Research Highlights

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

Morningstar Equity Research
March 19-23, 2018

Contents

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

We'd Drop the Idea of Buying Into Dropbox's IPO

Dropbox, a Silicon Valley "decacorn" valued at $10 billion during its most recent raise in 2014, is listing on the Nasdaq with the intent of raising around $684 million. At Dropbox's latest IPO price range of $18-$20 per share (up from the original $16-$18), we don't see an attractive margin of safety in Dropbox's shares and arrive at a $14 fair value estimate. We would sit out this IPO if the stock price were to take off any further after launch.

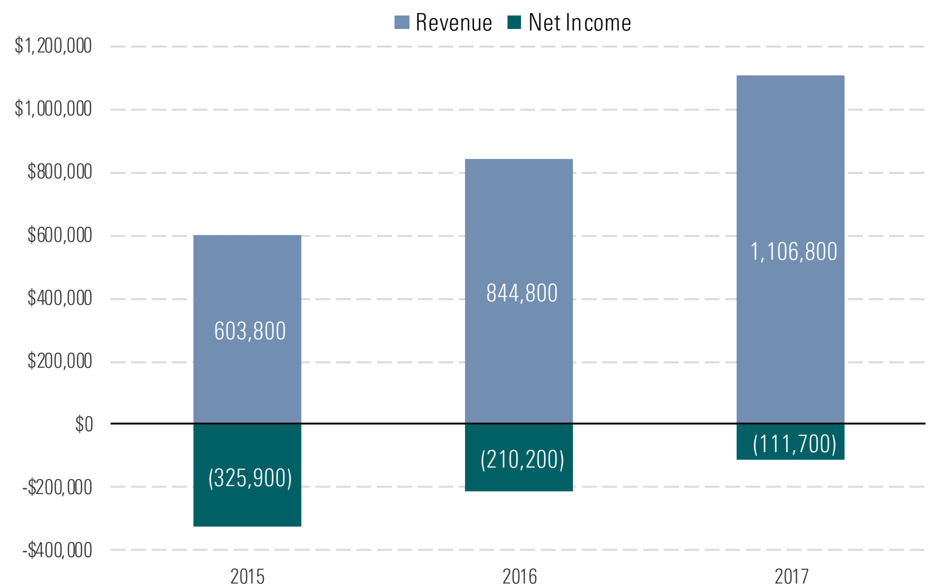
In our view, Dropbox's products benefited from a first-mover advantage when the firm was founded in 2007, offering cutting-edge technology, and experienced hyperbolic growth from a freemium business model. Since its inception, however, the competitive landscape has been characterized by wide- and narrow-moat rivals entering the market, relatively muted free-to-paid subscription metrics for Dropbox's user base, and the absence of a sizable foothold in the enterprise market. Elephantine competitors such as Google, Microsoft, Amazon, and Apple have essentially commoditized Dropbox's core business over the past decade. Thus, we do not believe Dropbox has entrenched itself with an economic moat, and we see no evidence of pricing power.

Dropbox's recent moves, coupled with language in the S-1, signals it wants to be a collaboration rather than a storage company. Furthermore, the business is gearing up to more aggressively target the enterprise market. However, current conversion rates are subscale, with only 2% of Dropbox's total users paying for a current product. As 90% of sales are through self-service channels, this implies that selling, general, and administrative costs will need to scale as Dropbox targets enterprises, and we are skeptical of its ability to compete with companies like Microsoft that have a long history of creating enterprise software products. While Dropbox's IPO price would suggest a market cap of between $7.88 billion and $8.75 billion, we think this valuation inadequately accounts for increased competition in consumer and enterprise cloud storage, slowing growth, and an undifferentiated offering.

- We believe Dropbox's competitive headwinds, characterized by large rivals with similar or better offerings, are commensurate with our no-moat, negative trend rating, along with our $14 fair value estimate, below the firm's reported IPO price of $18-$20 (originally $16-$18).
- Narrow- and wide-moat competitors such as Google, Microsoft, Amazon, and Apple offer comparable products, frequently bundling storage with other offerings, such as Office 360 in Microsoft's case. Dropbox cannot compete on price, and while Dropbox has integrated proprietary collaboration tools, we believe the company will likely be swimming upstream against these larger rivals.

- The firm's user base is largely consumer-based, and we believe the shift to the more lucrative enterprise market will be marred by precipitous headwinds, such as Dropbox's subscale enterprise-grade offerings and the increased cost of customer acquisition.
- We see some gives and takes associated with Dropbox's move from Amazon Web Services, or AWS, to proprietary infrastructure, as well as its recent integrations or partnerships with Google and Salesforce. On the upside, moving to a fixed-cost model may lead to gross margin accretion as Dropbox's revenue expands. But on the flip side, the firm may be exposed to downside risks if it cannot increase revenue enough to cover the high fixed costs associated with its in-house data centers.

Exhibit 1 Dropbox's Historical Financials



Source: Dropbox S-1

Bulls Say

- Dropbox has reached over $1 billion in revenue and has a large monetizable free user base.
- Dropbox outpaces Box and has moved off of AWS, decreasing reliance on competitors.
- Dropbox integrates with Microsoft, Google, Salesforce, and Slack, creating an open ecosystem product with many of its competitors.

Bears Say

- Consumer-oriented Dropbox has limited exposure to enterprise clients, which has limited sales and marketing costs thus far. We expect these to scale as it more actively targets business clients.
- The firm's move off of AWS will lead to capital expenditures and operating lease expenses.
- Dropbox has yet to demonstrate that it can create an ecosystem of products with an enticing value proposition that can compete with Microsoft Office or Google Docs, Sheets, and Slides.

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Facebook Stock Falls After Controversy

The recent news surrounding the security of Facebook users' personal data has dragged the stock down 14% as of March 23. The controversy may further justify Europe's General Data Protection Regulation campaign, the enforcement of which will begin in May, and increase the probability of similar demands in the U.S. A congressional committee has asked CEO Mark Zuckerberg to testify about the scandal, but a date has not been set.

Though we've accounted for such risk, to a certain extent, in our model, which has much lower than consensus projections over the next five years, the news is concerning, and we continue to analyze possible impacts from it on our valuation of Facebook and its peers.

In the meantime, we are maintaining our $198 per share fair value estimate for this wide-moat name, and with the pullback, shares are now slightly undervalued.

The scandal has reignited the discussion and fear about the safety of private user data and how that data can be used by various groups, organizations, or companies. This specific issue began to unfold after reports that Cambridge Analytica (a London-based data-mining and analytics firm providing strategic consulting for various political campaigns, including Brexit in the U.K. and Donald Trump's run for president of the U.S.), gained access to the data of approximately 50 million Facebook users, which it may have used to target voters during the 2014 U.S. midterm elections and the U.S. presidential election in 2016.

According to Facebook, Cambridge Analytica got its hands on user data by working with Aleksandr Kogan, a psychology professor at the University of Cambridge. Facebook had given him permission to operate an app for psychology-related research on the platform. However, Facebook claims that Kogan then violated the agreement and passed on the data gathered to Cambridge Analytica. Facebook has suspended Cambridge Analytica from the platform.

While steps have been taken to limit access to personal data via the Internet in Europe with the launch of GDPR, given the recent news about Facebook and Cambridge Analytica, similar regulatory steps may spill into the U.S., which historically has addressed privacy issues only when it is needed. The Cambridge Analytica controversy could be a clear indication that further regulatory steps must be taken in the U.S. to ensure consumer consent and to increase the safety and transparency of data usage, which may increase risks for firms such as Facebook and social media peers Snap and Twitter.

In our view, the amount of data collected by these firms may decline when forced to seek user consent. With data, or the intangible asset, growing at a lower rate, ROIs on the ad inventories sold by Facebook and other online ad firms could be negatively affected. If so, ad prices could decline, which may also decelerate growth of average revenue generated per user, which has been growing impressively, especially for Facebook.

In addition, we think that as user doubts increase about the overall security of private data, the probability of less time spent on the social network platform and of higher user churn can go up, possibly affecting the heterogeneous network effect moat source. However, with over 2 billion users worldwide, Facebook's network effect moat source and our wide rating on it is not at risk. Further, Facebook is taking steps to maintain users on its network, including limiting ads sold on its news feed, prioritizing user-generated content on the platform, and, as announced early on March 19, making it a bit easier for content creators to publish and promote on Facebook. We think these moves, along with further enhancements of data security, will help Facebook maintain its network effect moat source.

As mentioned earlier, with the 14% decline in Facebook's stock this week, shares are now slightly undervalued. The drop in Facebook shares also dragged down Snap 4% and Twitter 13%. Snap is now trading near our $16 per share fair value estimate, while Twitter remains significantly above our $24 valuation. We recommend patience for further pullback before investing in either of these two names.

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Smaller Business Equals Bigger Value for AkzoNobel

With AkzoNobel's specialty chemicals business on track to be sold or spun out in April, we move to a sum-of-the-parts valuation and increase our fair value estimate by nearly 30% to EUR 82. We think it's a great time to sell and accordingly value the division at EUR 8.5 billion, equivalent to 9 times trailing EBITDA, a handsome price for what we view as primarily a commodity chemicals operation at peak margins. Despite our optimism, we can't quite catch up to the consensus view, which we think is around EUR 9 billion-EUR 10 billion. Our fair value estimate increase is also supported by our more optimistic view on the residual paints and coatings business.

With a credible plan, 100% management focus, and intense pressure from activist investors, we think cost-cutting can increase AkzoNobel's EBIT margin by 270 basis points to 13.3% in 2020. This falls well below the company's target of 15%. Akzo has increased margins 220 basis points over the past three years; however, our analysis finds only modest evidence of outperformance versus peers. Consequently, we attribute most of the historical 220-basis-point improvement to raw material tailwinds, which have now reversed. As the 15% target calls for a 440-basis-point increase over the next three years in an inflationary environment, we find this hurdle too ambitious, and believe the market shares our skepticism.

- We increase our fair value estimate to EUR 82 from EUR 64 after moving to a sum-of-the-parts valuation, which puts the stock in fairly valued territory.
- We don't think the specialty chemicals business is "special" enough to justify the consensus valuation, due to the prevalence of commodity products. Nor do we see much potential for a strategic buyer to extract synergies. We value the business at EUR 8.5 billion, or 9 times trailing EBITDA.
- We expect the business to be sold in April to a private equity buyer, although a spin-out or IPO remain on the table if bids are unsatisfactory.
- We expect the residual paints and coatings business to increase its EBIT margin to 13.3% in 2020 from 10.6% in 2017, owing primarily to the new cost-cutting program. However, our expectations are well below AkzoNobel's 15% target, as we think the improvement expected is too demanding given the current inflationary environment, short timeline, and lack of clear margin outperformance versus peers historically.

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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	$9.09	High	Narrow	0.53	3.62	Inton
Compass Minerals International (CMP)	★★★★	$82	$60.3	High	Wide	0.74	2.04	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 218.85	High	Narrow	0.59	21.71	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 70.8	Medium	Narrow	0.69	1449.66	Baker
Telefonica (TEF)	★★★★	$13	$7.78	High	Narrow	0.60	40.43	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.22	Medium	Narrow	0.70	38.30	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$159	$111.71	Medium	Narrow	0.70	8.26	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.62	Medium	Narrow	0.80	1.57	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 85.33	High	Narrow	0.78	55.47	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 41.17	Medium	Narrow	0.78	3.61	Faul
General Motors (GM)	★★★★	$56	$36.35	High	None	0.65	50.91	Whiston
Great Wall Motor (2333)	★★★★★	HKD 14.9	HKD 8.48	High	None	0.57	115.44	Hu
Hanesbrands (HBI)	★★★★★	$29	$18.59	Medium	Narrow	0.64	6.70	Weishaar
Mattel (MAT)	★★★★	$21.5	$12.9	High	Narrow	0.60	4.44	Katz
TripAdvisor (TRIP)	★★★★	$55	$40.11	High	Narrow	0.73	5.57	Wasiolek
Walt Disney (DIS)	★★★★	$130	$100.6	Medium	Wide	0.77	151.27	Macker
Williams-Sonoma (WSM)	★★★★	$68	$50.75	Medium	Narrow	0.75	4.25	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1098	Medium	Narrow	0.73	13.90	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★★	$59	$44.45	Low	Wide	0.75	25.34	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2360	Low	Wide	0.61	22.51	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7274	Low	Wide	0.83	3519.61	Wei
Mondelez International (MDLZ)	★★★★	$51	$41.05	Medium	Wide	0.80	61.05	Lash
Procter & Gamble (PG)	★★★★	$98	$76.41	Low	Wide	0.78	192.63	Lash
Reckitt Benckiser Group (RB.)	★★★★★	GBX 7400	GBX 5895	Low	Wide	0.80	41.51	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$10.88	Very High	None	0.52	13.37	Gemino
Enbridge (ENB)	★★★★★	$62	$39.6	Medium	Wide	0.64	67.13	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$76	$63.85	Low	None	0.84	261.21	Good
RSP Permian (RSPP)	★★★★	$55	$38.55	High	None	0.70	6.15	Meats
Total (TOT)	★★★★	$70	$56.58	Medium	None	0.81	149.32	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$54.81	Medium	None	0.72	49.46	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.6	Very High	None	0.88	24.36	Heathfield
Capital One Financial (COF)	★★★★	$120	$94.65	Medium	Narrow	0.79	46.02	Plunkett
Invesco (IVZ)	★★★★	$42	$31.45	Medium	Narrow	0.75	12.80	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 685.6	Medium	None	0.78	9024.44	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.79	High	Narrow	0.75	13.31	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 28.85	Medium	Wide	0.82	97.69	Ellis

Source: Morningstar. As of March 23, 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	$162.58	Medium	Wide	0.62	53.26	Waterhouse
Express Scripts Holding (ESRX)	★★★★	$92	$70.47	Medium	Wide	0.77	39.55	Lekraj
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.94	Medium	Narrow	0.81	3.37	Kallos
McKesson (MCK)	★★★★	$210	$141.69	Medium	Wide	0.67	29.24	Lekraj
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 62.18	Medium	Narrow	0.76	12.57	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 216	Low	Wide	0.67	184.78	Andersen
Shire (SHP)	★★★★★	GBX 4890	GBX 2996	Medium	Narrow	0.61	27.29	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$75.6	Medium	Narrow	0.71	2.52	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 41.4	Medium	Narrow	0.71	52.25	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.73	Medium	Wide	0.87	15.48	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 124	HKD 94.8	Medium	None	0.76	365.71	Tan
Fluor (FLR)	★★★★	$69	$55.9	High	Narrow	0.81	7.82	Silver
G4S (GFS)	★★★★	GBX 337	GBX 238.4	Medium	None	0.71	3.70	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 35.16	Medium	Wide	0.75	6.39	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP B)	★★★★	MXN 225	MXN 189.08	High	Wide	0.84	106.07	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.75	High	None	0.70	40.61	Song
Johnson Controls International (JCI)	★★★★	$53	$35.5	High	Narrow	0.67	32.88	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 72.16	Medium	Narrow	0.84	8.51	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 32	Medium	Narrow	0.80	29.64	Vonk
Stericycle (SRCL)	★★★★	$99	$59.41	Very High	Wide	0.60	5.08	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.64	Medium	None	0.85	1.53	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 127.1	Medium	Narrow	0.83	368.21	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$67.16	Medium	None	0.80	12.76	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$100	$82.99	Medium	Wide	0.83	6.63	Nelson
KLA-Tencor (KLAC)	★★★	$125	$112.92	High	Wide	0.90	17.60	Davuluri
LM Ericsson Telephone (ERIC B)	★★★	SEK 61	SEK 53.72	Very High	None	NA	176.32	Colello
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.05	Medium	Narrow	0.75	1.84	James
Qualcomm (QCOM)	★★★★	$75	$55.58	High	Narrow	0.74	82.28	Davuluri
Sabre (SABR)	★★★★	$26	$21.63	Medium	Narrow	0.83	5.94	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$118.04	Medium	Wide	0.81	86.45	Nelson
Synaptics (SYNA)	★★★★	$64	$46.09	Very High	None	0.72	1.59	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9370	High	None	0.81	1182.49	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 420	High	Wide	0.66	3989.42	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.2	Medium	Narrow	0.84	3.72	Atkins
Dominion Energy (D)	★★★★	$84	$67.87	Low	Wide	0.81	44.22	Fishman
FirstEnergy (FE)	★★★★	$40	$34.45	Low	Narrow	0.86	16.38	Fishman
Gas Natural SDG (GAS)	★★★★	EUR 21	EUR 18.7	Medium	Narrow	0.89	18.70	Fulop
SCANA (SCG)	★★★★★	$60	$37.74	Medium	Narrow	0.63	5.38	Miller

Source: Morningstar. As of March 23, 2018

Highlighted Stocks

Murata Manufacturing 6981:JP

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Technology	Stable	JPY	20,000	14,060	High	Narrow	0.70	2,991

Source: Morningstar. As of March 23, 2018

The recent decline on Murata's stock is pricing in the uncertainty of the future economy, including a possible trade war and further risk that the Japanese yen might appreciate.

Analyst Note, March 23, 2018
We are raising our fair value estimate for Murata Manufacturing to JPY 20,000 from JPY 16,800, as we are more confident that 1) growth of multilayer ceramic capacitors, or MLCCs, will exceed our previous view, driven by the increasing power consumption of handsets and digitalization of auto; 2) demand for SAW filters in China will recover after the inventory adjustment; and 3) Murata will reignite its RF module business by leveraging its advantage on product lineups.

We view Murata's economic moat as intact, which stems from the close relationship with handset manufacturers. Thus, we believe Murata's RF components and module business will come back on track, and as a result, the recovery on operating margin will be much faster than the market's expectation. Our foreign exchange assumption underpinning our earnings forecast and fair value estimate is JPY 110/USD 1 at this point, and we estimate that JPY 1 appreciation per U.S. dollar will lower 2019 operating income by 1.2%, while decreasing our fair value estimate by approximately 1%.

The recent decline on Murata's stock is pricing in the uncertainty of the future economy, including a possible trade war and further risk that the Japanese yen might appreciate, in our view. However, we still see room for re-evaluation of Murata's shares in the medium term, even in an environment with a JPY 100/USD 1 exchange rate.

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Salesforce.com CRM

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Technology	Positive	USD	145	114.49	Medium	Wide	0.79	86.45

Source: Morningstar. As of March 23, 2018

Shares are trading at a 16% discount to our fair value estimate and continue to represent one of the best investment opportunities in software.

Analyst Note, March 20, 2018
Salesforce.com announced on March 20 that it has reached a definitive agreement to purchase integration platform-as-a-service provider MuleSoft. The $6.5 billion deal (depending on the price of Salesforce stock at the time of closing) will be financed with roughly 80% cash and 20% Salesforce stock, making this Salesforce's largest acquisition to date. Salesforce plans to finance the cash portion of the deal using a combination of the firm's $4.5 billion cash and investments war chest and $3 billion in term loans and senior notes. Although the purchase price looks steep, we think Salesforce can achieve significant revenue synergies given the 60% overlap with MuleSoft's largely enterprise customer base (which totals more than 1,200 customers). Further, we believe Salesforce can accelerate Mulesoft's growth trajectory with its expansive sales organization and partner ecosystem. The deal is slated to close in the second quarter, and we expect it to pass regulatory muster without incident. We are maintaining our wide moat rating for Salesforce, and our $145 fair value estimate is unchanged, as we believe Salesforce will successfully integrate the company and generate revenue synergies that will offset the acquisition cost in the long run. Shares are trading at a 16% discount to our fair value estimate and continue to represent one of the best investment opportunities in software, in our view.

Founded in 2006, MuleSoft provides enterprises with tools to link various applications, devices and data sets together, making technology ecosystems more cohesive and data more accessible to enable greater efficiency across the organization. The company leverages its own internal development team, the open-source community, and its channel partners to provide customers with templates and APIs to interconnect technology resources, while also providing lifecycle management tools for those APIs under the Anypoint Platform moniker. The firm hosts its platform on Amazon Web Services, though its offerings can be deployed in myriad environments both in the cloud and on-premises. MuleSoft competes with a bevy of other big-name providers, including Microsoft, Oracle, and SAP, but the company's offering is among the most robust on the market, scoring behind only Dell Boomi and Informatica in Gartner's latest Magic Quadrant for Enterprise Integration Platform as a Service. The firm counts Coca-Cola, AT&T, Accenture, McDonald's, and Salesforce among its customer base. We do not cover MuleSoft directly, but the firm produced nearly $300 million in total revenue in fiscal 2017, and management expects the firm to reach $410 million in total sales in fiscal 2018, while consensus estimates show the firm achieving positive free cash flow this fiscal year as well.

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Dominion Energy D

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Utilities	Stable	USD	84	67.34	Low	Wide	0.80	44.22

Source: Morningstar. As of March 23, 2018

Dominion Midstream Partners' unit price fell almost 9% in the two days after the Federal Energy Regulatory Commission tax allowance policy change, due in large part to potential impact on the Carolina Gas, Questar, and Iroquois pipelines with mostly cost-of-service rates.

Analyst Note, March 19, 2018
Regulators and legislators have recently been tougher than expected on Dominion Energy, resulting in us lowering our fair value estimate to $84 per share from $87. In Virginia, modest negative developments included lower rate riders and new utility legislation. Then on March 15, federal regulators revised it ratemaking policy for master limited partnerships that could result in lower gas pipeline tariffs.

Virginia Electric Power Co. rate riders that will go into effect on April 1 remain attractive, but not as good as they used to be. The base ROE for the riders is 9.2%, down from last year’s 9.6%. Vepco's recently completed or modified power plants will continue to receive a minimum 100-basis-point incentive, bringing the new rate rider ROE to at least 10.2%. This remains well above most other U.S. utilities' rates.

On March 9, Virginia Gov. Ralph Northam signed new utility legislation that reboots the earnings review process in 2021. Strong growth in Vepco’s service territory, driven in large part by new data centers and automatic rate riders, provided 10% adjusted EBIT growth in 2016 and 5.4% growth last year despite mild weather. We expected earnings growth to remain in the high single digits with the review suspension, topping most U.S. utilities' growth rates. We now expect a more pedestrian 5% annual growth rate.

Dominion Midstream Partners' unit price fell almost 9% in the two days after the Federal Energy Regulatory Commission tax allowance policy change, due in large part to potential impact on the Carolina Gas, Questar, and Iroquois pipelines with mostly cost-of-service rates. Rates at the Cove Point LNG facility are FERC-regulated but aren't subject to the policy revision. However, we expected Cove Point drop-downs to start midyear financed in part by the issuance of new DMP units. The drop in DMP's unit price and potential for lower cash flow reduces its usefulness as a financing vehicle.

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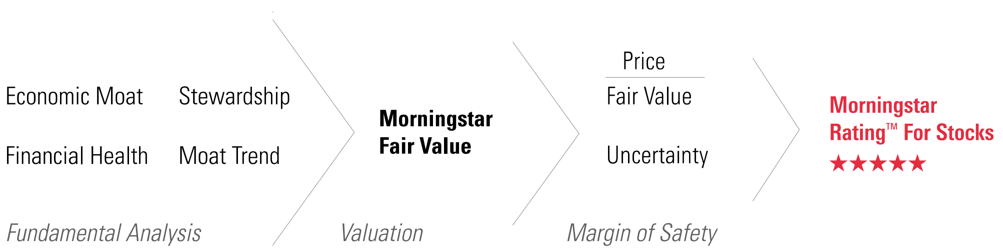
Research Methodology for Valuing Companies

Overview

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

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

Morningstar Research Methodology



Source: Morningstar.

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

Economic Moat

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

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

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

Estimated Fair Value

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

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

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

Stage II: Fade

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

Stage III: Perpetuity

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

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

Uncertainty Around That Fair Value Estimate

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

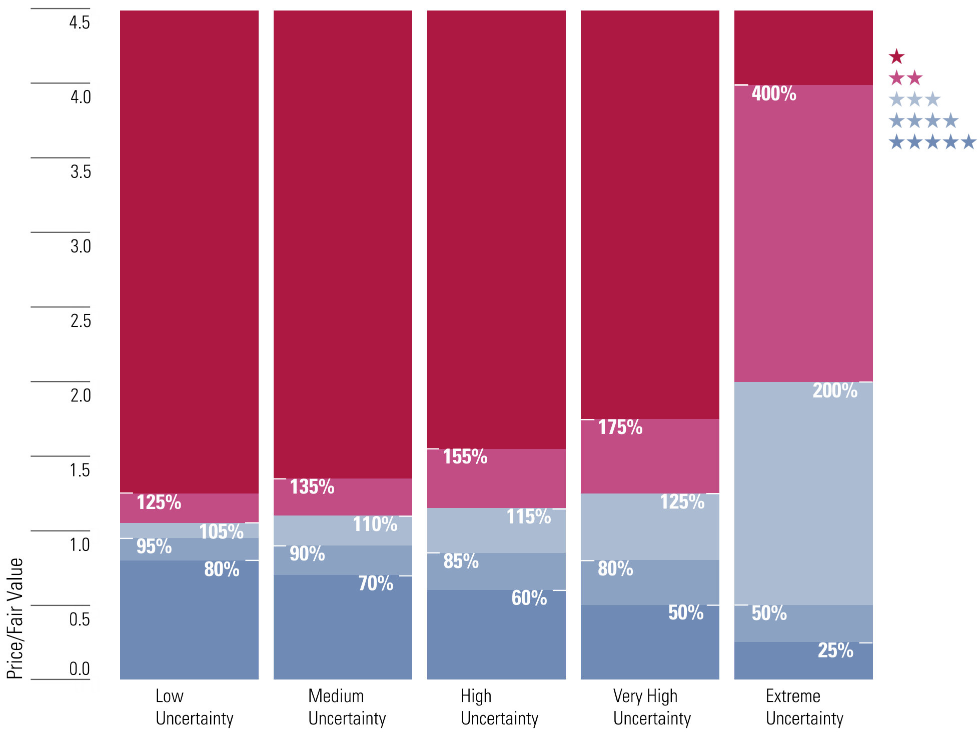
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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

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

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

Morningstar Equity Research Star Rating Methodology



Market Price

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

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

Morningstar Star Rating for Stocks

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

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

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

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

The Morningstar Star Ratings for stocks are defined below:

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

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

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

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

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

Risk Warning

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

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