
Introducing the Morningstar Capital Allocation Rating: FAQs

Why Is Morningstar Transitioning to Capital Allocation Ratings From the Prior Stewardship Ratings?

Capital Allocation focuses on the key areas where we strive to assess management efficacy. The change avoids confusion with environmental, sustainability, and governance factors, which are to be captured through Sustainalytics company-level ratings and incorporated into our research. Our new Capital Allocation framework builds on the prior Stewardship methodology but focuses on three key items: balance sheet health, investment efficacy, and shareholder distributions.

What Are the Benefits of Moving to a Capital Allocation Framework?

The framework aims to enhance the consistency, relevance and efficacy of the ratings. By focusing on balance sheet, investment and shareholder distributions, we have simplified the methodology. Our goal is to efficiently and consistently communicate our key opinions on the major drivers of total shareholder returns.

How Does Morningstar Arrive at Its Capital Allocation Ratings?

Analysts assess balance sheet, investment, and shareholder distributions on a forward-looking basis to establish the Capital Allocation rating. We retain the Poor, Standard, and Exemplary ratings for capital allocation, carrying over from the prior stewardship ratings. These ratings clearly communicate our opinions in keeping with Morningstar's core "investors first" value. The Capital Allocation Ratings are assigned using analysts' assessments of balance sheet, investment and shareholder distributions and the capital allocation flow chart in Exhibit 1, shown below.

How Does Morningstar Assess Balance Sheet Strength?

Our assessment is forward looking. We consider a company's balance sheet position and how it is likely to evolve to arrive at an assessment of sound, weak, or poor. We consider if a firm has reasonable or excessive leverage, if debt repayment is prioritized and if a firm likely has the cash flow to make meaningful improvement if necessary. Potential for the balance sheet to change in an economic downturn or if material company-specific risks come to pass is also assessed.

How Does Morningstar Assess Investment?

We consider if a firm is likely to invest to fortify or enhance its competitive position in future, and if it is likely to do so at the right price--that is, generate attractive rates of return above the estimated cost of capital. We also consider execution, including the management of material ESG risks, and if material missteps or successes are likely.

How Does Morningstar Assess Shareholder Distributions?

Assessment of shareholder distributions considers if future cash returns to shareholders--dividends and/or share buybacks--are likely the appropriate size and form. Cash flow should be distributed to shareholders unless better uses exist; namely, balance sheet repair or value-adding investment. How much is appropriate depends on the opportunity cost of forgoing reinvestment or strengthening the balance sheet, and the likely future investment and balance sheet needs.

How Will Concerns Around Environmental, Social and Corporate Governance Be Treated Under the Framework?

The framework centers on the key areas where Morningstar strives to assess management efficacy; namely, balance sheet, investment, and shareholder distributions. Health, safety, environment, stakeholder, and/or governance factors are considered in the capital allocation framework if they meaningfully influence our assessment of balance sheet, investment, and shareholder distributions. If not, our attention focuses on the factors we think are likely to be material. ESG commentary will be primarily covered in Sustainalytics' company-level ESG ratings, and incorporated into our equity research through our Economic Moat and Uncertainty Rating frameworks.

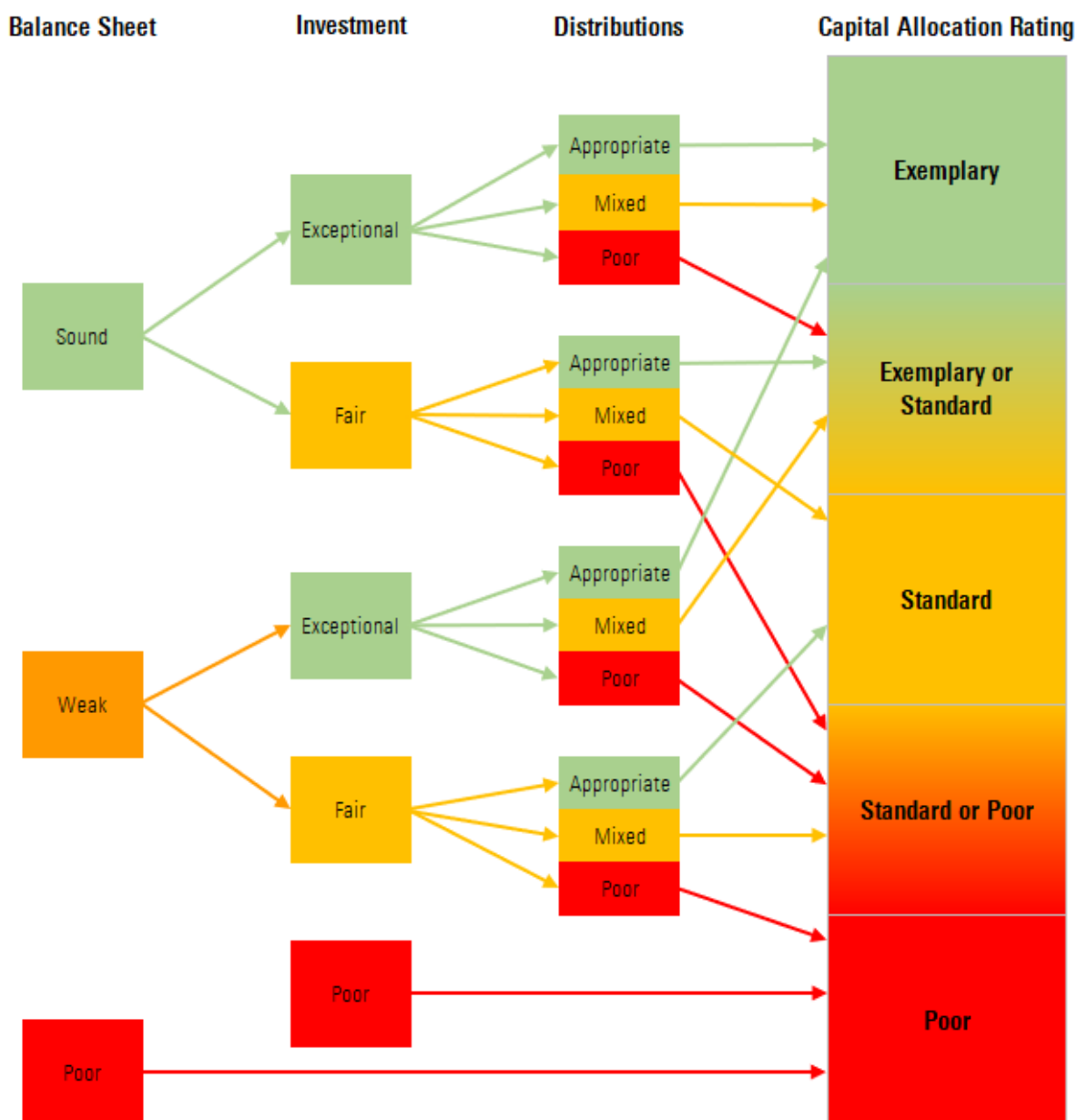
Over What Time Frame Will the Changes Take Place?

The new methodology will become effective from Dec. 9, 2020. The assessments and ratings will progressively be incorporated into our research as Morningstar analysts update the company reports for their respective companies. Any company reports dated prior to Dec. 9 will be under the prior framework.

What Changes Do You Expect With the Adoption of the New Capital Allocation Framework?

While it's difficult to be definitive prior to implementing the methodology, we expect most of the prior Stewardship ratings to transfer to the Capital Allocation framework without change. However, with the framework more defined, we expect a greater proportion of nonstandard Capital Allocation ratings. That is, either Poor or Exemplary. ■■■

Exhibit 1 Morningstar's Capital Allocation Flow Chart



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+1 312 696-6869

equitysupport@morningstar.com



22 West Washington Street
Chicago, IL 60602 USA

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