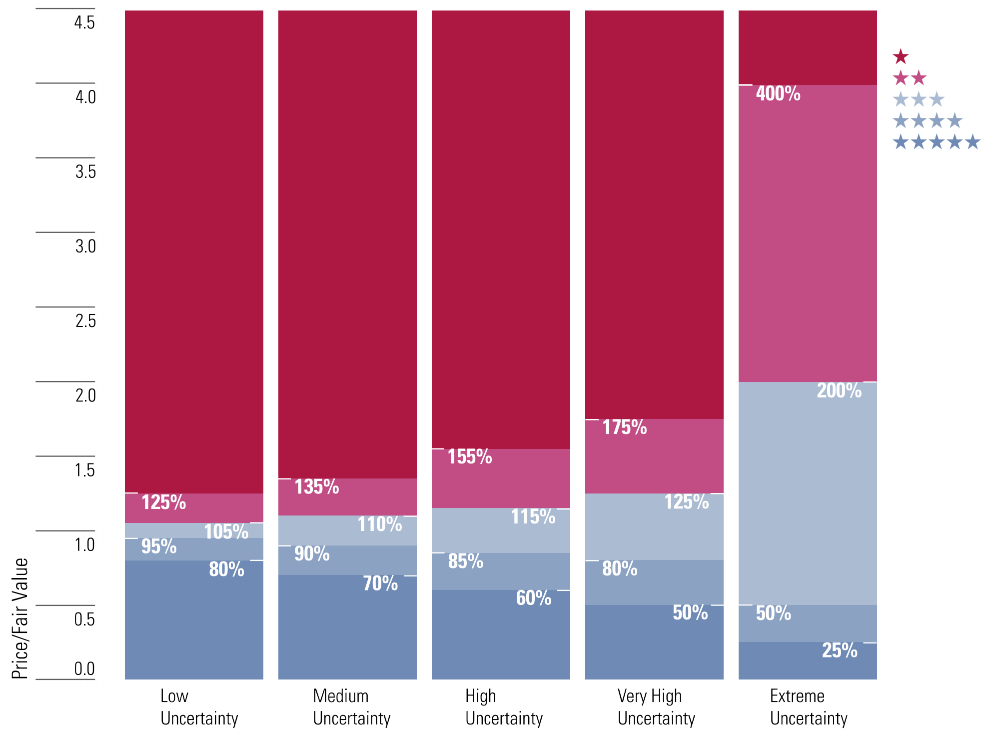
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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