VF Corp VFC (NYSE) | ★★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

Wide moat VF's growth engines are working well despite U.S. wholesale weakness.

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

Research as of 01 May 2017
Estimates as of 01 May 2017
Pricing data through 18 May 2017
Rating updated as of 18 May 2017

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Contents

Investment Thesis 01 May 2017

VF has established a broad and growing array of leading lifestyle brands, selected to enhance its presence in high-growth categories and for synergies within existing operating units. The brand portfolio is currently anchored in outdoor and action sports and jeans, a dominance we expect to continue, with the two coalitions expected to account for about 90% of revenue in 2017.

We believe that apparel manufacturers are uniquely positioned to strengthen brand intangible asset moats by developing direct relationships with consumers and retaining absolute control over product and experiences in this e-commerce environment. Currently, VF's direct-to-consumer channel accounts for 28% of revenue; we see this growing to over one third by 2021. Within this, we expect store growth to slow and the focus to shift to digital, which management sees growing from 5% of revenue to 12% in 2021 (or from mid- to high-teens penetration versus stores to north of 30% in 2021). Although we expect the U.S. wholesale environment to remain weak, we think VF's exposure is minimized. More than 70% of the wholesale business is international, specialty, and pure-play digital retailers. 15% of the business is mass-merchant.

The international channel will be another high-growth channel with the potential to continue growing at a high-single-digit constant-currency CAGR over the next five years. We see this growth as being particularly driven by China, with 300 million new consumers entering the middle class. Asia-Pacific currently accounts for only 28% of international revenue, but we see this growing to 32% by 2021.

Near-term performance will likely be muted given retailer bankruptcies and weak apparel consumer demand, but VF is a wide-moat company that continues to gain market share, and we see it as an attractive investment. We think shareholder value could be enhanced through share buybacks, a future acquisition, outsize growth of the direct-to-consumer channel, and possible further divestitures of underperforming businesses.

Vital Statistics

Market Cap (USD Mil)	20,728
52-Week High (USD)	65.27
52-Week Low (USD)	48.05
52-Week Total Return %	-11.4
YTD Total Return %	-2.2
Last Fiscal Year End	31 Dec 2016
5-Yr Forward Revenue CAGR %	3.5
5-Yr Forward EPS CAGR %	6.8
Price/Fair Value	0.81

Valuation Summary and Forecasts

Fiscal Year:	2015	2016	*2017(E)*	*2018(E)*
Price/Earnings	20.2	17.9	*17.6*	*15.6*
EV/EBITDA	13.8	13.8	*12.0*	*11.6*
EV/EBIT	15.9	16.5	*14.1*	*13.3*
Free Cash Flow Yield %	3.4	5.9	*5.6*	*6.4*
Dividend Yield %	2.1	2.9	*3.5*	*3.9*

Financial Summary and Forecasts (USD Mil)

Fiscal Year:	2015	2016	*2017(E)*	*2018(E)*
Revenue	12,377	11,449	*11,520*	*11,995*
Revenue YoY %	0.8	-7.5	*0.6*	*4.1*
EBIT	1,805	1,485	*1,613*	*1,712*
EBIT YoY %	-1.6	-17.7	*8.6*	*6.2*
Net Income, Adjusted	1,329	1,256	*1,223*	*1,337*
Net Income YoY %	-1.9	-5.5	*-2.6*	*9.4*
Diluted EPS	3.08	2.98	*2.94*	*3.31*
Diluted EPS YoY %	-0.1	-3.2	*-1.1*	*12.3*
Free Cash Flow	838	1,397	*1,417*	*1,365*
Free Cash Flow YoY %	-38.2	66.8	*1.4*	*-3.6*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.
Analyst Note: LSG moved to discontinued operations in 2016 for 2017 comparability purposes; restated segment data not provided

Profile

VF owns a large portfolio of leading lifestyle brands including The North Face, Timberland, Vans, Lee, Wrangler, and Nautica. Consumers are served through multiple distribution channels and geographies, with about 38% of revenue international and 28% direct-to-consumer. Brands are organized into four coalitions: outdoor and action sports, jeanswear, imagewear, and sportswear. VF has a broad supply chain, with 22% of products produced by VF and the remainder sourced across an array of countries.

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Morningstar Analysis

Valuation, Growth and Profitability 01 May 2017
We are maintaining our $64 fair value estimate as our lowered U.S. tax rate assumption (to a 17% annual rate from about 20% in 2017) offsets the impact of the exit from LSG. We continue to model mid-single-digit constant currency average annual revenue growth and high-single-digit adjusted EPS growth over the long term. Our discounted cash flow analysis is based on a 9% cost of capital.

We model 2017 revenue to grow almost 1% (including a 2-point impact from foreign exchange rates), fueled by 3% growth in the outdoor and action sports category, a 3% decline in jeanswear and a 15% decline in sportswear. We think international penetration will fuel mid- to high-single-digit constant-currency growth and direct-to-consumer will also fuel constant-currency growth in the mid- to high-single-digit range. Our updated model also assumes that adjusted operating margin will be roughly flat with 2016's adjusted 14.0% margin (including LSG) but includes a 60-basis-point impact from foreign currency.

Over the next five years, we think that VF can increase revenue and EPS at CAGRs of 4% and 7%, respectively (roughly in line with our prior forecast of 4% and 8%). We see growth weighted heavily to the Asia-Pacific region, which we see growing at a 10% compound annual rate, while we expect Europe, the Middle East, and Africa, or EMEA, to grow in the mid-single-digits and the non-U.S. Americas to grow in the high single digits on average, yielding mid-single-digit total compound annual growth. We see the jeanswear coalition as more mature but still capable of delivering 2% compound annual growth due to innovation and international expansion. We think operating margins can expand from 14% (adjusted and including LSG) in 2016 to almost 16% in 2021. Expansion should be driven by the aforementioned mix shifts, as well as an easing of foreign exchange headwinds.

Scenario Analysis
We assign VF a medium uncertainty rating and have completed a scenario analysis to account for a margin of error in estimating top-line demand and the margin expansion opportunity.

If outdoor and action sports penetrates international markets and increases direct-to-consumer sales more quickly than expected, both revenue and margin assumptions may underestimate the brands' true potential. Potential acquisitions in higher-margin performance wear could also provide an unexpected benefit. In our bull-case scenario, we model outdoor and action sports revenue growing at a 7% compound annual rate over the next five years, versus just under 5% in the base case. We could also see slight upside in jeanswear growth, given the positive response to more innovative higher-priced products, and we model 4% compound growth in our bull-case scenario (versus 2% in the base case). Together, these two coalitions are expected to account for about 90% of revenue in 2017. The bull-case scenario is dependent on the sale of higher-margin products. As such, we model the operating margin reaching 16.7% by 2021 versus our base-case scenario of 15.6% and the current adjusted margin of 14.0% (including LSG). Using a 9% weighted average cost of capital, we arrive at our $84 bull-case fair value estimate.

It is also possible that weaker consumer confidence and extended low wages could pressure both volume and pricing. Especially in the outdoor and action sports category, there are plenty of options to which consumers might trade down, albeit also trading on quality, performance, and durability. In our bear-case scenario, we model outdoor and action sports revenue growing only 2% on average over five years, versus almost 5% in the base case. We also assume jeanswear will be down 1% versus 2% growth in the base case, as consumers would trade down to lower-priced products or extend the period of replenishment in this scenario. Margins would suffer, and we model an operating

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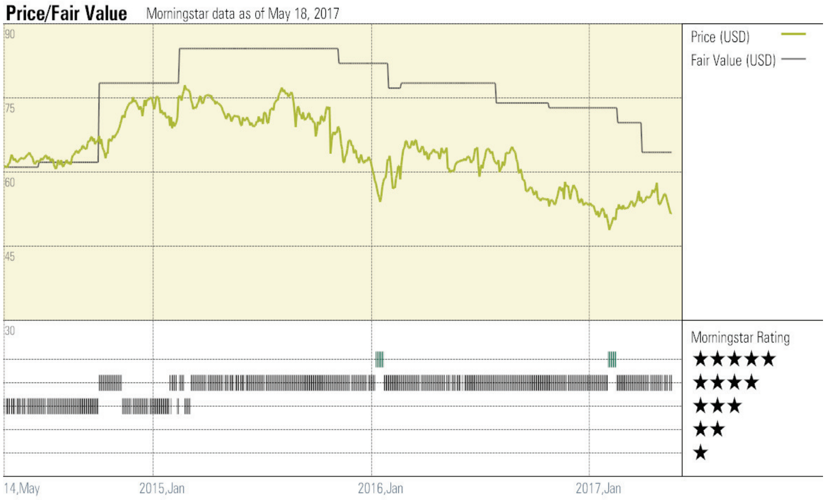
Price/Fair Value Morningstar data as of May 18, 2017



margin of 14.6% in 2021, below our base-case scenario of 15.6%. Using a 9% weighted average cost of capital, we arrive at our $51 bear-case fair value estimate.

Economic Moat

We are maintaining our wide moat rating, given the pricing power VF has attained through its intangible brand assets. We believe management's ability to cull declining brands, nurture growing brands, and acquire strong brands will continue to support a portfolio of names worthy of a wide moat. We believe the company bases its acquisition strategy and brand positioning on intense consumer research and reviews its brand portfolio annually to divest any brands that do not make strategic sense for the overall portfolio. In our view, these two practices will ensure that the overall VF brand intangible asset will remain strong over a significant period, as the brands and products it owns will be adjusted to maintain value. Furthermore, we see sustainable cost advantages through scale, a partially owned manufacturing platform, and a shared supply chain. We expect VF to achieve an average return on invested capital of 22% over the next five years, above its 9% weighted average cost of capital.

VF has a portfolio of about 30 brands in four categories that drive above market returns. Three of the largest brands are in the outdoor and action sports category: The North Face, Timberland, and Vans. The North Face is an outdoor brand in a $63 billion global market. The Vans market opportunity is equally attractive, with Vans holding only 5% share of the $39 billion footwear opportunity and 1% share of the $43 billion apparel opportunity. Finally, Timberland is an outdoor lifestyle brand with a $94 billion opportunity in global men's footwear, a $141 billion opportunity in global women's footwear, and a $217 billion opportunity in global men's apparel. The jeanswear category has two long-standing brands in Lee and Wrangler. Lee Jeans has a history that stretches back to 1889 and generates about $1 billion in sales. Wrangler is an iconic American brand associated with the West. It has a 23% share of the men's denim market, 16% share of the men's casual bottoms market, and 18% share of the men's woven tops market.

VF customers have demonstrated a willingness to pay a premium for high-performance products, innovations in fit and fabrication, and the consistency of a brand, all of which are attributes of a strong brand intangible asset. At Macy's, The North Face hooded puffer parka sells for $289, versus Laundry by Shelli Segal's parka at $275 and Guess' coat at $225. Vans sneakers sell in the $60 range, roughly in line with Puma and Adidas.

VF actively manages its brand portfolio. In 2007, the company divested its entire intimate apparel business, including the Vanity Fair brand (its original brand), citing its intent to move to become a higher-growth and higher-margin lifestyle company. The company also shed its John Varvatos ownership in 2012, which we think was wise given its luxury, high-fashion positioning. Finally, it divested the Contemporary Brands coalition in 2016. We think the company's practice of frequently reviewing its portfolio means that investors will be shielded from declining brands or those that are no longer synergistic to the other companies. We also think that management does intense consumer research before buying a company (it spoke to 18,000 consumers in eight countries about their Timberland brand perception), which should lead to a stronger brand portfolio and data-driven product development, marketing, and price positioning.

VF's manufacturing and distribution scale and centralized procurement and logistics are competitive advantages. In 2016, VF produced more than 500 units of apparel, footwear, and accessories for more than 30 brands; 22% of units are manufactured in VF-operated facilities at a lower cost and shorter lead time than contracted production.

This scale and global network affords synergies across its brands. Operating margin at Timberland has increased from 7.9% in 2011 (the year it was acquired) to an estimated 12.9% at the end of 2014, a 500-basis-point increase. Overall, the Outdoor & Action Sports Coalition had a 16.3% operating margin in 2016. Midteens margins are notable in the apparel manufacturing segment, with PVH (the nearest competitor) having margins only in the low double digits. Even more notable is the consistency of its margins. The outdoor and action sports coalition has had a 17.3% average operating margin over the past five years (ranging from 16.3% to 18.2%) despite acquisitions, changes in input costs, and variances in overall economic conditions. We think this supports our belief that VF has significant cost advantages.

Moat Trend

We are maintaining our positive moat trend rating. We think one of VF's largest strengths is its ability to manage its brands as a portfolio. Management has proved adept at acquiring strong brands that fit synergistically into its portfolio and divesting brands it thinks it is unable to develop. The company's most recent acquisition was of Timberland in 2011, at an 11 times enterprise value/EBITDA multiple and an 18% premium to Timberland's 60-day average. Although a premium, the acquisition was immediately earnings-accretive and increased VF's exposure to lifestyle brands. We expect the company to remain acquisitive, especially in the categories where consumers have demonstrated a willingness to pay a high premium for a brand, such as outdoor and action sports. Management demands a 15% return on acquisitions in three years.

We also see organic investments that we think will strengthen the existing brand portfolio. In the strategic plan introduced in early 2017, VF said it hoped to increase direct-to-consumer sales to over one third of revenue in 2021 from 28% at the end of 2016. We think this added control of the in-store experience or online platform will further clarify the brands and portray them more fully in a lifestyle manner. Finally, the company has demonstrated a willingness to leave the traditional confines of retail and to connect with customers across lifestyles, aspirations, and passions. An example of this can be seen through the geographic expansion of The North Face into the Asia-Pacific region. VF drove demand for The North Face products by actively developing an outdoor community. The brand participated in building outdoor education programs around China and organizing events for people at all levels.

The increased pricing power of the brands is apparent in gross margin expansion. Gross margin reached 48.6% in 2016 (including LSG), up from 45.8% in 2011. We expect this trend to continue and see margins exceeding 50% in the next five years, which speaks to the positive moat trend of VF, in our view.

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Bulls Say/Bears Say

Bulls Say

- The outdoor and action sports coalition represents more than half of VF revenue and is a high-margin, quickly growing category with significant room for innovation. At 16.3% in 2016 (pre-LSG exit), EBIT margins were about 230 basis points higher than the consolidated VF EBIT margin.

- International expansion and direct-to-consumer growth opportunities indicate that most existing brands have further market expansion opportunities.

- Mix shifts resulting from the execution of strategic goals should lead to annual margin expansion of about 30-60 basis points in constant currency.

Bears Say

- The firm's businesses, including sportswear, carry a high degree of fashion risk and are discretionary. These could weigh on both top-line and margin performance.

- Significant international exposure could provide near-term margin pressure, given current foreign exchange rates.

- Further acquisitions may be difficult to find or to integrate. Acquisition valuations may be at a premium and take longer to close than expected.

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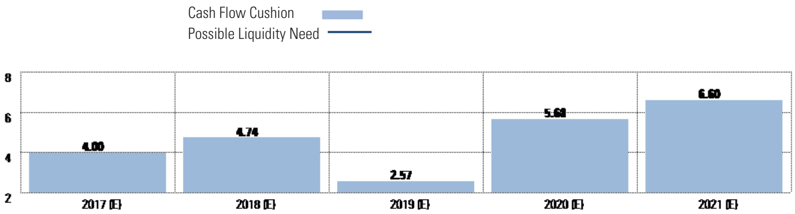
Five Year Adjusted Cash Flow Forecast (USD Mil)

	2017(E)	2018(E)	2019(E)	2020(E)	2021(E)
Cash and Equivalents (beginning of period)	1,228	1,409	972	1,944	2,483
Adjusted Available Cash Flow	642	950	993	1,079	1,148
Total Cash Available before Debt Service	1,870	2,359	1,965	3,022	3,632
Principal Payments	0	0	-250	0	0
Interest Payments	-81	-95	-95	-95	-95
Other Cash Obligations and Commitments	-387	-402	-419	-437	-455
Total Cash Obligations and Commitments	-468	-497	-765	-532	-550

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	1,228	43.7
Sum of 5-Year Adjusted Free Cash Flow	4,812	171.1
Sum of Cash and 5-Year Cash Generation	6,040	214.8
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	6,040	214.8
Sum of 5-Year Cash Commitments	-2,812	—

Financial Health

We believe that a strong balance sheet, combined with steady free cash flow generation and disciplined investing, has given VF a solid financial base. After increasing to over 1.4 times EBITDA in 2011 to finance the Timberland acquisition, debt had fallen to pre-Timberland levels of 0.9 times by 2015. Debt levels ramped back up to over 1 time at the end of 2016, which we believe will fund future acquisitions, investments, and return cash to shareholders. Long-term debt maturities are staggered, and we estimate that EBITDA can cover interest expenses by 21 times (including LSG). We do not foresee VF having any problem meeting interest payments or paying back debt. Free cash flow has grown at a healthy rate, and we expect it to continue doing so from the $1.3 billion base in fiscal 2016 (including LSG). As such, we think the company is well positioned to make further acquisitions (Timberland was a $2 billion acquisition) and maintain or exceed its targeted 40% dividend payout ratio. We believe that cash will not be stockpiled but will be divided between these two activities based on the attractiveness of the potential acquisition pipeline.

Enterprise Risk

As a manufacturer and seller of fashion and core fashion merchandise, VF is exposed to the cyclical nature of its category, and we give the stock a medium uncertainty rating. Weak employment, shifts in spend away from the apparel category, increasing consumer uncertainty, international macroeconomic pressures, or lower-than-expected wage inflation could all affect company performance. Additionally, VF is exposed to changes in raw material prices, labor, and distribution expenses, including shipping costs. Any change in these categories could have a noticeable impact on margins. We view VF's brand portfolio as its most valuable asset. Any declines in brand value could negatively affect volume and pricing, and could potentially result in a write-down of goodwill and other intangible

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assets. With both worldwide sales and sourcing, VF will be affected by weather and political and economic situations in a broad array of countries, not just in the U.S. Any challenges in finding suitable acquisition targets at an attractive price could pressure long-term growth rates. Finally, 21% of sales in 2016 were derived from VF's 10 largest customers. Any adverse changes with these customers could have a significant impact on revenue and/or earnings.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
ERIC C. WISEMAN	Director	617,217	13 Feb 2017	—
KARL HEINZ SALZBURGER		505,006	13 Feb 2017	—
ROBERT J. HURST	Director	188,706	22 Feb 2017	—
MR. STEVEN E. RENDLE	Director	135,882	13 Feb 2017	—
SCOTT H. BAXTER		128,646	22 Feb 2017	—
MR. SCOTT A. ROE		97,777	22 Feb 2017	—
CURTIS A. HOLTZ		42,817	14 Feb 2017	—
MR. RICHARD T. CARUCCI	Director	41,467	22 Feb 2017	—
MS. LAURA C. MEAGHER		34,142	13 Feb 2017	—
JULIANA L. CHUGG	Director	24,539	22 Feb 2017	—

*Represents the date on which the owner's name, position, and common shares held were reported by the holder or issuer.

Fund Ownership

Top Owners	% of Shares Held	% of Fund Assets	Change (k)	Portfolio Date
Vanguard Dividend Growth Fund	2.59	1.85	854	31 Mar 2017
VA CollegeAmerica Washington Mutual	2.54	0.67	—	31 Mar 2017
Parnassus Core Equity Fund	2.09	2.96	—	30 Apr 2017
Vanguard Total Stock Mkt Idx	1.51	0.06	43	30 Apr 2017
Vanguard 500 Index Fund	1.27	0.09	39	30 Apr 2017
Concentrated Holders				
PI Global Value Fund	0.03	6.38	—	31 Mar 2017
Max Otte Vermögensbildungsfonds AMI	0.01	6.34	—	31 Mar 2017
Parnassus Endeavor Fund	0.82	4.47	—	30 Apr 2017
Nomura Pictet Premium Brand Fund MF	0.01	4.14	10	22 Aug 2016
GWL FOREIGN EQUITY (CCM)	—	3.96	1	30 Apr 2017

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Wellington Management Company LLP	7.20	0.40	7,903	31 Dec 2016
Parnassus Investments	3.24	3.38	2,740	31 Mar 2017
State Street Corp	4.99	0.10	1,217	31 Dec 2016
Morgan Stanley & Co Inc	0.46	0.12	921	31 Dec 2016
Diam U.S.A. Inc	0.14	0.08	560	31 Dec 2016
Top 5 Sellers				
J.P. Morgan Investment Management Inc	1.02	0.10	-1,805	31 Dec 2016
Merrill Lynch & Co Inc	0.14	0.02	-1,605	31 Dec 2016
Vanguard Group Inc	5.27	0.06	-1,511	31 Dec 2016
Citadel Advisors Llc	0.04	0.01	-1,318	31 Dec 2016
Pnc Bank, National Association	33.78	8.76	-1,131	31 Dec 2016

Management 04 Apr 2017

Given VF's ability to actively manage its brand portfolio to drive shareholder returns and its willingness to return excess cash to shareholders through a growing dividend, we rate management stewardship as Exemplary. Over the past five years, VF Corp has achieved an average annual total shareholder return of 13%, versus the S&P 500 return of almost 15%; however, performance only trailed that of the S&P 500 in 2016. Eric Wiseman is chairman of the board and was CEO of VF from 2008 to 2016. Steve Rendle succeeded Wiseman as CEO in January 2017. Rendle has more than 30 years of experience in the specialty outdoor and action sports industry, 16 of which have been with VF Corp. As president and COO, Rendle oversaw all of VF's business coalitions worldwide and was responsible for VF's global supply chain and direct-to-consumer platforms. He has also been a member of the board of directors since 2015. Wiseman has been with the company over 20 years and CEO for nine years. In our view, this transition is not a sign of a shift in strategic direction, but is simply part of the company's succession planning. As Wiseman is remaining on the board, we expect that he will continue to work with Rendle to make the transition seamless.

The board of directors has 12 other members in addition to Wiseman and Rendle, all of whom are independent. We believe that the board composition reflects a desirable array of skill sets and independence to drive returns for shareholders.

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Analyst Notes

Wholesale a Headwind but Growth Drivers Intact for VF; Shares Undervalued 28 Apr 2017

Wide moat VF Corp. saw first-quarter wholesale performance come in lighter than we'd have liked, but performance in the growth driving categories was solid and we continue to think that the market is undervaluing the company's future potential. With first-quarter revenue of the big three brands up 4%, Bulwark, Timberland Pro, and Wrangler Riggs up at a midteen rate, International business increasing 5%, and direct to consumer up 7% (with more than 25% growth in digital), we feel comfortable that the company continues to be on track to deliver our long-term expectation for mid-single-digit average annual constant currency revenue growth over the next five years. Further, 190 basis points of gross margin expansion in the first quarter to 50.2% reinforced our belief that gross margin can expand 30-50 basis points annually over the next five years, primarily driven by mix shifts (driving our adjusted operating margin assumption from 14% in 2016 to just under 16% in 2021). Although our model will be adjusted to reflect the sale of the Licensed Sports Group (the businesses contributed about $575 million in revenue in 2016 and about $0.13 of earnings per share), we see little change to our $64 fair value estimate as we expect this to be offset by the time value of money and the impact of a lowered U.S. tax rate assumption beginning in 2018.

By segment, Jeanswear (over 20% of revenue) produced the largest disappointment in the first quarter with Wrangler revenue down 9% and Lee down 6% constant currency. We attribute the majority of this weakness to channel issues. At Wrangler, the direct to consumer channel grew in the low-double digits while Lee saw midteen growth. However the wholesale channel declined in the low double digits at Wrangler and high-single-digits at Lee, more than offsetting direct to consumer strength. We think that the next two quarters will continue to be challenging as retailer inventory destocking, the strategic repositioning of a key customer, and continued channel consolidation provide headwinds. However, we think strong brands supported by an established and nimble supply chain will be the winners in the long-run and see this group returning to growth in 2018.

The Outdoor and Action Sports coalition (over 60% of revenue) produced healthy first-quarter results, with revenue up 4% on a currency neutral basis. Strength at The North Face (up 8% currency neutral) and Vans (up 7% currency neutral) was offset by weakness at Timberland (down 4% currency neutral). We expect Timberland performance to begin to recover in the second half of the year as the company works to reduce its exposure to the boot in the U.S. and increase product newness with technology and styles that have already seen success in the direct to consumer channel and European markets. Further, we think management has been wise to strategically trade volume for pricing in the Outdoor and Action Sports segment and think that future growth will be driven by high-quality sales.

VF Updated Strategic Plan Consistent with Past Goals; Shares Undervalued 30 Mar 2017

Wide moat-rated VF's investor day yielded few surprises as growth initiatives for the next five years were consistent with the past five, focusing on outdoor and action sports brands, direct-to-consumer channels, and international markets to drive both top-line increases and margin expansion. One notable change from the last strategic plan was the lack of focus on acquisitions and its exclusion from five-year goal metrics. Despite this, we think management remains committed to this growth strategy and comments that acquisitions were still believed to yield the best return for investors and were the preferred bucket for capital allocation, supports this. That said, we think the company is having a difficult time finding acquisitions that meet its criteria of 15% return on capital in three years and good fit for brand portfolio, and now plan to remove our $1.5 billion

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Analyst Notes

acquisition assumption for 2018 from our estimates.

From a core growth standpoint, plans to grow revenue at a mid-single-digit compound annual growth rate over the next five years, operating income at a high-single-digit growth rate, and EPS at a low-double-digit rate align with our estimates. Overall, the consistency in strategic plan is exactly what we would expect from a wide-moat company. We see little change to our organic growth estimates calling for mid-single-digit revenue growth and high-single-digit operating income growth over the next five years, but expect that the removal of our acquisition assumption will drop our $70 fair value estimate to $64. We continue to view shares as undervalued and an attractive opportunity to own a wide-moat company in the branded apparel space.

The brand portfolio is currently anchored in outdoor and action sports and jeans, a dominance we expect to continue in the future with the two coalitions accounting for about 90% of revenue in 2016 and expected in 2021. Outdoor and action sports will likely be one of the largest growth drivers with high-single-digit growth expectations topping plans for mid-single-digit consolidated growth. Vans appears to be the outperformer in the segment, growing at a 14% constant currency CAGR from 2012 to $2.3 billion in revenue. Although we expect this growth to moderate to the high-single digits, on average, over the next five years simply due to the law of large numbers, we are encouraged that consumer demand is so high across all geographies and distribution channels and see this continuing to be a point of strength in the coalition. The North Face and Timberland brands, however, seem to be underperforming their potential, growing only 6% and 8% on a constant currency compound annual growth basis since 2012 to $2.3 billion and $1.8 billion in revenue, respectively. We think planned innovations in style and fabrications as well as better execution on noncore categories (outside of winter-wear for TNF and boots for Timberland) can eventually accelerate this growth to high-single-digit levels.

Two other branded categories worth mentioning are jeanswear and work wear. Although we expect jeanswear to be an underperformer versus consolidated growth (growing only in the low-single digits on average annually and aligning with management commentary), we note that operating margin is the highest among the coalitions. The potential for Lee seems limited given its exposure to U.S. wholesale channels, but the potential for Wrangler excites us. The brand has grown at a low-single-digit compound annual growth rate since 2012, gaining market share versus total U.S. denim sales, which were down 0.5% over the same period. We agree with management's conclusion that the brand is strong enough to upsell through department store and boutique channels, thereby expanding from its current western specialty, mass, and midtier distribution channels. The workwear segment is a new focus for the company, currently accounting for $800 million in revenue and encompassing the Wrangler Riggs, Timberland Pro, Red Kap, and Bulwark brands. Given VF's scale and the consumer focus on performance, customization, and quick ship demands, we think the company is well-positioned to grow its current approximate 5% market share in the roughly $30 billion fragmented space.

Perhaps most encouraging to us was the increased emphasis VF is putting on growing its direct-to-consumer channel, calling its strategy over the next five years "retail and consumer centric." We believe that apparel manufacturers are uniquely positioned to strengthen brand intangible asset moats by developing direct relationships with consumers and having absolute control over product and experiences in this e-commerce environment. Currently, VF's direct-to-consumer channel accounts for 28% of revenue and we see this growing to over one third by 2021. Within this, we expect store growth to slow and the focus to shift to digital, which management sees growing from

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Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

Analyst Notes

5% of revenue to 12% in 2021 and from mid- to high-teens penetration versus stores to north of 30% in 2021.

Although we expect the U.S. wholesale environment to remain weak, we think VF's exposure is minimized. More than 70% of the wholesale business is international, specialty and pure play digital retailers. 15% of the business is mass merchant. Therefore we think expectations for low-single-digit growth in the channel are reasonable and will be driven in international markets.

The international channel appears to have the potential to continue growing at a high-single-digit constant currency CAGR over the next five years. We see this growth particularly driven by China with 300 million new consumers entering the middle class. Currently, Asia Pacific accounts for only 28% of international revenue but we see this growing to 32% by 2021.

On a final note, management reinforced our belief that mix shifts toward the outdoor and action sports coalition, direct-to-consumer channel, and international geographies will continue to drive margin expansion. Furthermore, we think that pricing power is strong enough to offset the negative impacts of cost inflation and foreign currency over time. Management guidance calling for a 16.0% operating margin in 2021 (up 210 basis points) is in line with our current estimates.

VF Corp Uses Competitive Strengths to Navigate the Negative Apparel Environment; Shares Undervalued 17 Feb 2017

With department stores and mass merchants struggling with traffic declines, it was no surprise that fourth-quarter performance was weak for wide-moat VF, evidenced by constant-currency revenue growth of only 1%. However, the company delivered on protecting its brand intangible assets and flexed its scale competitive advantages, managing to reduce shipments to off-price channels, keep inventory clean (inventory was up less than 1% over last year), and expand gross margin (up 250 basis points in constant currency to an adjusted gross margin of 49.8%). Even with a strong brand portfolio and diversified distribution strategy, VF will be unlikely to offset wholesale weakness in the near term, given that the midtier, mass, and department-store channels combined are just under 20% of revenue. However, we still believe that VF will be a long-term winner in the apparel manufacturing space as it shifts resources into expanding its presence in the higher-margin, more productive international and direct-to-consumer channels, which are continuing to work despite wholesale weakness in the U.S.

We see little change to our $73 fair value estimate, as additional 2017 headwinds (guidance suggests low-single-digit revenue growth and flat operating margin, versus our mid-single-digit organic revenue growth estimate and roughly flat operating margin assumption) are offset by the time value of money. In the long term, we still believe that VF can achieve high-single-digit organic revenue growth and operating margin expansion from 14% to just under 16% over the next five years. These assumptions rely on mix shifts to direct-to-consumer and international channels, which we view as likely to accelerate. In our opinion, VF is attractively valued for long-term investors looking to increase apparel exposure.

Fourth-quarter revenue weakness was confined to the U.S. wholesale channel, giving us confidence that brand strength is firmly intact. Direct-to-consumer revenue was up 12% excluding foreign exchange in the fourth quarter, driven by a midteen increase in the Outdoor & Action Sports business and a midteen increase in the international business. E-commerce was up 21% in the quarter, a key metric in establishing that VF will be just as relevant in an Internet

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Analyst Notes

consumer world as it was in the brick-and-mortar one. Overall international revenue was up 7% currency-neutral in the fourth quarter, showing that wholesale weakness was pretty much contained to U.S. markets. With a long runway for growth in China and e-commerce, we think VF is very well positioned to survive wholesale channel declines (down high single digits on a midteen decline in the Americas). We look forward to learning more about VF's long-term growth strategy at next month's investor day.

We were encouraged to see strength in gross margin during the quarter, as this is a key metric for assessing the pricing power of brands. With fourth-quarter adjusted gross margin of 49.8% (up 250 basis points in constant currency), the brand intangible asset underlying our wide moat appears intact. We think continued efforts to strategically manage the brand portfolio, like the decision to limit the off-price channel and roll Lucy product into The North Face brand, will further support this metric. Although the adjusted operating margin of 15.3% was down 30 basis points in constant currency, we attribute this to strategic investments in expanding the direct-to-consumer channel and improving technology, efforts we see as crucial to reaccelerating the top line.

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Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in December

Growth (% YoY)	3-Year Hist. CAGR	2014	2015	2016	*2017* (Forecast)	*2018* (Forecast)	*5-Year Proj. CAGR*
Revenue	*0.1*	7.6	0.8	-7.5	*0.6*	*4.1*	*3.5*
EBIT	*-3.6*	10.6	-1.6	-17.7	*8.6*	*6.2*	*7.4*
EBITDA	*-2.6*	10.4	-1.5	-15.0	*7.4*	*2.9*	*6.2*
Net Income	*1.0*	11.1	-1.9	-5.5	*-2.6*	*9.4*	*5.9*
Diluted EPS	*2.9*	12.8	-0.1	-3.2	*-1.1*	*12.3*	*6.8*
Earnings Before Interest, after Tax	*-0.8*	2.8	-14.6	11.2	*-4.9*	*10.4*	*5.3*
Free Cash Flow	*5.7*	14.6	-38.2	66.8	*1.4*	*-3.6*	*3.9*

Profitability	3-Year Hist. Avg	2014	2015	2016	*2017*	*2018*	*5-Year Proj. Avg*
Operating Margin %	*14.2*	14.9	14.6	13.0	*14.0*	*14.3*	*14.7*
EBITDA Margin %	*16.5*	17.2	16.8	15.4	*16.5*	*16.3*	*16.8*
Net Margin %	*10.9*	11.0	10.7	11.0	*10.6*	*11.2*	*11.5*
Free Cash Flow Margin %	*10.0*	11.0	6.8	12.2	*12.3*	*11.4*	*12.0*
ROIC %	*15.9*	16.7	17.5	13.6	*15.6*	*16.4*	*17.2*
Adjusted ROIC %	*19.9*	21.1	21.9	16.8	*19.0*	*19.7*	*20.5*
Return on Assets %	*11.4*	10.4	12.6	11.1	*12.6*	*14.3*	*14.2*
Return on Equity %	*20.4*	17.9	22.4	20.8	*24.5*	*27.3*	*26.7*

Leverage	3-Year Hist. Avg	2014	2015	2016	*2017*	*2018*	*5-Year Proj. Avg*
Debt/Capital	*0.26*	0.20	0.26	0.32	*0.32*	*0.31*	*0.31*
Total Debt/EBITDA	*0.96*	0.68	0.90	1.31	*1.22*	*1.12*	*1.19*
EBITDA/Interest Expense	*24.10*	26.42	25.24	20.64	*23.48*	*20.55*	*22.89*

Valuation Summary and Forecasts

	2015	2016	*2017(E)*	*2018(E)*
Price/Fair Value	0.76	0.73	—	—
Price/Earnings	20.2	17.9	*17.6*	*15.6*
EV/EBITDA	13.8	13.8	*12.0*	*11.6*
EV/EBIT	15.9	16.5	*14.1*	*13.3*
Free Cash Flow Yield %	3.4	5.9	*5.6*	*6.4*
Dividend Yield %	2.1	2.9	*3.5*	*3.9*

Key Valuation Drivers

Cost of Equity %	9.0
Pre-Tax Cost of Debt %	5.8
Weighted Average Cost of Capital %	8.7
Long-Run Tax Rate %	17.9
Stage II EBI Growth Rate %	5.0
Stage II Investment Rate %	7.1
Perpetuity Year	20

Additional estimates and scenarios available for download at http://select.morningstar.com.

Discounted Cash Flow Valuation

	USD Mil	Firm Value (%)	Per Share Value
Present Value Stage I	11,019	39.6	26.80
Present Value Stage II	7,951	28.6	19.34
Present Value Stage III	8,842	31.8	21.51
Total Firm Value	**27,812**	**100.0**	**67.64**
Cash and Equivalents	1,105	—	2.69
Debt	-2,319	—	-5.64
Preferred Stock	—	—	—
Other Adjustments	-769	—	-1.87
Equity Value	**25,829**	**—**	**62.82**
Projected Diluted Shares	411		
Fair Value per Share (USD)	**64.00**		

The data in the table above represent base-case forecasts in the company's reporting currency as of the beginning of the current year. Our fair value estimate may differ from the equity value per share shown above due to our time value of money adjustment and in cases where probability-weighted scenario analysis is performed.

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51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

Morningstar Analyst Forecasts

Income Statement (USD Mil)
Fiscal Year Ends in December

				Forecast	
	2014	2015	2016	*2017*	*2018*
Revenue	**12,282**	**12,377**	**11,449**	***11,520***	***11,995***
Cost of Goods Sold	6,288	6,394	5,820	*5,815*	*6,026*
Gross Profit	**5,994**	**5,983**	**5,628**	***5,705***	***5,969***
Selling, General & Administrative Expenses	4,160	4,178	4,144	*4,092*	*4,257*
Other Operating Expense (Income)	—	—	—	—	—
Other Operating Expense (Income)	—	—	—	—	—
Depreciation & Amortization (if reported separately)	—	—	—	—	—
Operating Income (ex charges)	**1,834**	**1,805**	**1,485**	***1,613***	***1,712***
Restructuring & Other Cash Charges	396	144	80	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**1,438**	**1,661**	**1,405**	***1,613***	***1,712***
Interest Expense	80	82	86	*81*	*95*
Interest Income	-6	2	2	*0*	*0*
Pre-Tax Income	**1,352**	**1,580**	**1,321**	***1,532***	***1,617***
Income Tax Expense	305	349	205	*309*	*279*
Other After-Tax Cash Gains (Losses)	—	—	-43	*-6*	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	—	—	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	**1,048**	**1,232**	**1,074**	***1,217***	***1,337***
Weighted Average Diluted Shares Outstanding	440	432	422	*415*	*404*
Diluted Earnings Per Share	**2.38**	**2.85**	**2.54**	***2.93***	***3.31***
Adjusted Net Income	1,354	1,329	1,256	*1,223*	*1,337*
Diluted Earnings Per Share (Adjusted)	**3.08**	**3.08**	**2.98**	***2.94***	***3.31***
Dividends Per Common Share	1.11	1.33	1.53	*1.74*	*2.00*
EBITDA	**1,713**	**1,933**	**1,686**	***1,896***	***1,952***
Adjusted EBITDA	**2,109**	**2,077**	**1,766**	***1,896***	***1,952***

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51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in December

	2014	2015	2016	*Forecast 2017*	*2018*
Cash and Equivalents	972	946	1,228	*1,409*	*972*
Investments	—	—	—	—	—
Accounts Receivable	1,276	1,320	1,198	*1,199*	*1,249*
Inventory	1,483	1,612	1,569	*1,466*	*1,519*
Deferred Tax Assets (Current)	—	—	—	—	—
Other Short Term Assets	301	286	298	*298*	*298*
Current Assets	**4,032**	**4,163**	**4,293**	***4,373***	***4,038***
Net Property Plant, and Equipment	942	988	940	*881*	*881*
Goodwill	1,825	1,788	1,737	*1,512*	*1,512*
Other Intangibles	2,434	2,113	1,840	*1,840*	*1,840*
Deferred Tax Assets (Long-Term)	—	—	—	—	—
Other Long-Term Operating Assets	613	587	930	*930*	*930*
Long-Term Non-Operating Assets	—	—	—	—	—
Total Assets	**9,845**	**9,640**	**9,739**	***9,535***	***9,201***
Accounts Payable	691	690	665	*637*	*660*
Short-Term Debt	26	463	280	*280*	*280*
Deferred Tax Liabilities (Current)	—	—	—	—	—
Other Short-Term Liabilities	897	789	841	*591*	*591*
Current Liabilities	**1,614**	**1,942**	**1,785**	***1,508***	***1,531***
Long-Term Debt	1,414	1,402	2,039	*2,039*	*1,900*
Deferred Tax Liabilities (Long-Term)	—	—	—	—	—
Other Long-Term Operating Liabilities	1,187	911	974	*974*	*974*
Long-Term Non-Operating Liabilities	—	—	—	—	—
Total Liabilities	**4,214**	**4,255**	**4,798**	***4,521***	***4,405***
Preferred Stock	—	—	—	—	—
Common Stock	108	107	104	*104*	*104*
Additional Paid-in Capital	2,993	3,193	3,333	*3,333*	*3,333*
Retained Earnings (Deficit)	3,232	3,129	2,545	*3,039*	*3,566*
(Treasury Stock)	—	—	—	*-420*	*-1,165*
Other Equity	-702	-1,043	-1,041	*-1,041*	*-1,041*
Shareholder's Equity	**5,631**	**5,385**	**4,941**	***5,014***	***4,796***
Minority Interest	—	—	—	—	—
Total Equity	**5,631**	**5,385**	**4,941**	***5,014***	***4,796***

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Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in December	2014	2015	2016	*Forecast* 2017	*Forecast* 2018
Net Income	1,048	1,232	1,074	*1,217*	*1,337*
Depreciation	275	272	282	*283*	*240*
Amortization	—	—	—	—	—
Stock-Based Compensation	104	73	68	*67*	*70*
Impairment of Goodwill	396	144	80	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	-78	7	-72	—	—
Other Non-Cash Adjustments	-8	-231	195	—	—
(Increase) Decrease in Accounts Receivable	1	-124	47	*-2*	*-50*
(Increase) Decrease in Inventory	-131	-175	-37	*104*	*-53*
Change in Other Short-Term Assets	—	—	—	—	—
Increase (Decrease) in Accounts Payable	70	14	-10	*-27*	*23*
Change in Other Short-Term Liabilities	20	-65	-149	*-250*	—
Cash From Operations	**1,698**	**1,147**	**1,478**	***1,392***	***1,567***
(Capital Expenditures)	-234	-255	-176	*-225*	*-240*
Net (Acquisitions), Asset Sales, and Disposals	-68	-63	72	*225*	—
Net Sales (Purchases) of Investments	—	—	—	—	—
Other Investing Cash Flows	-27	-5	-8	—	—
Cash From Investing	**-329**	**-323**	**-112**	**—**	***-240***
Common Stock Issuance (or Repurchase)	-693	-702	-952	*-420*	*-746*
Common Stock (Dividends)	-479	-565	-636	*-724*	*-811*
Short-Term Debt Issuance (or Retirement)	5	431	-421	—	—
Long-Term Debt Issuance (or Retirement)	-5	-4	932	—	*-139*
Other Financing Cash Flows	64	57	—	*-67*	*-70*
Cash From Financing	**-1,107**	**-783**	**-1,077**	***-1,211***	***-1,765***
Exchange Rates, Discontinued Ops, etc. (net)	-65	-67	-6	—	—
Net Change in Cash	**195**	**-26**	**282**	***182***	***-438***

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Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Valuation Analysis

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
PVH Corp PVH USA	0.85	10.4	13.8	13.5	8.1	9.0	9.2	9.5	10.4	17.2	1.3	1.5	1.3	0.7	0.9	0.9
Average		10.4	13.8	13.5	8.1	9.0	9.2	9.5	10.4	17.2	1.3	1.5	1.3	0.7	0.9	0.9
VF Corp VFC US	**0.81**	**17.9**	**17.6**	**15.6**	**13.8**	**12.0**	**11.6**	**17.0**	**17.8**	**15.6**	**4.5**	**4.1**	**4.3**	**1.9**	**1.8**	**1.7**

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
PVH Corp PVH USA	— USD	6.7	7.1	7.3	9.5	10.2	10.6	12.8	11.7	9.7	5.3	5.0	4.5	0.2	0.2	0.2
Average		6.7	7.1	7.3	9.5	10.2	10.6	12.8	11.7	9.7	5.3	5.0	4.5	0.2	0.2	0.2
VF Corp VFC US	**9,739** USD	**13.6**	**15.6**	**16.4**	**16.8**	**19.0**	**19.7**	**20.8**	**24.5**	**27.3**	**11.1**	**12.6**	**14.3**	**2.9**	**3.5**	**3.9**

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
PVH Corp PVH USA	8,020 USD	-2.7	2.3	2.3	-7.8	-6.4	4.5	-3.4	-3.6	7.9	23.8	-9.6	-0.5	—	—	—
Average		-2.7	2.3	2.3	-7.8	-6.4	4.5	-3.4	-3.6	7.9	23.8	-9.6	-0.5	—	—	—
VF Corp VFC US	**11,449** USD	**-7.5**	**0.6**	**4.1**	**-17.7**	**8.6**	**6.2**	**-3.2**	**-1.1**	**12.3**	**66.8**	**1.4**	**-3.6**	**15.0**	**13.9**	**15.0**

VF Corp VFC (NYSE) | ★★★★

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Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Profitability Analysis

Company/Ticker	Last Historical Year Net Income (Mil)	Gross Margin % 2016	2017(E)	2018(E)	EBITDA Margin % 2016	2017(E)	2018(E)	Operating Margin % 2016	2017(E)	2018(E)	Net Margin % 2016	2017(E)	2018(E)	Free Cash Flow Margin % 2016	2017(E)	2018(E)
PVH Corp PVH USA	586 USD	51.9	*53.3*	*53.4*	13.8	*13.6*	*13.2*	10.6	*9.7*	*9.9*	7.3	*6.7*	*6.9*	7.9	*8.6*	*5.4*
Average		51.9	*53.3*	*53.4*	13.8	*13.6*	*13.2*	10.6	*9.7*	*9.9*	7.3	*6.7*	*6.9*	7.9	*8.6*	*5.4*
VF Corp VFC US	**1,256** USD	**49.2**	***49.5***	***49.8***	**15.4**	***16.5***	***16.3***	**13.0**	***14.0***	***14.3***	**11.0**	***10.6***	***11.2***	**11.4**	***10.1***	***11.1***

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity % 2016	2017(E)	2018(E)	Debt/Total Cap % 2016	2017(E)	2018(E)	EBITDA/Interest Exp. 2016	2017(E)	2018(E)	Total Debt/EBITDA 2016	2017(E)	2018(E)	Assets/Equity 2016	2017(E)	2018(E)
PVH Corp PVH USA	3,080 USD	67.7	*67.0*	*51.0*	40.4	*40.1*	*33.8*	9.8	*9.7*	*9.2*	2.8	*2.9*	*2.7*	2.3	*2.3*	*2.0*
Average		67.7	*67.0*	*51.0*	40.4	*40.1*	*33.8*	9.8	*9.7*	*9.2*	2.8	*2.9*	*2.7*	2.3	*2.3*	*2.0*
VF Corp VFC US	**2,319** USD	**46.9**	***46.2***	***45.5***	**31.9**	***31.6***	***31.3***	**20.6**	***23.5***	***20.5***	**1.3**	***1.2***	***1.1***	**2.0**	***1.9***	***1.9***

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share 2016	2017(E)	2018(E)	Current Ratio 2016	2017(E)	2018(E)	Quick Ratio 2016	2017(E)	2018(E)	Cash/Short-Term Debt 2016	2017(E)	2018(E)	Payout Ratio % 2016	2017(E)	2018(E)
PVH Corp PVH USA	7,730 USD	6.70	*9.02*	*16.87*	1.84	*1.84*	*2.20*	0.98	*1.00*	*1.36*	21.48	*38.23*	*13.46*	2.2	*2.2*	*2.3*
Average		6.70	*9.02*	*16.87*	1.84	*1.84*	*2.20*	0.98	*1.00*	*1.36*	21.48	*38.23*	*13.46*	2.2	*2.2*	*2.3*
VF Corp VFC US	**20,728** USD	**2.91**	***3.39***	***2.40***	**2.40**	***2.90***	***2.64***	**1.53**	***1.93***	***1.65***	**4.39**	***5.04***	***3.47***	**60.1**	***59.5***	***60.6***

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.

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.

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.

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 when we see signs of deterioration.

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 working-capital 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 pres-

Morningstar Research Methodology for Valuing Companies

ent 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 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 of 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 25% premium.
- ►**Medium:** margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- ►**High:** margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- ►**Very High:** margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- ►**Extreme:** Stock's uncertainty exceeds the parameters we have set for assigning the appropriate margin of safety.

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 detail information 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 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:

Five Stars ★★★★★

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.

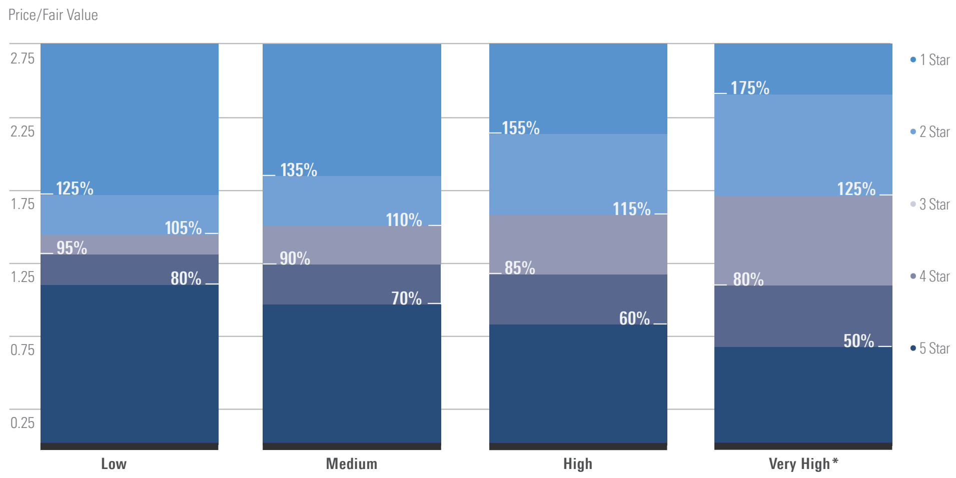
Four Stars ★★★★

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

Three Stars ★★★

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

Morningstar Research Methodology for Valuing Companies



* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

Research Methodology for Valuing Companies

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

One Star ★
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.

Stewardship Rating: Represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

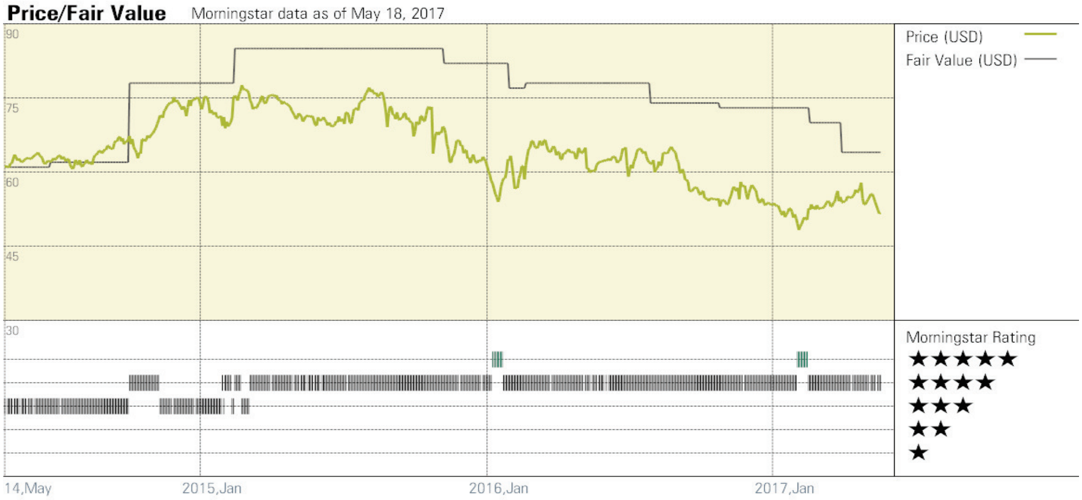
Quantitative Valuation: Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- **Undervalued:** Last Price is below Morningstar's quantitative fair value estimate.
- **Farily Valued:** Last Price is in line with Morningstar's quantitative fair value estimate.
- **Overvalued:** Last Price is above Morningstar's quantitative fair value estimate.

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 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.

VF Corp VFC (NYSE) | ★★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture



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VF Corp VFC (NYSE) | ★★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

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Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
51.76 USD	64.00 USD	Medium	Wide	Positive	Exemplary	Manufacturing - Apparel & Furniture

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