Research Highlights

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

Morningstar Equity Research
April 2-6, 2018

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

An Updated Look at Our Hospital Coverage

We've taken a fresh look at the healthcare provider space and come away a bit more constructive on acute care facilities in general. We're raising our moat rating for HCA to narrow from none, while maintaining our no-moat rating on Tenet Healthcare and initiating on LifePoint Health at no moat. We think aggregate valuations are beginning to look compelling. As a result, we're increasing our fair value estimate for HCA to $114 from $78, our Tenet fair value moves to $25 from $16.50, and we're initiating on LifePoint with a $58 fair value estimate.

HCA Healthcare

HCA's narrow moat is underpinned by scale-derived advantages that position the firm advantageously when contracting with supply vendors and commercial payers. Specifically, the firm's substantial local market share places it on more equal footing with national payers when negotiating network rates, wielding market power that third- and fourth-tier facilities within a municipality likely don't possess.

Bulls Say

- As the largest hospital operator in the U.S, HCA has gained material cost advantages that appear to be relatively unique in the industry, providing for a sustainable best-in-class margin structure.
- HCA's focus on dominating local urban markets with favorable demographics has positioned the firm well within an otherwise fragmented industry.
- Management has been shareholder friendly since the firm's IPO, advocating for special dividends, repurchases, and responsible acquisition activity over time. The recent initiation of a common dividend reinforces this view.

Bears Say

- Signs of labor market tightness could signal higher wage inflation in the near term, pressuring short-term profit absent any acceleration in reimbursement trends.
- Reliance on government reimbursement for a significant, and growing, portion of the population will structurally worsen HCA's payer mix over time, lowering its return on invested capital.
- Improvements in technology and medicine will continue to shift patients out of acute care environments and into lower cost outpatient settings, reducing the opportunity for volume growth over time.

LifePoint Health

Given its high uncertainty rating, LifePoint shares currently trade solidly in 4-star territory. While LifePoint's rural community focus precludes it from demonstrating the qualities we commonly attribute to moaty firms, recent issues relating to acquisition integration have been too harshly punished by the market, in our opinion. Management has a solid track record of acquiring and improving underperforming facilities, and we view recent setbacks as largely transitory.

Bulls Say

- Management has a history of effective acquisition integration, increasing the likelihood that recent acquisition-related mishaps are ultimately resolved.
- In its current markets, the firm has little in the way of direct competition and operates as the sole provider for many of its communities.
- While management has pursued an acquisition-heavy strategy in recent years, its systematic focus on subsequent debt reduction gives us confidence that the business will continue to maintain responsible leverage levels.

Bears Say

- LifePoint's high relative exposure to government- and self-pay patients increases the likelihood of heightened negative reimbursement pressure, in our view.
- The firm is likely to encroach upon more urban or nonrural markets as it continues to expand via acquisition, inviting competition against more formidable operators than in its core markets.
- Labor market tightness could signal an increased probability of accelerating wage growth in the near term, which would pressure profits.

Tenet Healthcare

For Tenet, early indications suggest its newly hired CEO has the potential to improve the trajectory of the business. In his short time in the role, he's shown a willingness to cut costs where needed, make decisive portfolio decisions, and reassess the strategic nature of assets previously held dear. While we're maintaining our very high uncertainty given the substantial debt burden, we're more optimistic for Tenet's prospects under new leadership.

Bulls Say

- Recent changes made to the management team and board should allow for a fresh look at the business, which is likely to find substantial cost savings, given the current cost structure.
- Management's willingness to sell noncore assets should give shareholders increased confidence in the company's ability to service its substantial debt burden.
- Tenet has been improving its local market position via portfolio additions and divestitures over time, which should help improve its hospital operations.

Bears Say

- Labor market tightness could lead to higher wage growth over time, which Tenet may not be able to offset via pricing concessions in the short run.

- High reliance on Medicare and Medicaid reimbursement programs could negatively affect profits should policymakers work to reduce the spending burden on state and federal budgets.
- Tenet's acquisition strategy has left it with a substantial debt burden, which could prove troublesome for shareholders should the economy materially deteriorate.

After reassessing industrywide valuations, we'd point investors toward HCA and LifePoint as the most attractive opportunities. Our fair value estimates for the firms imply enterprise value/adjusted EBITDA multiples of 8.5 and 7.0 times our estimates for 2018 adjusted EBITDA, respectively. While Tenet initially screens cheap at 6.3 times, we'd caution investors given the firm's sizable below-the-line minority interest requirements. After adjusting for this distribution, our fair value estimate implies 7.5 times adjusted EBITDA—a similar adjustment for HCA increases our implied valuation by only a half-turn. Given Tenet's sizable debt obligations and with turnaround efforts only in the early innings, we'd recommend a larger margin of safety before considering shares.

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Spectra Energy Partners: The Vortex, the Bomb, and the Moat

When the polar vortex hit in winter 2014 and the "bomb cyclone" dropped this January, Spectra Energy Partners brought the heat. Natural gas demand spiked to record levels and Spectra's interstate pipelines ensured that the eastern U.S. stayed warm and well-lit, illustrating how Spectra's dominant position in the eastern U.S. gas markets makes it one of the few energy and utility companies with a wide economic moat. However, investors seem confused about how to value Spectra. Is it a diversified master limited partnership? Or is it a utility?

Fundamentally, Spectra's business is more like a utility's, with no direct commodity exposure and regulated-like cash flows. But it regularly trades in line with diversified MLPs, which are sensitive to volatile energy prices and could face lower profitability due to recent federal policy changes. The collapse in MLP prices this year offers investors an opportunity to buy Spectra at a 30% discount to our fair value estimate and with a 9% distribution yield. If parent Enbridge supports Spectra's steady distribution growth potential, the market might give it the premium we think it deserves.

- ► In the eastern U.S., Spectra's pipelines dominate a growing market for natural gas heating and power generation, supporting high utilization rates, premium fees, long-term contracts, and a wide moat based on efficient scale.
- ► Spectra often gets grouped with its commodity-sensitive MLP peers, which we think creates buying opportunities when the market misprices its utility-like cash flows. With a 9% distribution yield and 30% discount to our fair value estimate, Spectra would be one of the cheapest utilities we cover.
- ► A recent change in federal ratemaking policy could lower some of Spectra's tariffs, but we think the impact will be much less than the market is anticipating.
- ► Enbridge's 83% stake in Spectra leaves minority investors with little influence. But Enbridge's commitment to investing in Spectra underpins our 6% annual distribution growth forecast through 2021.

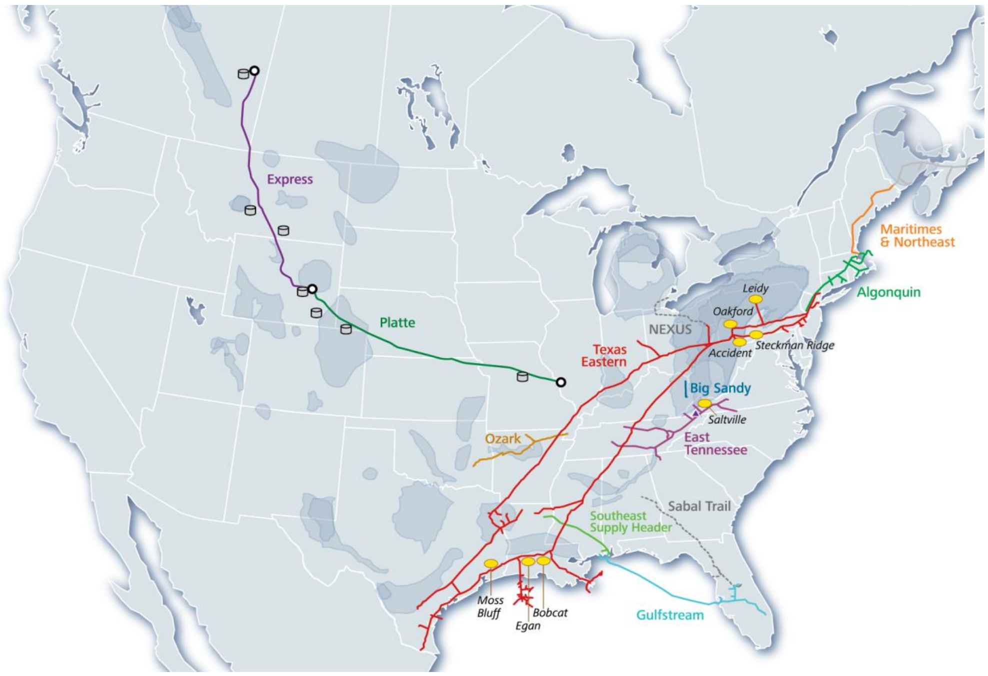
Bulls Say

- ► Spectra is one of the few MLPs that acts as a pure tollbooth operator with no direct commodity price exposure and nearly all of its income locked in with long-term capacity contracts.
- ► The average duration of Spectra's U.S. gas transmission contracts is nine years, and it has contracted approximately 96% of its revenue.
- ► Spectra is a wide-moat pipeline franchise and one of the most solid and attractive MLPs we cover.

Bears Say

- ► Expectations of an interest-rate hike may present headwinds to Spectra's units and other yield-oriented investments.
- ► Enbridge's 83% stake following the IDR conversion leaves minority unitholders with virtually no say in Spectra's strategic direction.
- ► A FERC policy revision in March 2018 could negate the tax benefits of the MLP structure and lead to modest pipeline tariff cuts.

Exhibit 1 Spectra's Assets Well-Positioned to Link Key U.S. Supply and Demand Regions



Source: Spectra Energy Partners.

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Rising Debt/GDP Ratio Threatens China's Financial System

The rapid expansion in China's debt/GDP ratio has raised concerns among many observers, including us, because it is reminiscent of prior credit booms that have ended badly. Having watched Beijing repeatedly stimulate its way to higher growth, investors ask why this can't continue. Bluntly, if credit continues to outpace GDP growth significantly, we expect one of two scenarios to eventually occur.

The first is a full-blown credit crisis. Here, credit availability would sharply contract, leading to a decline in investment spending. Overall economic activity would then slow amid a wave of borrower defaults. As the bad debt is recognized and written off by banks, lending growth can resume, helping the economy return to growth.

The second scenario is persistently weak economic growth. In this case, a rising share of credit would continue to flow to "zombie" state-owned enterprises and local governments and debt would roll over at banks, papering over losses. In turn, less credit would be available to private companies, which have been very productive and generated higher returns on equity than SOEs. With less credit flowing to productive investment, the credit returns continue to falter, leading to less productivity as more-productive sectors are starved of credit.

- Thailand, Malaysia, Japan, and Korea have all experienced similarly rapid credit booms that ended in painful deleveraging episodes, which caused real GDP growth to fall about 50% from boom-era levels. The International Monetary Fund has noted that in prior instances when the credit/GDP ratio increased more than 30 percentage points in five years, 38 out of 43 economies experienced a crisis or a sharp slowdown in growth.
- It is not the absolute level of debt in China that is destabilizing, but the growth in debt. The debt service ratio and credit/GDP gap have been sending danger signals for some time.
- We expect returns to continue to deteriorate until Beijing becomes serious about making the needed reforms, which include eliminating hard GDP targets and soft budget constraints on the state-owned enterprises. This would also include eliminating provincial growth targets and local governments focusing on only approving projects with sustainable long-term positive returns. Ultimately, the continued increases in credit intensity, lower returns on capital, and gradually weaker SOE performance will make it harder and harder to sustain and meet GDP growth targets of 6.5%-7% annually.

China's Debt Series

This is the first in an expected three-part series on China's debt and the implications for the Chinese financial system and economy over the next decade. This report will focus on China's current financial situation, what China is doing and should do to address the issues on an economywide level, and the potential consequences if reforms don't meaningfully reduce the current level of riskiness and instability in the system.

The second part in the series will focus on China's reforms within the financial system, including interest-rate liberalization, its monetary policy framework, local government financing, and banks' bad-debt progress. We believe financial reforms are moving forward but slower than the market expected.

We believe the reason the government hesitates in directly addressing the root cause of the systematic problem is to avoid financial instability and to balance the vested interest groups and monopolistic groups. The government is looking to tackle the problem gradually after the market infrastructure is improved, such as the development of capital markets to encourage direct financing and an interest-rate transmission system.

The third report will share our Chinese financial system credit loss model with our 10-year forecast. Broadly, we expect credit intensity and the incremental capital output ratio to begin to stabilize and slightly decline over our forecast period. We use three different models to estimate the size of credit losses to the Chinese financial system, which calculate the amount of excess credit and nonperforming loans as well as considering the performance of similar economies during credit busts. We then highlight how we expect China to intervene and what policy reforms are most appropriate.

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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	$9.98	High	Narrow	0.59	3.81	Inton
Compass Minerals International (CMP)	★★★★	$82	$63.75	High	Wide	0.78	2.16	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 232.25	High	Narrow	0.63	23.04	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 71.55	Medium	Narrow	0.70	1465.02	Baker
Telefonica (TEF)	★★★★	$13	$8.14	High	Narrow	0.63	42.26	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.1	Medium	Narrow	0.67	36.87	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$159	$116.39	Medium	Narrow	0.73	8.61	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.66	Medium	Narrow	0.81	1.58	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 88.7	High	Narrow	0.81	57.71	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 40.63	Medium	Narrow	0.77	3.47	Faul
General Motors (GM)	★★★★	$56	$38	High	None	0.68	53.22	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 7.75	High	None	0.57	109.04	Hu
Hanesbrands (HBI)	★★★★★	$29	$19.22	Medium	Narrow	0.66	6.93	Weishaar
Mattel (MAT)	★★★★	$21.5	$13.24	High	Narrow	0.62	4.55	Katz
TripAdvisor (TRIP)	★★★★	$55	$41.37	High	Narrow	0.75	5.75	Wasiolek
Walt Disney (DIS)	★★★★	$130	$102.11	Medium	Wide	0.79	153.54	Macker
Williams-Sonoma (WSM)	★★★★	$68	$51.98	Medium	Narrow	0.76	4.33	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1138.5	Medium	Narrow	0.76	14.41	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★★	$59	$45.43	Low	Wide	0.77	25.90	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2529.5	Low	Wide	0.65	24.12	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8315	Low	Wide	0.94	4097.42	Wei
Mondelez International (MDLZ)	★★★★	$51	$42.2	Medium	Wide	0.83	62.59	Lash
Procter & Gamble (PG)	★★★★	$98	$78.8	Low	Wide	0.80	198.66	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7400	GBX 6202	Low	Wide	0.84	43.69	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$12.11	Very High	None	0.58	14.88	Gemino
Enbridge (ENB)	★★★★★	$62	$40.18	Medium	Wide	0.65	68.11	Gemino
Enterprise Products Partners (EPD)	★★★★	$30	$24.42	Low	Wide	0.81	52.77	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$67.78	Low	None	0.87	265.68	Good
Total (TOT)	★★★★	$74	$59.7	Medium	None	0.81	151.82	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$54.55	Medium	None	0.72	49.26	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.79	Very High	None	0.89	24.66	Heathfield
Capital One Financial (COF)	★★★★	$120	$97.52	Medium	Narrow	0.81	47.41	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 15.67	High	Narrow	0.71	39.96	Scholtz
Invesco (IVZ)	★★★★	$42	$31.78	Medium	Narrow	0.76	13.06	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 692.8	Medium	None	0.79	9119.21	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.49	High	Narrow	0.73	12.90	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 29.05	Medium	Wide	0.83	98.37	Ellis

Source: Morningstar. As of April 6, 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	$165.13	Medium	Wide	0.63	54.09	Waterhouse
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.9	Medium	Narrow	0.79	3.31	Kallos
McKesson (MCK)	★★★★★	$210	$142.61	Medium	Wide	0.68	29.43	Lekraj
Medtronic (MDT)	★★★★	$105	$79.7	Medium	Wide	0.76	108.02	Wang
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 61.86	Medium	Narrow	0.75	12.50	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 217.2	Low	Wide	0.68	185.87	Andersen
Shire (SHP)	★★★★	GBX 4890	GBX 3707	Medium	Narrow	0.76	33.80	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$76.5	Medium	Narrow	0.71	2.55	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 41.5	Medium	Narrow	0.72	52.38	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.83	Medium	Wide	0.88	15.64	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 124	HKD 91.5	Medium	None	0.74	352.98	Tan
Fluor (FLR)	★★★★	$69	$58.54	High	Narrow	0.85	8.19	Silver
G4S (GFS)	★★★★	GBX 337	GBX 250.7	Medium	None	0.74	3.89	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 34.53	Medium	Wide	0.73	6.28	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP B)	★★★★	MXN 225	MXN 189.28	High	Wide	0.84	106.19	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.39	High	None	0.65	37.88	Song
Johnson Controls International (JCI)	★★★★	$53	$34.6	High	Narrow	0.65	32.04	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 77.18	Medium	Narrow	0.90	9.10	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 31.52	Medium	Narrow	0.79	29.20	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 79.36	Medium	Narrow	0.72	11.79	Field
Stericycle (SRCL)	★★★★	$99	$58.57	Very High	Wide	0.59	5.01	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.63	Medium	None	0.85	1.53	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 124.9	Medium	Narrow	0.82	361.83	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$67.77	Medium	None	0.81	12.88	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$100	$81.25	Medium	Wide	NA	6.49	Nelson
KLA-Tencor (KLAC)	★★★	$125	$108.71	High	Wide	0.87	16.94	Davuluri
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.05	Medium	Narrow	0.75	1.84	James
Qualcomm (QCOM)	★★★★	$75	$55.04	High	Narrow	0.73	81.48	Davuluri
Sabre (SABR)	★★★★	$26	$20.73	Medium	Narrow	0.80	5.69	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$119.04	Medium	Wide	0.82	87.25	Nelson
Synaptics (SYNA)	★★★★	$64	$44.61	Very High	None	0.70	1.54	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9280	High	None	0.81	1171.13	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 405.8	High	Wide	0.63	3856.40	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.26	Medium	Narrow	0.85	3.77	Atkins
Dominion Energy (D)	★★★★	$84	$67.34	Low	Wide	0.80	43.94	Fishman
FirstEnergy (FE)	★★★★	$40	$34.35	Low	Narrow	0.86	16.38	Fishman
Gas Natural SDG (GAS)	★★★	EUR 21	EUR 19.67	Medium	Narrow	0.94	19.67	Fulop
SCANA (SCG)	★★★★★	$60	$38.69	Medium	Narrow	0.64	5.52	Miller

Source: Morningstar. As of April 6, 2018

Highlighted Stocks

Rush Enterprises RUSHA

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Consumer	Stable	USD	46	38.64	High	None	0.84	1.6

Source: Morningstar. As of April 6, 2018

While we fail to award a moat rating to Rush, we believe it can leverage its leading position to gain market share over time within its heavily fragmented market.

Analyst Note, April 3, 2018
We are initiating coverage of Rush Enterprises at a fair value estimate of $46 per share and a none/stable moat rating. Over several decades management has amassed a 100-dealership empire across the U.S. in an integrated format that sells, leases, and services trucks; the company's wide geographic coverage, number of dealerships, and array of services has positioned the company to sell to a wider variety of customers than its peers. In fact, today, Rush sells around 5% of U.S. Class 4-8 trucks, bestowing upon it the title of largest commercial vehicle dealership in North America.

While we fail to award a moat rating to Rush, we believe it can leverage its leading position to gain market share over time within its heavily fragmented market. Additionally, relative to other heavy equipment dealers, we believe that Rush benefits from carrying a more diversified manufacturer product portfolio as brand reputations can change with the evolution of vehicle standards and technology. In our opinion, the OEM's sizeable R&D budgets, create long-term growth opportunities for Rush: greater advancements in engine and drive train technologies will serve as an additional catalyst for customers to patronize Rush's integrated parts and service centers that span the United States.

In terms of valuation, we believe that future revenue growth for Rush Enterprises will be achieved by a combination of market share gains as well as new truck equipment and parts & service opportunities. Historically, there has been a high correlation between new product sales in the commercial vehicle market and the rate of change in U.S. industrial production and the U.S. gross domestic product. In our view, the U.S. will witness robust industrial production and gross domestic product over the next couple years thanks to a combination of tax reform and synchronized global economic growth. We believe this outlook will translate into a 5-year revenue CAGR of 7.0% and midcycle operating margins of 4.3%.

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Lennar LEN

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	75	61.56	High	None	0.82	20.59

Source: Morningstar. As of April 6, 2018

We echo management's view that an improving economy, increased customer confidence, and strong demand from entry-level buyers are more than offsetting any pressure higher mortgage rates might have on demand.

Analyst Note, April 4, 2018

Lennar shares surged over 10% on April 4 after the no-moat homebuilder reported strong first-quarter results that showed no signs of slowing demand amid rising interest rates. While consolidated first-quarter revenue of $2.98 billion slightly missed the $3.05 billion consensus estimate, adjusted EPS of $1.11 handily beat the $0.82 consensus estimate. Lennar recently completed its strategic acquisition of fellow public homebuilder CalAtlantic, and management shared detailed full-year guidance for the combined entity. We expect to increase our fair value estimate by up to 5% after incorporating the company's new guidance given that our homebuilding revenue and deal-related synergy realization assumptions over the next few years now seem overly conservative.

Strong demand for Lennar's homes continued during the firm's fiscal first quarter despite the 30-year average fixed mortgage rate recently reaching the highest level since 2013. Excluding the addition of CalAtlantic, which could otherwise mask the underlying performance of legacy Lennar, order volume for new homes during the first quarter grew about 14% year over year, and the average selling price of these orders grew almost 3%. We echo management's view that an improving economy, increased customer confidence, and strong demand from entry-level buyers are more than offsetting any pressure higher mortgage rates might have on demand.

The CalAtlantic integration appears to be progressing well, and Lennar continues to target at least $100 million and $365 million of deal-related synergies in fiscal 2018 and 2019, respectively. Management provided an in-depth view of its synergy realization plan during the earnings call. The plan appears well vetted, and the level of detail provided increased our confidence in management's ability to achieve its stated synergy targets. However, up to $175 million of acquisition and integration-related costs will net against cost savings in 2018.

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Eldorado Gold EGO

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Basic Materials	Stable	USD	2	0.98	Extreme	None	0.49	0.73

Source: Morningstar. As of April 6, 2018

Although we view the arbitration ruling as a positive, it joins a long list of favorable rulings that Eldorado had already received from Greek courts in support of its legal position.

Analyst Note, April 4, 2018
On April 4, Eldorado Gold announced the results of arbitration regarding its Greek development projects. As we had long anticipated, the arbitration panel ruled in Eldorado's favor, agreeing that the company's technical study, specifically the metallurgy plant for treating concentrates from Olympias and Skouries, was not in violation of the terms set forth during the acquisition of the Greek assets. Due to the favorable ruling, share prices have risen about 12% over the last two days, as we write. Regardless, an even larger move would have been warranted if investors bought into the notion that this announcement would definitively lead to mine openings.

We're maintaining our assumption of a 50% probability that the Greek projects open. Thus, our fair value estimates of $2 per share and CAD 2.50 per share are unchanged. We're also maintaining Eldorado's no-moat rating and extreme uncertainty rating.

Although we view the arbitration ruling as a positive, it joins a long list of favorable rulings that Eldorado had already received from Greek courts in support of its legal position. Yet, these rulings haven't stopped the Greek government from dragging its feet on timely permit issuance. It remains unclear if this favorable arbitration ruling will be of any help in advancing discussions with the Greek government and lead to the actual opening of the development projects.

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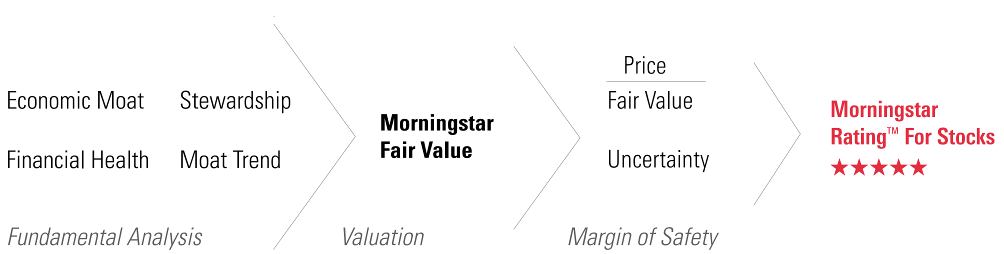
Research Methodology for Valuing Companies

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.

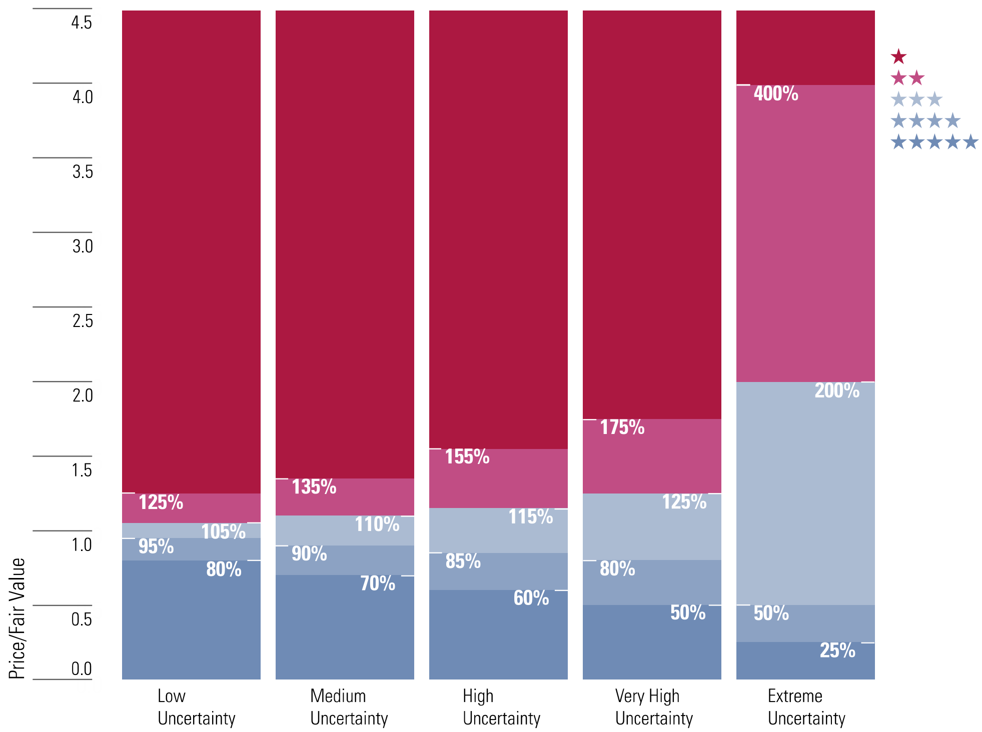
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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