MORNINGSTAR®

Equity Research: Stewardship Rating Methodology

May 1, 2012

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy, history of investment timing and valuation, financial leverage, dividend and share buyback policies, execution, management compensation, related party transactions, and accounting practices. Corporate governance practices, such as poison pills and staggered boards, are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three stewardship ratings: "exemplary," "standard," and "poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Companies are judged not against peers within their industry, but against ideal stewardship of shareholder capital. Most companies will receive a standard rating, and this should be considered the default rating in the absence of evidence that a management team has made exceptionally strong or poor capital allocation decisions.

A history of value-accretive acquisitions, optimal financial leverage, ideal dividend and share buyback policies, and investments that enhance competitive advantages--these are the marks of exemplary stewards of shareholder capital. Certain corporate practices, such as poison pills and staggered boards, are easily visible and garner much attention in governance analysis circles. Unfortunately, focusing on particular governance practices tends to poorly predict a firm's ability to generate improving returns on invested capital and shareholder returns. Fundamental investors should instead conduct a more thorough analysis of management stewardship of shareholder capital. Morningstar equity research's focus on competitive advantages and credit analysis puts its analysts in a unique position to assess stewardship.

Morningstar analysts provide support their stewardship ratings in the "Management & Stewardship" section of each company report.

Our new stewardship methodology focuses explicitly on a company's capital allocation policies and track record. While many of the factors we examine overlap with our previous methodology, the emphasis has evolved to more explicitly focus on capital allocation and stewardship of shareholder capital. We are deemphasizing proxies for good stewardship, and instead focusing on activities of the management team, board, and company to protect and grow shareholder value.

Investment Strategy

Given Morningstar's focus on competitive dynamics, analysts pay close attention to a company's investment strategies. A key question for all companies is, "Has the firm strayed from core competencies in the pursuit of growth?" A company with exemplary stewardship will be one that has made investments and acquisitions that support its competitive advantages and core businesses. Moreover, exemplary firms will divest underperforming or non-core businesses.

Investment Valuation

Unfortunately, investments that make sense from a strategic perspective can still destroy shareholder value if the price paid is too high. Therefore, analysts consider the price of acquisitions and the cost of major investments.

Financial Leverage

A company's strategy with regard to financial leverage can have a big impact on shareholder returns, uncertainty, and volatility. Analysts look unfavorably on cyclical, capital intensive companies that carry a high debt load. Likewise, mature, stable companies with minimal reinvestment needs that sport too little debt are clearly not doing everything to maximize shareholder value.

Dividend and Share Buyback Policies

Dividends and share repurchases are used to return cash to shareholders. Just like with financial leverage, a Morningstar analyst is like Goldilocks, looking for an ideal amount of returning cash to shareholders that's neither too little nor too much for a particular company. A company with many opportunities to invest cash at high rates of return within the business or even with acquisition opportunities should probably deemphasize dividends and share repurchases. Meanwhile, a mature company with minimal profitable investment opportunities should look to return cash to shareholders.

Execution

A robust portfolio of attractive operating assets and skilled human capital, assembled with favorable valuations, can't create shareholder value if a company has frequent operational and execution missteps. Industrial accidents, customer service problems, or product recalls can depress operational results and destroy shareholder value. Conversely, praiseworthy execution can lead to a company significantly outperforming its peers on operational metrics and shareholder value creation.

Compensation

In most cases, a company's compensation practices will not materially affect our stewardship rating. However, egregious compensation can keep an otherwise admirable management team from earning our "exemplary" rating. In certain cases where compensation is especially outrageous, where a material amount of value is being directed to managers at the expense of owners, companies can receive a "poor" rating on the basis of egregious compensation.

Related Party Transactions

Like compensation, related party transactions shouldn't materially affect our stewardship rating in most cases. However, when related party transactions indicate a material redirection of value to managers and their friends and family at the expense of a company's owners, analysts will assign a company a "poor" stewardship rating.

Accounting Practices

Deceitful accounting practices are good cause for a "poor" stewardship rating.

Management Backgrounds

Morningstar analysts assess the backgrounds of a company's managers and whether or not they're a good fit for the position. Factors such as relevant and sufficient experience influence our consideration of this factor.

Health, Safety, and the Environment

Since Morningstar analysts are assessing stewardship from a shareholder—not a stakeholder—perspective, the default stance on a company's HSE practices is agnostic. However, if a company's HSE track record has had a demonstrated impact on operational performance or shareholder value, then we take that into consideration in our assessment of stewardship of shareholder capital.

Ownership Structure

Morningstar analysts take note of a company's ownership structure: Is it family owned and controlled? Does the government have a controlling stake or a golden share? Is it majority owned by another company? Are there different classes of shares with unequal voting rights? These structures reduce the power of minority shareholders but in many cases we don't consider them cause for concern by themselves, especially when the controlling shareholders' economic interests are significantly aligned with minority shareholders'. However, when the ownership structure has led to value destructive capital allocation decisions, we certainly take this into consideration when assigning stewardship ratings.

Stakeholder Focus

Some jurisdictions require corporations to act in the interests of all stakeholders, not just shareholders. For example, Germany requires employee representation of many corporate boards. Many Japanese companies maintain ownership positions in their suppliers and customers. Morningstar analysts take note when a company has a stakeholder focus, and when that focus has led to actions for or against the interest of shareholders it is incorporated into the company's stewardship rating.