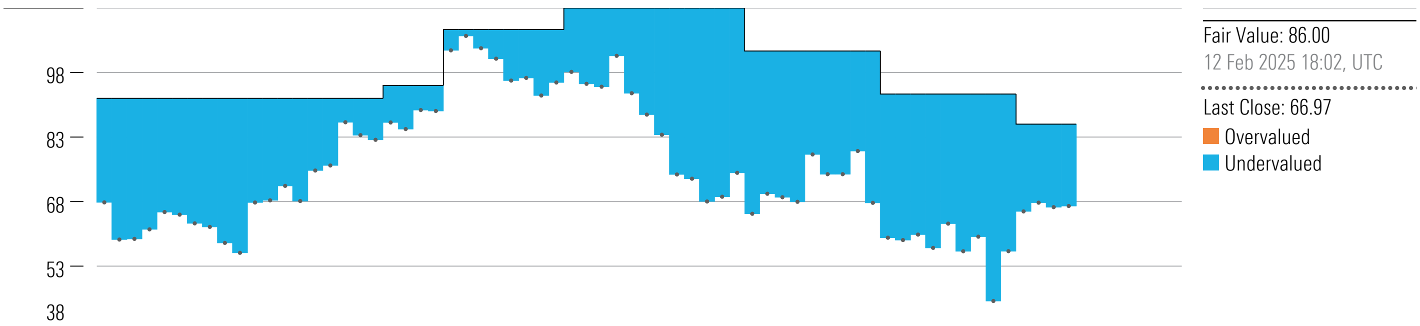
Morningstar Equity Analyst Report | Report as of 12 May 2025 17:05, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC.

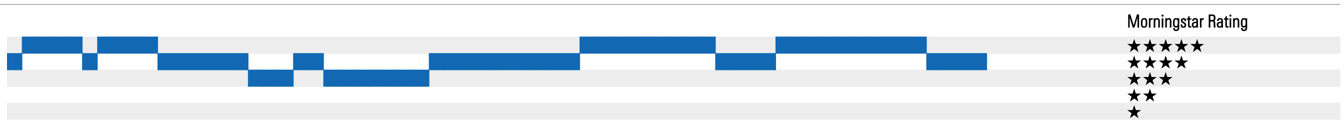
CVS Health Corp CVS ★★★★ 9 May 2025 21:22, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
66.97 USD 9 May 2025	86.00 USD 12 Feb 2025 18:02, UTC	0.78	80.53 USD Bil 12 May 2025	None	Large Value	High	Standard	7 May 2025 05:00, UTC

Price vs. Fair Value



	2020	2021	2022	2023	2024	YTD	
	0.74	0.96	0.82	0.77	0.48	0.78	Price/Fair Value
	-5.37	53.97	-7.53	-12.67	-39.78	52.15	Total Return %



Total Return % as of 09 May 2025. Last Close as of 09 May 2025. Fair Value as of 12 Feb 2025 18:02, UTC.

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The primary analyst covering this company does not own its stock.

[1]The ESG Risk Rating Assessment is a representation of Sustainalytics' ESG Risk Rating.

Healthcare Services: Medicaid and PBMs Still Under Fire in Updated Regulatory Moves

Analyst Note Julie Utterback, CFA, Senior Equity Analyst, 12 May 2025

On May 11 and 12, Republicans revealed updated regulatory stances that included plans to lower drug prices and pull back on Medicaid spending by about $715 billion over the next 10 years versus $880 billion expected previously.

Why it matters: In early trading, top-tier Medicaid insurer Elevance and healthcare service providers like HCA and Tenet rose in the low single digits, as the potential Medicaid changes look better than feared. However, PBM-focused firms, like Cigna and CVS, fell on the drug pricing efforts.

- On May 11, Republican House members revealed a proposed bill that looks likely to cut Medicaid spending less than the initial goal, which may moderately buoy the profits of Medicaid-reliant service providers and managed care organizations.
- On May 12, President Donald Trump signed an order to lower US drug prices, which could eliminate a key function that PBMs provide to clients, as the government looks likely to undertake drug price negotiations or set prices to lower, most-favored-nation levels.

The bottom line: We are keeping our fair value estimates intact for now, as Congress still needs to vote on Medicaid cuts, which are controversial even in Republican districts. Also, few details are known about how drug pricing negotiations would actually work, including how broadly they could reach.

- If Medicaid legislation passes as the House proposes, we would see the most risk at no-moat

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Sector	Industry
Healthcare	Healthcare Plans

Business Description

CVS Health offers a diverse set of healthcare services. Its roots are in its retail pharmacy operations, where it operates over 9,000 stores primarily in the US. CVS is also a large pharmacy benefit manager (acquired through Caremark), processing about 2 billion adjusted claims annually. It also operates a top-tier health insurer (acquired through Aetna) where it serves about 27 million medical members. The company's recent acquisition of Oak Street adds primary care services to the mix, which could have significant synergies with all existing business lines.

Centene, a Medicaid and individual exchange plan provider that faces a high-single-digit fair value cut under this bill plus the potential expiration of individual exchange subsidies.

- Narrow-moat Cigna faces the most downside risk if the US government starts negotiating drug prices, which is currently a key PBM function. It remains to be seen how broadly this order could reach beyond government programs, though, and service bundling may protect PBMs somewhat.

Business Strategy & Outlook Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

CVS aims to be the most customer-centric health company in the United States and has spent over a decade positioning itself as a managed care leader, with the acquisitions of pharmacy benefit manager Caremark (2007), insurance provider Aetna (2018), and healthcare service provider Oak Street (2023) defining its strategic direction. CVS' top-tier retail pharmacy, health insurer, and PBM franchises create the potential to improve health outcomes and even bend the healthcare cost curve for its clients, especially if it can align incentives by owning healthcare service providers, as well.

However, CVS has not lived up to that potential in the past, and with a new management team coming on board, the firm is trying to turnaround its lackluster results, particularly in medical insurance. With regulatory limits on how far Medicare Advantage margins can expand annually, though, CVS' turnaround story may take many years. Also, uncertainty continues to surround its retail store footprint. The company had previously aimed to boost the efficiency of those operations by adding more services to its existing stores. However, its addition of primary-care assets has not been fully integrated into its expansive retail pharmacy footprint yet, and it remains to be seen if the firm will invest in retro-fitting those stores eventually or pursue another strategy.

Overall, despite the recent management shakeup, CVS appears committed to its diverse business strategy. While we continue to see potential in this strategy in the long term, investors will at least be looking for management to meet the goals it sets for itself, which would be a nice change of pace from the previous team. Notably as well, the long-term goals under the previous management team appeared significantly lower than its managed care peers, and we suspect investors may have to accept lower growth prospects out of CVS than its key MCO peers in the long run because of the challenges it faces in its retail business.

Bulls Say Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

- CVS' diverse operations create the opportunity to view a patient more holistically by managing both medical and pharmacy benefits, which could lead to revenue and cost synergies for the organization.
- The firm's entry into provider services has the potential to improve returns for all of CVS' segments if it can help patients more easily and cost-effectively manage chronic conditions through early intervention.
- CVS' PBM remains an industry leader due to its intense focus on pharmaceutical cost trends that should continue to attract clients.

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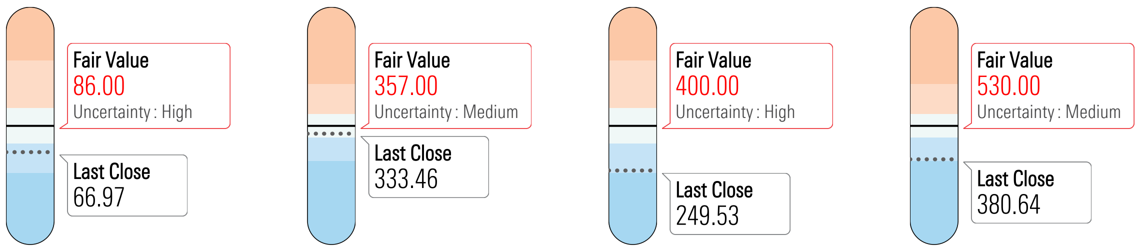
Competitors



	CVS Health Corp CVS	The Cigna Group CI	Humana Inc HUM	UnitedHealth Group Inc UNH
Economic Moat	None	Narrow	Narrow	Narrow
Currency	USD	USD	USD	USD
Fair Value	86.00 12 Feb 2025 18:02, UTC	357.00 30 Jan 2025 16:41, UTC	400.00 11 Feb 2025 18:30, UTC	530.00 17 Apr 2025 15:09, UTC
1-Star Price	133.30	481.95	620.00	715.50
5-Star Price	51.60	249.90	240.00	371.00
Assessment	Undervalued 9 May 2025	Fairly Valued 9 May 2025	Undervalued 9 May 2025	Undervalued 9 May 2025
Morningstar Rating	★★★★9 May 2025 21:22, UTC	★★★9 May 2025 21:20, UTC	★★★★9 May 2025 21:20, UTC	★★★★9 May 2025 21:22, UTC
Analyst	Julie Utterback, Senior Equity Analyst	Julie Utterback, Senior Equity Analyst	Julie Utterback, Senior Equity Analyst	Julie Utterback, Senior Equity Analyst
Capital Allocation	Standard	Standard	Standard	Exemplary
Price/Fair Value	0.78	0.93	0.62	0.72
Price/Sales	0.22	0.37	0.25	0.86
Price/Book	1.10	2.24	1.70	3.64
Price/Earning	14.41	12.08	17.61	15.24
Dividend Yield	3.97%	1.71%	1.42%	2.21%
Market Cap	84.72 Bil	89.08 Bil	30.12 Bil	345.29 Bil
52-Week Range	43.56—72.51	262.03—370.83	213.31—406.46	378.54—630.73
Investment Style	Large Value	Large Value	Mid Value	Large Value

Bears Say Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

- Healthcare reform will likely remain a recurring political topic until universal, affordable coverage is achieved in the US, and CVS' stock may experience volatility if scenarios that threaten its prospects gain traction.
- Foot traffic at physical retail stores could continue to decline as consumers increasingly favor online retailers, like Amazon, creating the need to reinvent its retail store footprint's operations.
- CVS' long-term profit growth prospects appear lower than its managed care peers primarily due to the challenges it faces in its retail operations.

Economic Moat Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

Historically, CVS has operated on the edge of the narrow and no moat spectrum, and we are now lowering our moat rating on CVS to none from narrow after the firm's medical insurance business fell to a large operating loss in 2024 that may take many years to resolve from an economic profitability perspective. In our base-case scenario, we estimate CVS may not reach durable economic profitability until 2029. Also, even if it returns to economic profitability, the margin of safety on those economic profits looks likely to remain slim and could be competed or even acquired away, given the tough end markets that CVS operates in and CVS' penchant for transformational acquisitions. For example, the retail store business remains a melting ice cube that will continue to pressure the overall organization, and there are no guarantees that that business will improve or even remain in its current state of mid-single-digit operating profit declines. Also, recent acquisitions—Aetna in 2018 and Oak Street plus Signify in 2023—still create hurdles to its economic profitability due to an inflated invested capital base. So, while we continue to recognize that this top-tier medical insurer, pharmacy benefit manager, and pharmacy retailer may be able to generate economic profits eventually, the margin of safety around CVS' ability generate economic profits through year 10 of our explicit forecast period appears too low to pass the "more likely than not" test that we require to award a narrow economic moat. We think it is just too much of a coin flip at this point.

Medical Insurance: CVS Moat Damaged by Poor Underwriting in Surging Utilization Environment

We have lowered our view on this segment's competitive advantages after recent weak results that may take many years to resolve. Specifically, poor underwriting in the Medicare Advantage market and surging medical utilization trends led CVS to severely misprice its MA plans for 2024. In MA, CVS generated a mid-single-digit operating loss in 2024 due to poor plan designs when it usually generates a positive mid-single-digit profit margin. While we think exits of unprofitable geographies and cuts to extra benefits should help CVS improve margins in that business over time, the company is limited by regulations on how much cost it can push back onto MA members, and the firm's own outlook suggests that it will take a multiyear endeavor to get MA margins back to target. By our current estimates, challenges in this business may prevent CVS from returning to economic profitability for several years, and another mispricing or other challenge could delay that progress even further, which keeps us cautious about this business.

However, we recognize that CVS may be able to improve results in this segment over time, and we typically see the potential for two moat sources—cost advantage and network effect—in this business that may help CVS reestablish a moat in this segment (and potentially the company) eventually. An insurer’s cost advantages relate primarily to local scale. The legacy Aetna operations represent the third-largest insurer that we cover, with about 27 million members, albeit a distant third in our coverage universe behind UnitedHealth and Elevance. Also, we believe CVS has the potential to benefit from local scale advantages in specific metropolitan markets. Local scale advantages allow for greater negotiating leverage versus local service providers than smaller insurers in each community, which contributes to cost advantages in each specific location.

Also, when local scale advantages are significant enough, we think CVS' insurance operations should benefit from a network effect. According to the American Medical Association, the share of local insurance markets in the US that were highly concentrated grew to 73% in 2022 from 71% in 2014, with top-tier players like CVS likely to take share in those markets due to local market dynamics. However, given how severely CVS' medical insurance operations have fallen short recently, we would like to see more evidence of its potential profit improvement before assuming this business has a moat.

CVS Pharmacy Benefit Manager Still Retains Signs of a Narrow (but Weakening) Moat

CVS also provides pharmacy benefit management services, which appear competitively advantaged with a combination of moat sources. The PBM industry has consolidated into three top players—CVS, UnitedHealth, and Cigna—controlling about 80% of US prescription volumes on an adjusted basis, and we believe those players built their leadership positions on previous cost advantages. While these companies do not appear to have significant cost advantages over each other now, we see evidence of some switching costs and network effects in this industry, although CVS' recent and potential contract losses suggest that its company-specific advantages may have weakened a bit. We continue to positively view the fixed-cost leverage associated with processing about 2 billion of the nearly 7 billion adjusted prescriptions filled annually in the US, though. This consolidation of purchasing power helps CVS extract discounts from drug manufacturers on one end of the transaction and pharmacies on the other end of the transaction, which helps create value for its clients, such as insurance plans and employers, on their pharmacy cost trends.

We see some switching costs in this business with contract lengths typically around three years and annual retention rates in the high 90s for all three of the top-tier PBM players. Switching the administrative activities, partner relationships, and pharmacy benefit plan specifications to a new PBM vendor can be time-consuming and onerous, which creates inertia for clients with limited realistic alternatives, in our opinion. However, switching is possible, and the loss of specific clients is already constraining CVS' growth now and could continue to do so, especially as new competitors including key CVS client Elevance take aim at this market.

In recent years, we have seen evidence of some network effects in the PBM industry with other PBMs losing share to the big-3 PBMs. Negatively, CVS lost its contract with Centene in 2024 and may eventually lose its contract with emerging PBM, Elevance, too. Broadly, we continue to think clients are most attracted to the discounts they can get on drugs due to a PBM's scale-driven negotiating power with other stakeholders in this market, primarily drug manufacturers and pharmacies. As more users are attracted to top-tier PBMs, drug manufacturers and pharmacies have incentive to offer even larger discounts to benefit from those volume-based discounts, which can help the top-3 PBMs attract even more users and create a virtuous cycle, or a network effect, in the long run. However, the recent loss of the Centene contract to Cigna and the potential loss of the Elevance contract suggest CVS' network effect is being challenged at least in the intermediate term.

CVS Retail Pharmacy Stores Face Too Many Challenges to Dig a Moat

CVS possesses a top-tier retail pharmacy position that appears to have some positive qualities, albeit probably not a moat, as pressures mount on its business model. Specifically, PBMs continue squeezing reimbursement rates in their pharmacy networks that represent about 80% of total store sales, and online and discount retailers continue to steal foot traffic from the front of its stores. This ongoing pressure has contributed to significantly lower segment margins in recent years, and management continues to expect the stores to be a mid-single-digit drain from a segment profit perspective, going forward.

While we suspect the retail pharmacy business is just too challenging to keep a moat intact, we recognize that CVS may have some advantages over smaller pharmacies. First, CVS drives significant volumes through over 9,000 pharmacy locations. This large, convenient store network is attractive for PBMs when assembling pharmacy benefit plans to obtain volume-based discounts from pharmaceutical manufacturers and when assembling convenient retail store locations that would be attractive to insurance plan members. Also, CVS' average store revenue remains significantly higher than most other US pharmacies, aside from no-moat-rated Walgreens. Scale allows CVS to leverage fixed costs, such as pharmacist salaries and rent, more effectively than subscale peers, and both CVS and Walgreens continue to steal share from smaller independent pharmacies on drug volumes. CVS, Walgreens, and Walmart also have advantageous relationships with the top US drug distributors, which may give them a mild leg up over other retail pharmacies on generic drug pricing. Beyond that, its retail store locations give CVS a unique asset that it may be able to leverage into destinations for higher-margin healthcare services, like primary care offerings, eventually. Just as rising tides lift all boats, though, we suspect a receding tide in this business negatively affects CVS from a moat perspective.

Regulatory Concerns Primarily Surround CVS' PBM, Where Reform Appears Likely

Our moat rating is informed by an analysis of potential changes to the US healthcare system, which is the key long-term environmental, social, and governance risk that CVS faces, as the US strives to reach universal, affordable coverage. During the next 10 years, we view scenarios where CVS provides medical and pharmaceutical benefits through employers and government programs as much more likely than not. However, regulators appear to have set their sights on the PBM industry as one that needs reform. Transparency-related changes like removing spread and rebate-based pricing mechanisms look like the most probable change in this industry, but we remain on the lookout for other major changes, such as international reference pricing or the separation of medical dispensers and insurers, including the PBMs. On a probability-weighted basis, we think those primarily PBM-related risks for CVS create a mid-single-digit headwind to operating profits, which we include in our bear-case regulatory scenario below. This potential risk pushes ROICs basically down to WACC even in the outer years of our 10-year explicit forecast period, which informs our new no-moat rating on CVS, since there appears to be no room for error.

Fair Value and Profit Drivers Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

We are keeping our fair value estimate for CVS at $86 per share, which reflects a relatively slow turnaround in its profits.

CVS continues to face substantial challenges in its medical insurance operations, which is constraining the company's intermediate-term outlook, and we continue to have questions about the long-term prospects of its retail pharmacy operations. On a very weak 2024 base, we expect 3% revenue growth compounded annually through 2029, including weak growth from the PBM, as the firm absorbs recent and potential contract losses, and mid-single-digit top-line growth from its other segments. Also, in 2024, CVS' profit margins declined substantially due primarily to a significant mismatch in rates and medical utilization in its Medicare Advantage business. With that weak 2024 as a base, we expect significant margin improvement over time in the medical insurance operations, which drives our view that adjusted EPS should grow about 10% compounded annually during the next five years.

We remain on the lookout for potential regulatory changes as well, particularly in its PBM operations. While we suspect a low-single-digit profit headwind is the most likely outcome for potential regulations on rebates and spreads in the PBM business, we recognize that more substantial regulations may create more significant headwinds for CVS, if enacted.

Risk and Uncertainty Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

We are raising our Uncertainty Rating on CVS to High from Medium previously to reflect the rising regulatory risk around its PBM operations on top of the lackluster recent results and intermediate-term outlook for its medical insurance business. This new Uncertainty Rating also reflects risks surrounding CVS' efforts to derive synergies from recent and potential acquisitions.

We think healthcare policy risks may plague MCOs like CVS, as the US attempts to reach affordable, universal coverage. In the near term, we see headwinds emerging from potential regulations to increase PBM transparency and pricing techniques, which could constrain the firm's results. Also, we think long-term policy risks may remain high for the foreseeable future.

CVS' penchant for transformational acquisitions, including the Caremark, Aetna, and Oak Street, creates some uncertainty for long-term investors, too. First, those acquisitions inflated the company's invested capital base, creating pressure on the firm's economic profitability including goodwill, which may take a while to return to WACC. Also, the firm's integration efforts, execution, and shareholder distributions after these mergers were typically weak, which adds risk to the situation for long-term investors.

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Additionally, in the wake of these acquisitions, investors were left to wait indefinitely for CVS to achieve an MCO industry-standard EPS growth rate in the low double digits. In late 2023, CVS' management finally admitted defeat on this goal by announcing a significantly lower profit growth goal for the long run that recognizes the challenges the firm faces, particularly in its retail store operations. Problems in the medical insurance business in 2024 caused a management shakeup, and the new management team has yet to endorse a long-term profit growth target. CVS investors have been left waiting yet again for the company to deliver industry-standard profit growth, and uncertainty surrounds if that will ever be possible.

Capital Allocation Julie Utterback, CFA, Senior Equity Analyst, 7 Apr 2025

Our Capital Allocation Rating on CVS remains on the weak end of Standard, reflecting its weak balance sheet management, mixed shareholder distributions, and fair investment strategy.

CVS' ongoing acquisitions and weak execution represent the most significant constraints on its capital allocation rating. Specifically, CVS spent nearly two decades positioning itself as a managed care leader, with the acquisitions of pharmacy benefit manager Caremark (2007), insurance provider Aetna (2018), and healthcare service provider Oak Street (2023) defining its strategic direction. And while we think most of the company's moves have made sense strategically, the prices and debt required to make them have been high, in our opinion. For example, CVS has written down much of the value of Omnicare acquisition (2015). Also, CVS also paid about double what we thought Aetna was worth prior to the acquisition's announcement in late 2017. While we definitely see significant potential synergies between these now combined organizations, returns on invested capital weakened after the merger, and we continue to worry that CVS paid too much for the asset, especially considering its weak execution in Medicare Advantage in recent years. Also, its early 2023 Oak Street acquisition initially pushed off its double-digit earnings growth target yet again before management gave up altogether at its December 2023 investor day. Overall, CVS' acquisition track record has been muddy at best, and we continue to view its execution in its highly diversified business model as subpar.

Also, the debt that CVS takes on to make these acquisitions often constrains its ability to push cash out to shareholders, which has been a recurring theme for the organization. Specifically, after the Aetna acquisition in 2018, CVS took on such substantial financial leverage that its credit rating was cut and shareholder distributions were severely limited through 2021. The 2023 acquisitions of Signify and Oak Street are again tying its hands while executional errors in its Medicare Advantage business are constraining its cash flows. So instead of purchasing shares while they are cheap, CVS has been forced to focus on deleveraging and maintaining its dividend. Specifically, the company aims to maintain a solidly investment-grade credit rating with leverage in the low to mid-3s in the long run. However, we recognize that CVS missed an opportunity to repurchase shares at cheap levels after the Aetna transaction and is repeating that pattern again in 2024-25 after its 2023 acquisitions.

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Analyst Notes Archive

Medical Services: MCOs Immune, but Tariffs May Cause Near-Term Stress at Providers and Suppliers Julie Utterback, CFA,Senior Equity Analyst,10 Apr 2025

Over the past week, tariff-related news has created significant volatility in the US market, including in medical services-related firms like managed care organizations, caregivers, and medical suppliers.Why it matters: Some of these companies look largely tariff-proof, including managed care organizations like UnitedHealth, while others look merely recession-resistant, including caregivers like HCA and medical suppliers like Baxter. As US-based and US-focused firms, MCOs look largely immune to tariffs. The only concern could be in the near term if the US economy falls into recession and causes a mix shift in medical insurance members from employer to lower-margin Medicaid plans. Providers and medical suppliers could feel more direct effects of higher costs in their supply chains due to tariffs. Of these two, medical suppliers face the more significant profit risk due to multiyear contracts with clients and potential delays in large equipment orders from clients.The bottom line: In February, we reduced our fair value estimate for medical supplier Baxter on near-term tariff concerns, and we do not anticipate making further changes to it. We see most of the medical services firms we cover (MCOs, providers, and suppliers) as undervalued currently. In managed care, our moat ratings were all recently updated during our moat staleness review process. UnitedHealth, Humana, Elevance, and Cigna remain at narrow, while CVS and Centene are now at none. In providers and suppliers, most of our moat ratings were also reviewed in late 2024 or early 2025. They remain narrow for Baxter, DaVita, Fresenius Medical Care, HCA, and Tenet and none for ICU Medical.Coming up: We plan to keep a close eye on how hospital capital expenditure budgets develop and how they could affect medical suppliers in a scenario where tariffs create sticker shock on large equipment especially. Also, investors should be aware of other regulatory factors that could affect the MCOs.

MCOs: Strong Final 2026 Rate Notice for Medicare Advantage Boosts Undervalued Shares Julie Utterback, CFA,Senior Equity Analyst,7 Apr 2025

Late on April 7, the Centers for Medicare and Medicaid Services released its final reimbursement rate notice for Medicare Advantage, highlighting an expected change in per capita revenue of 5.06% in 2026 even after risk-related adjustments. This is up from 2.23% in the January initial rate notice.Why it matters: This announcement represents a first look at how Republicans plan to regulate rates in the important Medicare Advantage market. It appears they will be more generous than Democrats have been in recent years, which is a welcome change of pace for the MCOs we cover. In after-hours trading, MA-focused insurer Humana traded up about 12%, MA-leader UnitedHealth rose about 6%, and top-tier MA insurer CVS increased about 7%. Even lower-tier MA players Elevance (up 7%) and Centene (up 4%) rose on the news. Also, Cigna, which has no exposure to Medicare Advantage after selling off that business to Health Care Service Corporation in March, inexplicably rose 1% after hours,

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generally benefiting from the improving market sentiment in the industry. The bottom line: In our valuation models, we previously suspected that the recent lean years in Medicare Advantage under Democrats would give way to more normalized trends eventually, so this good start under Republican rule merely starts that normalization process for MA insurers. We are not changing any of our fair value estimates in the industry and continue to view most of the MCOs we cover as moderately undervalued, including MA-focused insurer Humana which still trades at a roughly 30% discount to fair value even following the after-hours rally. Our moat ratings were all recently updated during our moat staleness review process and remain narrow for UnitedHealth, Humana, Elevance, and Cigna and none for CVS and Centene.

CVS Health Earnings: Reducing Fair Value Estimate on Weak 2025 Guidance; Shares Still Undervalued Julie Utterback, CFA,Senior Equity Analyst,12 Feb 2025

CVS Health turned in solid fourth-quarter results, and its 2025 guidance for 6%-11% adjusted EPS growth without any share repurchase activity appeared to relieve the market. Shares rose in the midteens on a percentage basis in early trading on this news. Why it matters: With new management at the helm, the market appears to appreciate that further deterioration in profits is unlikely in 2025. However, the firm's 2025 guidance looks well below our profit and free cash flow estimates, as the firm may continue to struggle with ongoing challenges in Medicare Advantage, Medicaid, and Medicare Part D related to a mismatch in rates and utilization. Given how weak CVS' 2024 performance was in its Aetna medical insurance operations, it may take multiple years to return to more normalized margins, particularly in Medicare Advantage. Positively, management highlighted that it has $3-$4 of EPS upside if MA margins reach its target. The bottom line: We are reducing our fair value estimate on narrow-moat CVS to $86 per share from $93 previously to reflect the weaker expectations for 2025 and a slower turnaround thereafter, given the challenges that CVS faces in its Aetna medical insurance operations in particular. With weak expected profits at CVS, ROICs have fallen below WACC, and we currently place no value on its narrow economic moat rating in our model. However, we do assume significant improvement in CVS' profits and cash flows over time, including a return to a more normalized $10 billion in free cash flow generation after a particularly weak year expected in 2025 of around $4 billion. Coming up: In the next few months, we expect to hear more about Republican priorities for regulatory changes in the industry. While headline risks create uncertainty, we think potential downside risks for CVS profits are largely reflected in its heavily discounted shares.

PBM Transparency Initiatives Included in New US Spending Bill Julie Utterback, CFA,Senior Equity Analyst,18 Dec 2024

The US federal spending bill expected to pass this week includes pharmacy benefit manager transparency efforts that eliminate rebate- and spread-based pricing benefits for PBMs.Why it matters: Managed care organizations, which own the PBMs, face a mild headwind to their profits from this new regulatory action. PBM clients currently use rebates and spread-based pricing mechanisms to incentivize PBMs to negotiate bigger discounts in biopharmaceutical prices, but this new legislation looks likely to force PBMs to pass those rebates and spreads on to clients. However, we expect PBMs to replace those variable pricing mechanisms with fees to resolve most of that risk to profits. This should result in the potential for a low-single-digit profit headwind for even the most exposed MCO—Cigna—based on our estimates.The bottom line: We maintain our fair value estimates for covered MCOs despite this legislation, because the potential profit headwinds are not enough to materially affect our valuations. Our narrow moat ratings also remain intact, despite the increased risk of regulation by Republicans in recent weeks that have caused shares to decline significantly. We think shares are trading at moderate (Cigna, Centene, and UnitedHealth) to significant (CVS, Elevance, and Humana) discounts to fair value.Coming up: Recent commentary from incoming Republican officials and negative sentiment from the public in the wake of a UnitedHealth executive's killing suggest that the MCOs should brace themselves for more potential policy changes. Republicans appear focused on reducing federal spending on Medicaid expansion and the individual exchanges, while bipartisan support of further PBM regulations or wasteful spending in Medicare Advantage would create more profit risks. Mild positive offsets to those potential risks appear possible, though, in the form of increased outsourcing of government programs to private insurers.

CVS Earnings: Reveals Full Extent of Weakness in Aetna Operations in Final Release of Q3 Results

Julie Utterback, CFA,Senior Equity Analyst,6 Nov 2024

After a preliminary announcement a few weeks ago including a CEO change, narrow-moat CVS Health released its full third-quarter results that highlighted weakness in its Aetna medical insurance operations. The earnings call also featured a first look at David Joyner in his new CEO role after previously leading the Caremark pharmacy benefit management business. While CVS refrained from giving guidance, at first glance, we are not changing our $93 fair value estimate. Shares remain cheap, and investors should note that Republican Party election wins could ease pressures a bit on the Medicare Advantage business that has roiled CVS' results so much in 2024.As expected after the preliminary announcement, CVS delivered weak third-quarter results related to the ongoing mismatch in rates and the elevated medical utilization in key markets, such as in Medicare Advantage and the individual exchanges. The company delivered $1.09 of adjusted EPS, in line with the preliminary results highlighted a few weeks ago but well below FactSet consensus of $1.69 prior to that preliminary announcement. Because of the ongoing mismatch between rates and utilization in its medical insurance membership, CVS had to take a premium deficiency reserve charge in the quarter worth about $0.63 per share, as the firm's medical loss ratio spiked substantially to 95% from 86% a year ago. This segment's weakness accounted for most of the company's 43% adjusted operating profit decline in the quarter.The rest of CVS performed admirably. The healthcare services segment, which includes the PBM and healthcare services operations, grew adjusted operating profits by 17%, as growth in healthcare

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Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
66.97 USD 9 May 2025	86.00 USD 12 Feb 2025 18:02, UTC	0.78	80.53 USD Bil 12 May 2025	None	Large Value	High	Standard	7 May 2025 05:00, UTC

services and specialty pharmacy offset the loss of the Centene PBM contract. Even the retail pharmacy stores looked strong with 15% adjusted operating profit growth on strong volume trends in a rising medical utilization environment and improved drug purchasing dynamics, despite ongoing reimbursement pressure.

Republican Party Win in US Election Could Ease Key Pressures in Managed-Care Industry Julie Utterback, CFA,Senior Equity Analyst,6 Nov 2024

With the Republicans winning key federal electable bodies (White House and Senate at the time of writing) in the US election, pressure on certain parts of the managed-care industry could ease a bit, while other areas would still face scrutiny, but at this point, we're not changing any fair values. Positively, the Republicans' leadership could mean less pressure on Medicare-focused insurers like Humana and CVS Health, while antitrust scrutiny also could dissipate. Negatively, Medicaid and the individual exchanges—two Centene strongholds—could see less support under the Republicans. Also, we still view pharmacy benefit management transparency as a key concern for both major political parties, but we expect potential legislation to be manageable for top-tier players like Cigna, CVS, and UnitedHealth.Medicare Advantage is currently facing many regulatory challenges under the Democratic Party leadership, including risk adjustments down toward traditional Medicare rates and weak star ratings that promise to constrain future bonus payments. However, the switch to Republican leadership could ease those pressures a bit, given the Republicans support these privatized plans for senior citizens. At the very least, we would expect regulators to stop turning the screws so hard on Medicare Advantage beyond current risk-adjustment initiatives that are projected to be completed in 2026, which would bode well for M&A-focused insurers like Humana, CVS, and UnitedHealth.Also, the Republican victories could grease the wheels of future M&As in the channel, which has almost been halted under the Biden administration. The potential merger of Cigna and Humana could have a better chance of success than under the Democrats, though we still see increasing claims concentration in the PBM industry as a concern. Also, the combination of medical insurance and healthcare services firms may face less scrutiny, which could bode well for UnitedHealth's diversified business model and any imitators.

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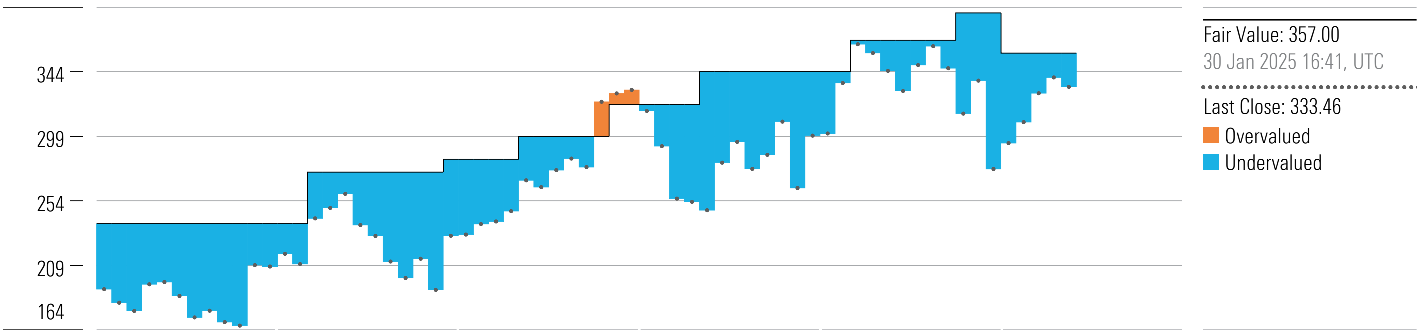
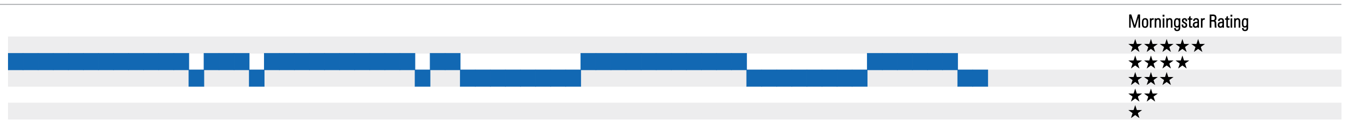
CVS Health Corp CVS ★★★★ 9 May 2025 21:22, UTC

Competitors Price vs. Fair Value

The Cigna Group CI

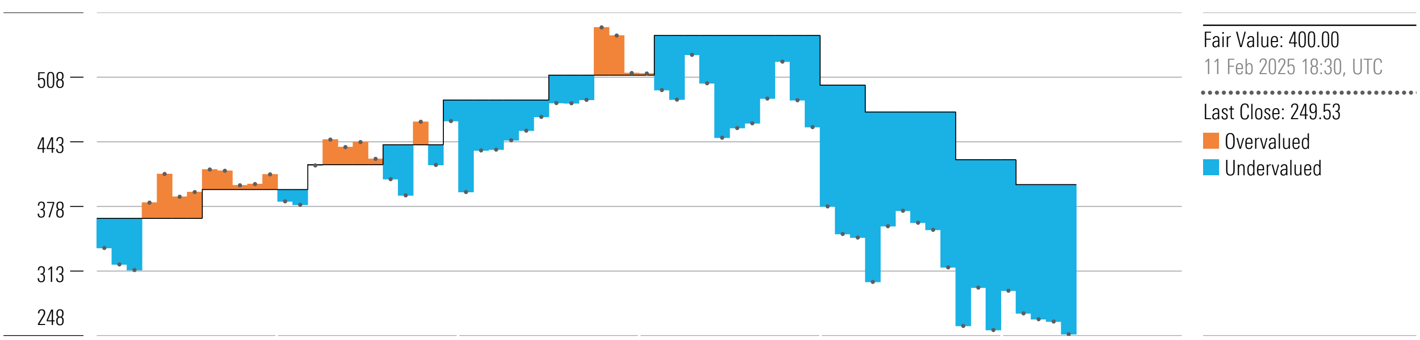


2020	2021	2022	2023	2024	YTD	
0.87	0.81	1.03	0.87	0.72	0.93	Price/Fair Value
1.82	12.23	46.24	-8.14	-5.91	21.30	Total Return %

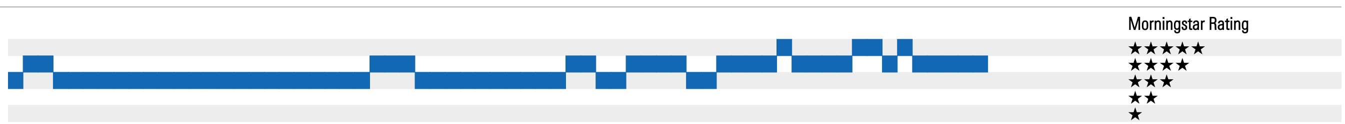


Total Return % as of 09 May 2025. Last Close as of 09 May 2025. Fair Value as of 30 Jan 2025 16:41, UTC.

Humana Inc HUM



2020	2021	2022	2023	2024	YTD	
1.04	0.96	1.00	0.83	0.60	0.62	Price/Fair Value
12.62	13.74	11.10	-9.93	-43.81	-1.30	Total Return %



Total Return % as of 09 May 2025. Last Close as of 09 May 2025. Fair Value as of 11 Feb 2025 18:30, UTC.

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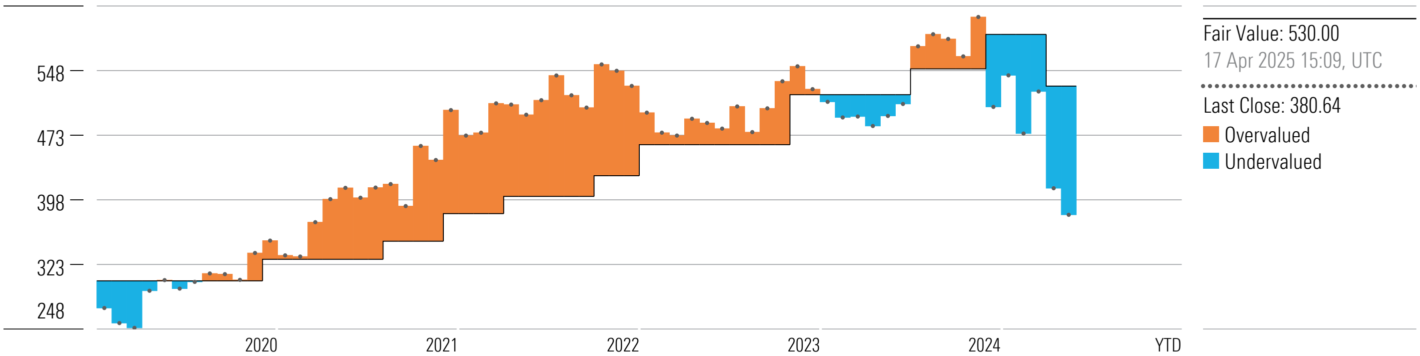
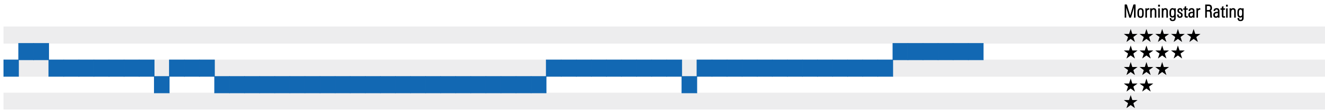
CVS Health Corp CVS ★★★★ 9 May 2025 21:22, UTC

Competitors Price vs. Fair Value

UnitedHealth Group Inc UNH



	2020	2021	2022	2023	2024	YTD	
	1.07	1.31	1.24	1.01	0.86	0.72	Price/Fair Value
	20.93	44.79	6.86	0.68	-2.36	-24.34	Total Return %



Total Return % as of 09 May 2025. Last Close as of 09 May 2025. Fair Value as of 17 Apr 2025 15:09, UTC.

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CVS Health Corp CVS ★★★★ 9 May 2025 21:22, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
66.97 USD 9 May 2025	86.00 USD 12 Feb 2025 18:02, UTC	0.78	80.53 USD Bil 12 May 2025	None	Large Value	High	Standard	7 May 2025 05:00, UTC

Morningstar Valuation Model Summary

Financials as of 01 May 2025	Actual			Forecast				
Fiscal Year, ends 31 Dec	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**
Revenue (USD Mil)	322,467	357,776	372,809	382,243	393,819	410,244	404,507	424,674
Operating Income (USD Mil)	16,082	14,599	9,795	11,429	13,409	15,302	15,189	15,946
EBITDA (USD Mil)	11,993	18,109	13,703	16,085	17,870	19,763	19,336	20,158
Adjusted EBITDA (USD Mil)	21,925	22,018	16,684	18,772	20,288	21,939	21,295	21,920
Net Income (USD Mil)	4,149	8,344	4,614	6,112	7,637	8,961	8,814	9,333
Adjusted Net Income (USD Mil)	11,499	11,272	6,838	7,689	9,056	10,239	9,964	10,368
Free Cash Flow To The Firm (USD Mil)	13,311	-6,217	6,231	4,833	7,940	8,724	9,223	10,225
Weighted Average Diluted Shares Outstanding (Mil)	1,323	1,290	1,262	1,262	1,262	1,262	1,242	1,206
Earnings Per Share (Diluted) (USD)	3.14	6.47	3.66	4.84	6.05	7.10	7.09	7.74
Adjusted Earnings Per Share (Diluted) (USD)	8.69	8.74	5.42	6.09	7.18	8.11	8.02	8.59
Dividends Per Share (USD)	2.20	2.18	2.66	2.66	2.66	2.66	2.66	2.66

Margins & Returns as of 01 May 2025		Actual			Forecast					
	3 Year Avg	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**5 Year Avg**
Operating Margin %	2.9	5.0	4.1	2.6	3.0	3.4	3.7	3.8	3.8	3.5
EBITDA Margin %	—	3.7	5.1	3.7	4.2	4.5	4.8	4.8	4.8	—
Adjusted EBITDA Margin %	—	6.8	6.2	4.5	4.9	5.1	5.4	5.3	5.2	5.2
Net Margin %	1.6	1.3	2.3	1.2	1.6	1.9	2.2	2.2	2.2	2.0
Adjusted Net Margin %	2.9	3.6	3.2	1.8	2.0	2.3	2.5	2.5	2.4	2.3
Free Cash Flow To The Firm Margin %	1.4	4.1	-1.7	1.7	1.3	2.0	2.1	2.3	2.4	2.0

Growth & Ratios as of 01 May 2025		Actual			Forecast					
	3 Year CAGR	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**5 Year CAGR**
Revenue Growth %	8.5	10.4	11.0	4.2	2.5	3.0	4.2	-1.4	5.0	2.6
Operating Income Growth %	-13.2	7.3	-9.2	-32.9	16.7	17.3	14.1	-0.7	5.0	10.2
EBITDA Growth %	-1.9	-32.3	51.0	-24.3	17.4	11.1	10.6	-2.2	4.3	8.2
Adjusted EBITDA Growth %	-8.8	-0.4	0.4	-24.2	12.5	8.1	8.1	-2.9	2.9	5.6
Earnings Per Share Growth %	-14.9	-47.2	106.3	-43.5	32.5	25.0	17.3	-0.1	9.1	16.2
Adjusted Earnings Per Share Growth %	-14.9	3.7	0.5	-38.0	12.5	17.8	13.1	-1.2	7.2	16.2

Valuation as of 01 May 2025	Actual			Forecast				
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**
Price/Earning	10.7	9.0	8.3	11.0	9.3	8.3	8.4	7.8
Price/Sales	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Price/Book	1.7	1.3	0.7	1.1	1.0	1.0	0.9	0.9
Price/Cash Flow	—	—	—	—	—	—	—	—
EV/EBITDA	7.9	7.5	7.8	8.2	7.6	7.0	7.2	7.0
EV/EBIT	10.8	11.3	13.2	13.4	11.4	10.0	10.1	9.6
Dividend Yield %	2.4	2.8	5.9	4.0	4.0	4.0	4.0	4.0
Dividend Payout %	25.3	25.0	49.1	43.7	37.1	32.8	33.2	31.0
Free Cash Flow Yield %	—	—	—	—	—	—	—	—

Operating Performance / Profitability as of 01 May 2025	Actual			Forecast				
Fiscal Year, ends 31 Dec	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**
ROA %	1.8	3.3	1.8	2.2	2.7	3.1	3.0	3.1
ROE %	5.8	10.9	6.1	7.8	9.2	10.1	9.7	10.1
ROIC %	9.4	8.0	5.4	6.1	6.8	7.5	7.0	7.4

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CVS Health Corp CVS ★★★★ 9 May 2025 21:22, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
66.97 USD 9 May 2025	86.00 USD 12 Feb 2025 18:02, UTC	0.78	80.53 USD Bil 12 May 2025	None	Large Value	High	Standard	7 May 2025 05:00, UTC

Financial Leverage (Reporting Currency)	Actual			Forecast				
Fiscal Year, ends 31 Dec	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**
Debt/Capital %	36.6	43.9	59.5	37.1	35.4	34.6	32.9	32.5
Assets/Equity	3.2	3.3	3.3	3.5	3.4	3.3	3.2	3.3
Net Debt/EBITDA	4.6	3.8	5.2	2.8	2.1	1.6	1.5	1.3
Total Debt/EBITDA	3.2	3.6	5.0	3.5	3.2	3.0	3.0	3.0
EBITDA/ Net Interest Expense	10.4	8.6	5.6	5.8	6.4	6.7	6.3	6.4

Forecast Revisions as of 1 May 2025	2025		2026		2027	
Prior data as of 7 Apr 2025	**Current**	**Prior**	**Current**	**Prior**	**Current**	**Prior**
Fair Value Estimate Change (Trading Currency)	86.00	85.01	—	—	—	—
Revenue (USD Mil)	382,243	382,243	393,819	396,084	410,244	412,622
Operating Income (USD Mil)	11,429	10,855	13,409	13,090	15,302	15,390
EBITDA (USD Mil)	18,772	18,199	20,288	19,985	21,939	22,045
Net Income (USD Mil)	7,689	7,262	9,056	8,819	10,239	10,305
Earnings Per Share (Diluted) (USD)	4.84	4.50	6.05	5.86	7.10	7.15
Adjusted Earnings Per Share (Diluted) (USD)	6.09	5.75	7.18	6.99	8.11	8.17
Dividends Per Share (USD)	2.66	2.66	2.66	2.66	2.66	2.66

Key Valuation Drivers as of 01 May 2025	
Cost of Equity %	9.0
Pre-Tax Cost of Debt %	6.5
Weighted Average Cost of Capital %	7.8
Long-Run Tax Rate %	25.5
Stage II EBI Growth Rate %	3.0
Stage II Investment Rate %	37.5
Perpetuity Year	11

Additional estimates and scenarios available for download at https://pitchbook.com/.

Discounted Cash Flow Valuation as of 01 May 2025	**USD Mil**
Present Value Stage I	61,711
Present Value Stage II	4,450
Present Value Stage III	94,576
Total Firm Value	**160,736**
Cash and Equivalents	10,993
Debt	66,270
Other Adjustments	0
Equity Value	**105,459**
Projected Diluted Shares	1,262
Fair Value per Share (USD)	**86.00**

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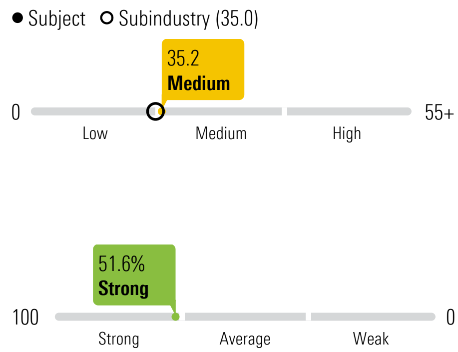
CVS Health Corp CVS ★★★★ 9 May 2025 21:22, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
66.97 USD 9 May 2025	86.00 USD 12 Feb 2025 18:02, UTC	0.78	80.53 USD Bil 12 May 2025	None	Large Value	High	Standard	7 May 2025 05:00, UTC

ESG Risk Rating Breakdown

Exposure	
Company Exposure[1]	35.2
– Manageable Risk	33.5
Unmanageable Risk[2]	**1.6**
Management	
Manageable Risk	33.5
– Managed Risk[3]	17.3
Management Gap[4]	**16.2**
Overall Unmanaged Risk	**17.8**



- Exposure represents a company's vulnerability to ESG risks driven by their business model
- Exposure is assessed at the Subindustry level and then specified at the company level
- Scoring ranges from 0-55+ with categories of low, medium, and high-risk exposure

- Management measures a company's ability to manage ESG risks through its commitments and actions
- Management assesses a company's efficiency on ESG programs, practices, and policies
- Management score ranges from 0-100% showing how much manageable risk a company is managing

ESG Risk Rating

ESG Risk Ratings measure the degree to which a company's value is impacted by environmental, social, and governance risks, by evaluating the company's ability to manage the ESG risks it faces.

1. A company's Exposure to material ESG issues 2. Unmanageable Risk refers to risks that are inherent to a particular business model that cannot be managed by programs or initiatives 3. Managed Risk = Manageable Risk multiplied by a Management score of 51.6% 4. Management Gap assesses risks that are not managed, but are considered manageable 5. ESG Risk Rating Assessment = Overall Unmanaged Risk = Management Gap plus Unmanageable Risk

ESG Risk Rating Assessment[5]

ESG Risk Rating is of May 07, 2025. Highest Controversy Level is as of May 08, 2025. Sustainalytics Subindustry: Managed Health Care. Sustainalytics provides Morningstar with company ESG ratings and metrics on a monthly basis and as such, the ratings in Morningstar may not necessarily reflect current Sustainalytics' scores for the company. For the most up to date rating and more information, please visit: sustainalytics.com/esg-ratings/.

Peer Analysis 07 May 2025

Peers are selected from the company's Sustainalytics-defined Subindustry and are displayed based on the closest market cap values

Company Name	Exposure			Management			ESG Risk Rating		
CVS Health Corp	35.2 | Medium	0	55+	51.6 | Strong	100	0	17.8 | Low	0	40+
The Cigna Group	34.2 | Low	0	55+	66.7 | Strong	100	0	12.4 | Low	0	40+
Walgreens Boots Alliance Inc	35.7 | Medium	0	55+	59.3 | Strong	100	0	15.5 | Low	0	40+
Humana Inc	37.2 | Medium	0	55+	60.7 | Strong	100	0	15.8 | Low	0	40+
UnitedHealth Group Inc	34.1 | Low	0	55+	54.0 | Strong	100	0	16.6 | Low	0	40+

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Appendix
Historical Morningstar Rating

CVS Health Corp CVS 9 May 2025 21:22, UTC

Dec 2025	Nov 2025	Oct 2025	Sep 2025	Aug 2025	Jul 2025	Jun 2025	May 2025	Apr 2025	Mar 2025	Feb 2025	Jan 2025
—	—	—	—	—	—	—	★★★★	★★★★	★★★★	★★★★	★★★★★
Dec 2024	Nov 2024	Oct 2024	Sep 2024	Aug 2024	Jul 2024	Jun 2024	May 2024	Apr 2024	Mar 2024	Feb 2024	Jan 2024
★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★
Dec 2023	Nov 2023	Oct 2023	Sep 2023	Aug 2023	Jul 2023	Jun 2023	May 2023	Apr 2023	Mar 2023	Feb 2023	Jan 2023
★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★
Dec 2022	Nov 2022	Oct 2022	Sep 2022	Aug 2022	Jul 2022	Jun 2022	May 2022	Apr 2022	Mar 2022	Feb 2022	Jan 2022
★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★	★★★	★★★	★★★
Dec 2021	Nov 2021	Oct 2021	Sep 2021	Aug 2021	Jul 2021	Jun 2021	May 2021	Apr 2021	Mar 2021	Feb 2021	Jan 2021
★★★	★★★	★★★	★★★★	★★★★	★★★	★★★	★★★	★★★★	★★★★	★★★★	★★★★
Dec 2020	Nov 2020	Oct 2020	Sep 2020	Aug 2020	Jul 2020	Jun 2020	May 2020	Apr 2020	Mar 2020	Feb 2020	Jan 2020
★★★★	★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★

The Cigna Group CI 9 May 2025 21:20, UTC

Dec 2025	Nov 2025	Oct 2025	Sep 2025	Aug 2025	Jul 2025	Jun 2025	May 2025	Apr 2025	Mar 2025	Feb 2025	Jan 2025
—	—	—	—	—	—	—	★★★	★★★	★★★★	★★★★	★★★★
Dec 2024	Nov 2024	Oct 2024	Sep 2024	Aug 2024	Jul 2024	Jun 2024	May 2024	Apr 2024	Mar 2024	Feb 2024	Jan 2024
★★★★	★★★★	★★★★	★★★	★★★	★★★	★★★	★★★	★★★	★★★	★★★	★★★★
Dec 2023	Nov 2023	Oct 2023	Sep 2023	Aug 2023	Jul 2023	Jun 2023	May 2023	Apr 2023	Mar 2023	Feb 2023	Jan 2023
★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★	★★★
Dec 2022	Nov 2022	Oct 2022	Sep 2022	Aug 2022	Jul 2022	Jun 2022	May 2022	Apr 2022	Mar 2022	Feb 2022	Jan 2022
★★★	★★★	★★★	★★★	★★★	★★★	★★★★	★★★★	★★★	★★★★	★★★★	★★★★
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Dec 2025	Nov 2025	Oct 2025	Sep 2025	Aug 2025	Jul 2025	Jun 2025	May 2025	Apr 2025	Mar 2025	Feb 2025	Jan 2025
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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, indepth 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 shortterm market-price movements), but we believe these negatives are mitigated by deep analysis and our longterm 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.

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 singlepoint star rating.

1. 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 (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or 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 the firm's cost of capital more quickly than companies with moats.

When considering a company's moat, we also assess whether there is a substantial threat of value destruction, stemming from risks related to ESG, industry disruption, financial health, or other idiosyncratic issues. In this context, a risk is considered potentially value destructive if its occurrence would eliminate a firm's economic profit on a cumulative or midcycle basis. If we deem the probability of occurrence sufficiently high, we would not characterize the company as possessing an economic moat.

2. 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 five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in workingcapital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and the 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.

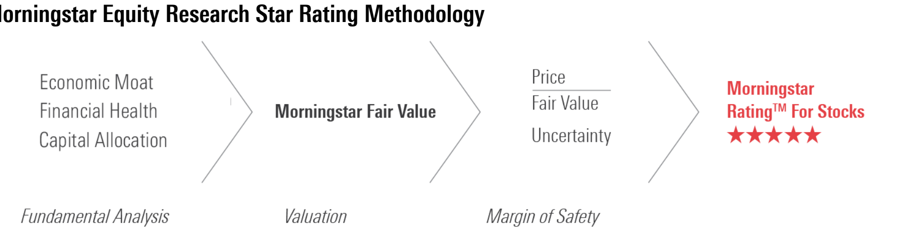
Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return 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.

3. Uncertainty Around That Fair Value Estimate

Morningstar's Uncertainty Rating is designed to capture the range of potential outcomes for a company's intrinsic value. This rating is used to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating is aimed at identifying the confidence we should have in assigning a fair value estimate for a given stock.

Our Uncertainty Rating is meant to take into account anything that can increase the potential dispersion of future outcomes for the intrinsic value of a company, and any-

Morningstar Equity Research Star Rating Methodology



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thing that can affect our ability to accurately predict these outcomes. The rating begins with a suggested rating produced by a quantitative process based on the trailing 12-month standard deviation of daily stock returns. An analyst overlay is then applied, with analysts using the suggested rating, historical rating data, and their own knowledge of the company to inform them as they make the final Uncertainty Rating decision. Ultimately, the rating decision rests with the analyst. Analysts take into account many characteristics when making their final decision, including cyclical factors, operational and financial factors such as leverage, company-specific events, ESG risks, and anything else that might increase the potential dispersion of future outcomes and our ability to estimate those outcomes.

Our recommended margin of safety—the discount to fair value demanded before we'd recommend buying or selling the stock—widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the potential dispersion of outcomes, 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 are: Low, Medium, High, Very High, and Extreme.

Qualitative Analysis Uncertainty Ratings	Margin of Safety ★★★★★Rating	★Rating
Low	20% Discount	25% Premium
Medium	30% Discount	35% Premium
High	40% Discount	55% Premium
Very High	50% Discount	75% Premium
Extreme	75% Discount	300% Premium

Our uncertainty rating is based on the interquartile range, or the middle 50% of potential outcomes, covering the 25th percentile–75th percentile. This means that when a stock hits 5 stars, we expect there is a 75% chance that the intrinsic value of that stock lies above the current market price. Similarly, when a stock hits 1 star, we expect there is a 75% chance that the intrinsic value of that stock lies below the current market price.

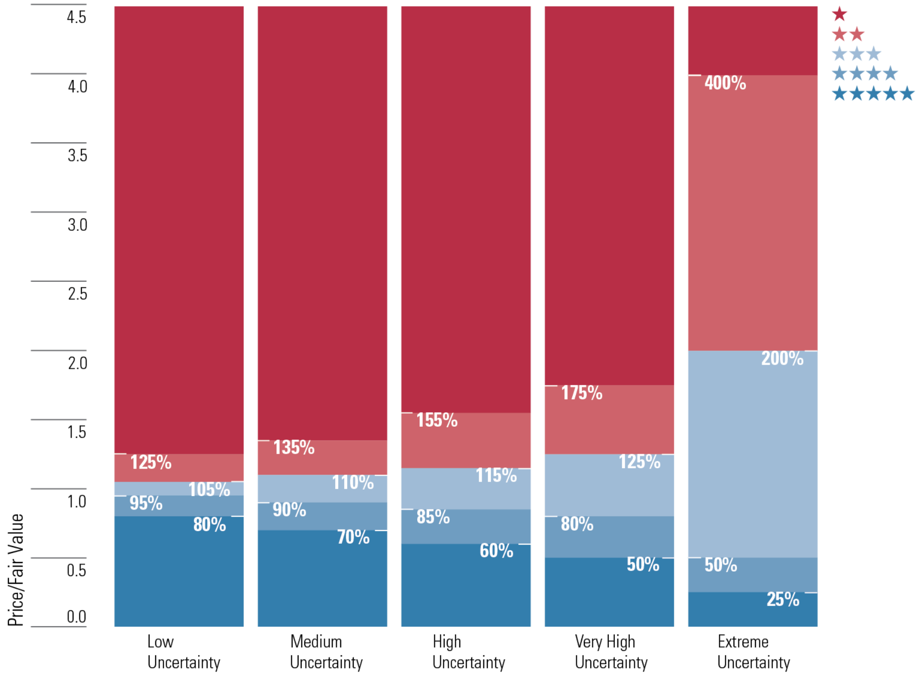
4. Market Price

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

For more details about our methodology, please go to https://shareholders.morningstar.com

Morningstar Star Rating for Stocks

Morningstar Equity Research Star Rating Methodology



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 re-calculated 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.

Other Definitions

Last Price: Price of the stock as of the close of the market of the last trading day before date of the report.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider compan-

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ies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

Capital Allocation (or Stewardship) analysis published prior to Dec. 9, 2020, was determined using a different process. Beyond investment strategy, financial leverage, and dividend and share buyback policies, analysts also considered execution, compensation, related party transactions, and accounting practices in the rating.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider companies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

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Sustainalytics ESG Risk Rating Assessment: The ESG Risk Rating Assessment is provided by Sustainalytics; a Morningstar company.

Sustainalytics' ESG Risk Ratings measure the degree to which company's economic value at risk is driven by environment, social and governance (ESG) factors.

Sustainalytics analyzes over 1,300 data points to assess a company's exposure to and management of ESG risks. In other words, ESG Risk Ratings measures a company's unmanaged ESG Risks represented as a quantitative score. Unmanaged Risk is measured on an open-ended scale starting at zero (no risk) with lower scores representing less unmanaged risk and, for 95% of cases, the unmanaged ESG Risk score is below 50.

Based on their quantitative scores, companies are grouped into one of five Risk Categories (negligible, low, medium, high, severe). These risk categories are absolute, meaning that a 'high risk' assessment reflects a comparable degree of unmanaged ESG risk across all subindustries covered.

The ESG Risk Rating Assessment is a visual representation of Sustainalytics ESG Risk Categories on a 1 to 5 scale. Companies with Negligible Risk = 5 Globes, Low Risk = 4, Medium Risk = 3 Globes, High Risk = 2 Globes, Severe Risk = 1 Globe. For more information, please visit sustainalytics.com/esg-ratings/

Ratings should not be used as the sole basis in evaluating a company or security. Ratings involve unknown risks and uncertainties which may cause our expectations not to occur or to differ significantly from what was expected and should not be considered an offer or solicitation to buy or sell a security.

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