The Hershey Co HSY (NYSE) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
91.59 USD	102.00 USD	71.40 USD	137.70 USD	Medium	Wide	Negative	Standard	Consumer Packaged Goods

Despite tepid performance abroad, the strength of Hershey's brand intangible asset is unwavering.

Updated Forecasts and Estimates from 07 Aug 2015

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

Research as of 07 Aug 2015
Estimates as of 07 Aug 2015
Pricing data through 20 Aug 2015
Rating updated as of 20 Aug 2015

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

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Investment Thesis 07 Aug 2015

Wide-moat Hershey doesn't just rest on the dominance of its U.S. chocolate market (approximately 45% share). For one, the firm invests to bring new products to market (including "hand to mouth" offerings) that win with consumers. Further, as consumers are increasingly shopping the perimeter of the store (at the expense of the center of the store) Hershey is working to ensure its products are in front of consumers, stocking its wares underneath checkouts, between self-checkouts, and at curbside pickups, which we view positively in light of the intensely competitive environment in which it plays.

But we also think building out its international platform and expanding into adjacencies remain top priorities. In that light, management estimates it controls around 10% of the Chinese chocolate market, which we think contributes about 5% to its total sales. While the firm has faltered in the region of late, Hershey intends to extend its distribution in China, particularly in online sales channels, and expand its product set to include more everyday items, away from gifting, where sales have faltered. We think these efforts should prove advantageous longer term, and drive our forecast for international sales growth (about 10% of the firm's total sales) at a high-single-digit rate beginning in 2017. Earlier this year, Hershey also announced the acquisition of Krave Pure Foods, a leading meat jerky player (which is attractive since meat snacks represent a $2.5 billion domestic opportunity which management claims is growing 11%), with $35 million in annual sales. This represents one of the first times Hershey has taken a bigger step outside confectionery, and signals to us an openness to expanding beyond confectionery.

Similar to industry peers, the firm is also attempting to improve its cost structure. While we expect modest margin improvement to result from these efforts--our forecasts call for operating margin expansion of 200 basis points to 21% by fiscal 2019 over 2014 levels--we also anticipate Hershey will reinvest in its core brands in R&D and marketing (which amount to 8% of sales annually in combination or $600 million) to support its brand intangible asset.

Vital Statistics

Market Cap (USD Mil)	20,093
52-Week High (USD)	111.35
52-Week Low (USD)	87.79
52-Week Total Return %	1.9
YTD Total Return %	-10.8
Last Fiscal Year End	31 Dec 2014
5-Yr Forward Revenue CAGR %	3.7
5-Yr Forward EPS CAGR %	7.8
Price/Fair Value	0.90

Valuation Summary and Forecasts

Fiscal Year:	2013	2014	*2015(E)*	*2016(E)*
Price/Earnings	26.5	26.6	*22.2*	*20.6*
EV/EBITDA	14.7	15.1	*12.8*	*12.1*
EV/EBIT	16.9	17.3	*14.8*	*14.0*
Free Cash Flow Yield %	3.9	2.0	*2.4*	*4.5*
Dividend Yield %	1.8	1.9	*2.3*	*2.4*

Financial Summary and Forecasts (USD Mil)

Fiscal Year:	2013	2014	*2015(E)*	*2016(E)*
Revenue	7,146	7,422	*7,601*	*7,872*
Revenue YoY %	7.6	3.9	*2.4*	*3.6*
EBIT	1,358	1,435	*1,494*	*1,576*
EBIT YoY %	17.5	5.7	*4.1*	*5.5*
Net Income, Adjusted	833	876	*921*	*972*
Net Income YoY %	20.7	5.3	*5.1*	*5.6*
Diluted EPS	3.67	3.90	*4.13*	*4.44*
Diluted EPS YoY %	21.3	6.4	*6.0*	*7.4*
Free Cash Flow	822	57	*488*	*896*
Free Cash Flow YoY %	32.9	-93.1	*763.7*	*83.4*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.

Profile

Hershey is the largest confectionery manufacturer in the United States (about a $33 billion market), maintaining around 45% share of the domestic chocolate market. Over its 85-year history, the firm has developed a product portfolio that consists of more than 80 brands, including Hershey's, Reese's, Kit Kat, Twizzlers, and Ice Breakers. Hershey's products are sold in more than 70 countries, with just around 15% of total sales coming from outside of the United States.

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Morningstar Analysis

Cost Savings Fuel Further Brand Investments, but Hershey Muddles Along in China; Shares Attractive 07 Aug 2015

Following second-quarter results, we don't plan to alter our $102 fair value estimate for Hershey, which incorporates our forecast for 5% sales growth longer term and operating margins of 22% by fiscal 2024. In what is historically the firm's smallest quarter, accounting for just one-fifth of annual sales on average the past five years, organic sales ticked up 1.3%. Higher prices and cost savings aided profits, as adjusted gross margins expanded 130 basis points to 46.7% and adjusted operating margins increased 70 basis points to 18.3%. Management reaffirmed its expectation for fiscal 2015 earnings per share of $4.10-$4.18, which we view as reasonable. With the shares off slightly, we think the margin of safety in Hershey, whose wide moat is based on its brand intangible asset and cost edge, is beginning to look attractive, and we suggest investors give the stock a look.

We think the stock's weakness is due in part to lackluster sales in China, which we estimate contributes 5% of consolidated sales, but this segment is too small to significantly affect the firm's consolidated performance. The chocolate category in China grew 6% in the quarter (an acceleration from 4% growth in the first quarter, but still lagging the 8% growth posted in the fourth quarter), but Hershey continues to trail the category with just 4.3% growth. Hershey intends to extend its distribution in China, particularly in online sales channels, and expand its product set to include more everyday items, away from gifting, where sales have faltered. We've long thought Hershey may be challenged as it extends abroad, and while we view efforts to improve its competitive positioning as prudent, we don't expect these initiatives will drive a material acceleration in the firm's international sales, which account for 10% of its total sales, in the near term. Our forecast calls for international sales to resume a high-single-digit rate of top-line growth in fiscal 2017 as investments take hold.

While Hershey's acquisition record appears to have hit a snag following the tie-up with Shanghai Golden Monkey in December 2013, we don't think this is enough reason to avoid the stock. In light of these challenges, CFO Patricia Little recently assumed responsibility for parsing through mergers and acquisitions at Hershey, and we expect the firm will exhibit more prudence in its pursuit of deals going forward. In addition, given the ownership stake of the Milton Hershey School Trust (which maintains 80% voting control of the business), we believe it is highly unlikely the firm will jeopardize its stable cash flows to pursue a larger, more transformative deal and expect its focus will remain on smaller, bolt-on deals. Based on management's commentary and our own estimates, we now suspect Shanghai Golden Monkey generates about half the level of sales--around $90 million annually, which equates to about 25% of its China sales but only 1% of its total sales base--compared with when the deal was inked. In that light, Hershey incurred at a $250 million impairment charge in the quarter (which is nearly half of the enterprise value at purchase) and cited issues surrounding accounts receivables collection and its acquired distributor network. We think this ultimately prompted the retirement of the firm's head of international, Bert Alfonso, earlier this summer.

On its home turf, where it derives nearly 90% of consolidated sales, the firm posted 2% top-line growth, as a 5.8% benefit from higher prices (following the 8% price increase announced a year ago) was offset by a 3.6% retreat in volume. While falling volume is far from a positive, the volume shortfall in the second quarter is not dissimilar to when the firm has raised prices in the past, most recently in 2012. We anticipate this volume degradation will ease over the course of the Halloween and holiday seasons, particularly as the firm spends to support its brand intangible asset; investments behind research and development and marketing amount to about 8% of sales annually or $600

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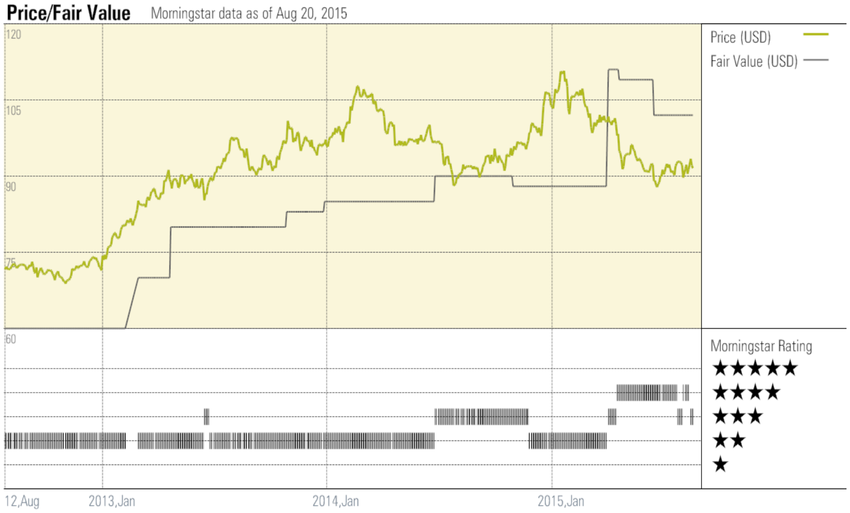
Price/Fair Value Morningstar data as of Aug 20, 2015



million. Further, as consumers are increasingly shopping the perimeter of the store (at the expense of center-of-store categories), we've been encouraged that Hershey is working to ensure its products are in front of consumers where they shop, stocking its wares underneath checkouts, between self-checkouts, and at curbside pickups. We expect Hershey will increase sales in North America at a low- to mid-single-digit rate annually over the course of our 10-year explicit forecast.

Valuation, Growth and Profitability 07 Aug 2015

We're maintaining our $102 per share fair, implies fiscal 2016 price/adjusted earnings of 23 times, enterprise value/adjusted EBITDA of 14 times, and a free cash flow yield of 4%. Hershey's China business (which we estimate accounts for about 5% of consolidated sales) continues to be challenged by a marked deceleration in overall market growth and the firm's efforts to lower trade inventories to match recent demand trends. Hershey intends to extend its distribution in China, particularly in online sales channels, and expand its product set to include more everyday items, away from gifting, where sales have faltered. We've long thought Hershey may be challenged as it extends abroad, and while we view efforts to improve its competitive positioning as prudent, we don't expect these initiatives will drive a material acceleration in the firm's international sales, which account for 10% of its total sales, in the near term. Our forecast calls for international sales to resume a high-single-digit rate of top-line growth in fiscal 2017 as investments take hold, which compares to our forecast for low- to mid-single-digit annual sales growth in North America over the course of our 10-year explicit forecast. Longer term, we expect consolidated sales to growth 5% annually.

In an effort to combat these headwinds, Hershey also is working to extract costs from the operating platform, including the elimination of 300 positions. These plans will result in $100 million-$120 million in charges this year, but will drive $65 million-$75 million in annual savings starting in 2016. On a consolidated basis, we continue to anticipate volatile input costs could prove challenging longer term, but efforts to reduce costs and simplify its supply chain should offset the impact of these pressures. Our long-term forecast still calls for operating margins of 22% by fiscal 2024, about 300 basis points above the level of profits generated in fiscal 2014, as the firm reinvests to support its brand intangible asset; investments behind R&D and marketing amount to about 8% of sales annually or $600 million.

Through 2019, we expect return on invested capital (including goodwill) to average 27% compared with our 7.2% cost of capital assumption, lending support to our opinion that Hershey possesses a wide economic moat.

Scenario Analysis

The biggest risk to our valuation surrounds Hershey's ability to compete and continue generating further margin improvement in an aggressive category, both at home and abroad, and as such, we assign Hershey a medium uncertainty rating. If Hershey is able to wring additional costs from the business--which ultimately drop to the bottom line--and input cost pressures fail to re-emerge, our

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current forecast may be too conservative. In addition, if consumer spending levels tick up and new products resonate with consumers more than our initial expectations, sales growth could accelerate. In this scenario, sales growth would average just north of 7% annually through 2024 (compared with just 4% in our base case), and operating margins would approximate 23% (versus 22% in our base case) at the end of our 10-year explicit forecast. This case results in a fair value estimate of $137 per share.

However, our current forecast could prove to be too optimistic if Hershey is required to ramp up its investments in product innovation and marketing support for core brands because of intense competitive pressures, which could make margin improvement unsustainable. Further, if consumers balk at Hershey's new product offerings or at the firm's prices, sales growth could become sluggish. We assume that sales growth would subsequently average just less than of 2% annually during the next 10 years, while operating margins would amount to 21% by 2024. This scenario results in a fair value estimate of $76 per share.

Economic Moat

The low level of private-label penetration and the prime shelf space afforded to firms in the confectionery industry have earned Hershey, the leading player in the U.S. chocolate market, a wide economic moat. Beyond the resilience of the category (and Hershey's positioning in it), the firm has operated with a renewed emphasis on heavily investing behind its brands via advertising and promotions while increasing its presence on the ground at retail outlets. These efforts are leading to accelerating sales growth and margin expansion at this dominant domestic confectionery player (even as the environment remains intensely competitive across the entire snacking category). For instance, in fiscal 2014, Hershey generated sales growth of 7.6% as well as 70 basis points of adjusted operating margin expansion, which is impressive in light of the higher raw material prices that plagued several firms across the packaged food landscape and Hershey's own strategic efforts to step up brand investments. Management isn't backing down from this spending, targeting one point of top-line growth from new products in fiscal 2015. Returns on invested capital (including goodwill), which have averaged 29% during the past five years, easily exceed our 7.2% estimate for the firm's cost of capital, further supporting our take.

Moat Trend

We contend that Hershey's moat trend is negative. Hershey still benefits from the economies of scale in its manufacturing and distribution as well as its stable of iconic brands, particularly in its core domestic market. However, it has been unable to demonstrate that it can leverage its brands to gain meaningful share in the consolidating global confectionery industry, especially given the varying tastes and preferences of consumers around the world. This point has been particularly evident in its China business of late, which has succumbed to challenges resulting from marked deceleration in overall market growth and the firm's efforts to reduce trade inventories to match recent demand trends. Further, the firm faces aggressive competition from several large and globally diversified firms, namely Mondelez, Nestle, and Mars/Wrigley. In addition, in 2012, Hershey terminated its Indian joint venture with Godrej Industries (which had been in place since 2007) as sales barely budged higher. However, we'd argue that this lack of growth suggests the firm possesses a sizable task in proving that it understands local consumers and can generate outsize growth in this fast-paced market. Given established rivals maintain beachheads in attractive emerging markets, like India, we think Hershey stands to own a smaller slice of the overall pie over time.

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Bulls Say/Bears Say

Bulls Say

- Hershey is attempting to prompt retailers to shrink the shelf space afforded to gum in favor of an expanded candy assortment, which could buoy its competitive positioning at the expense of peers.
- Minimal private-label penetration makes confectionery attractive. In U.S. chocolate, Hershey maintains 45% share versus just 1% for private label. Globally, private-label offerings constitute just 5% of the confectionery space.
- Hershey has worked to surgically remove costs and reinvest those funds behind the R&D and marketing of its core brands, efforts that appear to be gaining traction.

Bears Say

- While input cost pressures have abated, the purchase of Krave will expand Hershey's commodity basket to other proteins, and as such, could increase raw material cost volatility going forward.
- Hershey's sales in China (which we estimate account for 5% of the firm's total sales base) have succumbed to a pronounced slowdown in chocolate category sales and its own executional stumbles and may take time to rebound.
- Lumpy retail traffic and increased promotions from other snack alternatives have pressured Hershey's sales, and we expect this competitive activity will persist in the near term.

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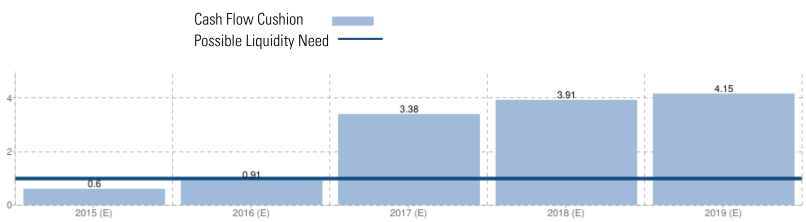
Five Year Adjusted Cash Flow Forecast (USD Mil)

	2015(E)	2016(E)	2017(E)	2018(E)	2019(E)
Cash and Equivalents (beginning of period)	472	144	175	150	158
Adjusted Available Cash Flow	-204	478	543	590	635
Total Cash Available before Debt Service	268	622	718	740	793
Principal Payments	-251	-506	-1	-1	-1
Interest Payments	-91	-95	-97	-99	-99
Other Cash Obligations and Commitments	-108	-81	-114	-89	-91
Total Cash Obligations and Commitments	-450	-682	-212	-189	-191

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	472	27.4
Sum of 5-Year Adjusted Free Cash Flow	2,042	118.4
Sum of Cash and 5-Year Cash Generation	2,514	145.7
Revolver Availability	1,000	58.0
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	3,514	203.7
Sum of 5-Year Cash Commitments	-1,725	—

Financial Health

In our view, Hershey's capital structure is reasonable and appropriate. In addition, we don't believe the firm depends on the capital markets to fund its operations. During the past five years, debt/capital and total debt/EBITDA (excluding restructuring charges) averaged 0.6 and 1.4, respectively. Free cash flow amounted to more than 9% of sales each year on average since fiscal 2010. Debt maturities (of $250 million and $500 million, which are concentrated in fiscal 2015 and 2016, respectively) should be supported by the firm's free cash flow, which we forecast to average north of 12% of sales annually through 2024. At the end of fiscal 2014, operating income covered interest expense just south of 16 times, and we forecast that interest coverage will approximate about 16 times on average over the next five years. We give Hershey an issuer credit rating of A+, implying low default risk.

In January, Hershey announced the acquisition of Krave Pure Foods, a leading meat jerky player, with $35 million in annual sales. This represents one of the first times Hershey has taken a bigger step outside confectionery, and despite the inherent risk, the small size of the deal (at less than 0.5% of sales but for which terms were not announced) limits the impact of such a move. However, we think this deal signals the firm’s openness to expanding its portfolio beyond confectionery and wouldn’t be surprised to see more tie-ups in the same vain. Management has said that an attractive acquisition (likely in the $300 million-$400 million range) would provide it with broader geographic exposure or additional go-to-market strategies (such as access to the untapped distribution routes). Excluding the challenges that have ensued following the tie-up with Shanghai Golden Monkey (a deal that was inked in December 2013), Hershey has shown capital allocation prudence in the past, and we expect it to proceed in the same manner going forward.

Absent a deal, we expect Hershey to return its excess cash

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to shareholders in the form of higher dividends or additional share repurchases. Hershey's dividend currently yields just 2%. Further, Hershey has repurchased about 2% of its shares annually during the past 10 years. We anticipate that the firm will increase its dividend at an average annual rate of 8% over our 10-year explicit forecast (maintaining a 50% dividend payout ratio), while also repurchasing about 2% of outstanding shares annually.

Enterprise Risk

Volatile commodity costs, particularly cocoa, sugar, and dairy costs, may hurt profitability. In particular, dairy costs--which can't be hedged--can ebb and flow. Longer term, we anticipate increased raw material demand in faster-growing emerging markets to keep upward pressure on commodity costs, and as such, may plague the leading domestic chocolate confectionery firm going forward. In addition, management has highlighted that competitive pressures are coming from other confectionery players as well as snacking options outside the confectionery aisle (a particularly challenging predicament given food channel traffic trends remain lackluster). Furthermore, we think that Hershey's growth and expansion efforts could be hindered, as larger and more diversified players maintain established positions in faster-growing emerging markets where tastes and preferences tend to be more localized. And given the significant consolidation that has occurred in the global confectionery arena during the past few years, Hershey may feel compelled to take part by pursuing a deal of its own, which could add risk to operations if it extends the firm beyond its core competencies.In that light, Hershey's acquisition record appears to have hit a snag following the tie-up with Shanghai Golden Monkey in December 2013. Based on management's commentary and our own estimates, we now suspect Shanghai Golden Monkey generates about half the level of sales--around $90 million annually, which equates to about 25% of its China sales but only 1% of its total sales base--compared with when the deal was inked, prompting a $250 million impairment charge (which is nearly half of the enterprise value at purchase). In addition, the firm has cited issues at its local partner surrounding accounts receivable collection and its distributor network. Given enhanced management oversight and the Trust's ownership stake, though, we expect the firm will exhibit more prudence in its pursuit of deals going forward.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
MR. JOHN P. BILBREY	CEO/President/Director,Director	163,131	17 Feb 2015	—
MS. MICHELE G. BUCK	President, Geographical	94,010	17 Feb 2015	—
MR. HUMBERTO P. ALFONSO		70,197	18 Mar 2015	—
ROBERT F. CAVANAUGH	Director	42,745	01 Jul 2015	—
LESLIE M. TURNER	General Counsel/Secretary/Senior VP	32,320	09 Jul 2015	—
GOVERNOR THOMAS J. RIDGE	Director	29,872	01 Jul 2015	—
D. MICHAEL WEGE	Chief Marketing Officer/Other Executive Officer/Senior VP	24,550	07 Jul 2015	2,440

*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 Total Stock Mkt Idx	1.15	0.06	-14	31 Jul 2015
Vanguard Five Hundred Index Fund	0.77	0.07	11	31 Jul 2015
Vanguard Institutional Index Fund	0.72	0.07	3	31 Jul 2015
VA CollegeAmerica Income Fund of America	0.68	0.15	—	30 Jun 2015
SPDR® S&P 500 ETF	0.63	0.07	-11	19 Aug 2015
Concentrated Holders				
HERSHEY COMMON STOCK FDNR -SLF	—	100.00	—	31 Jul 2015
Market Vectors® Mstar Wide Moat ETF	0.21	5.04	—	19 Aug 2015
ICICI Pru US Bluechip Equity	0.01	4.82	—	31 Jul 2015
WBI Large Cap Tactical Yield Shares	0.03	4.27	—	18 Aug 2015
Bright Rock Mid Cap Growth	0.01	4.01	—	31 Jul 2015

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Hershey Employee Savings Stock Investment and Ownership Plan	0.74	14.54	3,098	31 Dec 2007
State Street Global Advisors (Aus) Ltd	0.63	0.07	1,372	18 Aug 2015
Marathon Asset Management LLP	0.53	2.33	1,151	30 Jun 2015
Fidelity Management and Research Company	1.96	0.05	1,108	30 Jun 2015
Janus Capital Management LLC	2.11	0.52	1,047	30 Jun 2015
Top 5 Sellers				
Pioneer Investment Mgmt Inc	0.69	0.49	-794	30 Jun 2015
ING Investment Management LLC	0.05	0.02	-788	30 Jun 2015
BlackRock Advisors LLC	0.31	0.04	-748	30 Jun 2015
Bahl & Gaynor Inc	0.02	0.04	-635	30 Jun 2015
Managed Account Advisors LLC	0.15	0.02	-617	30 Jun 2015

Management 07 Aug 2015

Hershey's stewardship of shareholder capital is Standard. John Bilbrey, 58, assumed the top spot in May 2011 and added the role of chairman in April 2015. Bilbrey, who joined the confectionery company in 2003 and was appointed COO in November 2010, has extensive experience in the consumer products industry (including time spent at Danone and Procter & Gamble), as well as a deep understanding of Hershey's business, which is beneficial to the firm and ultimately its shareholders. Hershey also recently disclosed that CFO Patricia Little will assume responsibility for mergers and acquisitions. We believe this indicates Hershey is committed to expanding its international reach but recognizes partnering with the right local firm that understands a market's consumer base and distribution routes lowers the inherent risk.

Hershey is a controlled company, with 80% of the voting power (but only 32% share ownership) held by the Milton Hershey School Trust. Given this controlled structure, sudden leadership changes (like the departure of former CEO David West in 2011) aren't out of the ordinary for Hershey. For example, in 2002, the trust shook up the board, resulting in the resignation of eight former directors and the previous CEO. In 2009, nonexecutive chairman Ken Wolfe resigned from the board after the trust asked him not to stand for election. While we're not fans of the company's controlled structure, it is hard to take issue with Hershey's stewardship, as the firm has generated returns in excess of our estimate of its cost of capital in each of the past 10 years.

Overall, we believe Hershey's executive compensation structure is reasonable, and the firm's stock ownership requirements for its executive managers, which range from 3 to 5 times base salary, are a plus in our eyes. We also applaud the fact that 72%-86% of an executive's annual pay is based on performance. In fiscal 2014, Bilbrey earned $9.2 million in salary, stock, and option awards.

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Analyst Notes

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Following second-quarter results, we don't plan to alter our $102 fair value estimate for Hershey, which incorporates our forecast for 5% sales growth longer term and operating margins of 22% by fiscal 2024. In what is historically the firm's smallest quarter, accounting for just one-fifth of annual sales on average the past five years, organic sales ticked up 1.3%. Higher prices and cost savings aided profits, as adjusted gross margins expanded 130 basis points to 46.7% and adjusted operating margins increased 70 basis points to 18.3%. Management reaffirmed its expectation for fiscal 2015 earnings per share of $4.10-$4.18, which we view as reasonable. With the shares off slightly, we think the margin of safety in Hershey, whose wide moat is based on its brand intangible asset and cost edge, is beginning to look attractive, and we suggest investors give the stock a look.

We think the stock's weakness is due in part to lackluster sales in China, which we estimate contributes 5% of consolidated sales, but this segment is too small to significantly affect the firm's consolidated performance. The chocolate category in China grew 6% in the quarter (an acceleration from 4% growth in the first quarter, but still lagging the 8% growth posted in the fourth quarter), but Hershey continues to trail the category with just 4.3% growth. Hershey intends to extend its distribution in China, particularly in online sales channels, and expand its product set to include more everyday items, away from gifting, where sales have faltered. We've long thought Hershey may be challenged as it extends abroad, and while we view efforts to improve its competitive positioning as prudent, we don't expect these initiatives will drive a material acceleration in the firm's international sales, which account for 10% of its total sales, in the near term. Our forecast calls for international sales to resume a high-single-digit rate of top-line growth in fiscal 2017 as investments take hold.

While Hershey's acquisition record appears to have hit a snag following the tie-up with Shanghai Golden Monkey in December 2013, we don't think this is enough reason to avoid the stock. In light of these challenges, CFO Patricia Little recently assumed responsibility for parsing through mergers and acquisitions at Hershey, and we expect the firm will exhibit more prudence in its pursuit of deals going forward. In addition, given the ownership stake of the Milton Hershey School Trust (which maintains 80% voting control of the business), we believe it is highly unlikely the firm will jeopardize its stable cash flows to pursue a larger, more transformative deal and expect its focus will remain on smaller, bolt-on deals. Based on management's commentary and our own estimates, we now suspect Shanghai Golden Monkey generates about half the level of sales--around $90 million annually, which equates to about 25% of its China sales but only 1% of its total sales base--compared with when the deal was inked. In that light, Hershey incurred at a $250 million impairment charge in the quarter (which is nearly half of the enterprise value at purchase) and cited issues surrounding accounts receivables collection and its acquired distributor network. We think this ultimately prompted the retirement of the firm's head of international, Bert Alfonso, earlier this summer.

On its home turf, where it derives nearly 90% of consolidated sales, the firm posted 2% top-line growth, as a 5.8% benefit from higher prices (following the 8% price increase announced a year ago) was offset by a 3.6% retreat in volume. While falling volume is far from a positive, the volume shortfall in the second quarter is not dissimilar to when the firm has raised prices in the past, most recently in 2012. We anticipate this volume degradation will ease over the course of the Halloween and holiday seasons, particularly as the firm spends to support its brand intangible

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Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
91.59 USD	102.00 USD	71.40 USD	137.70 USD	Medium	Wide	Negative	Standard	Consumer Packaged Goods

Analyst Notes

asset; investments behind research and development and marketing amount to about 8% of sales annually or $600 million. Further, as consumers are increasingly shopping the perimeter of the store (at the expense of center-of-store categories), we've been encouraged that Hershey is working to ensure its products are in front of consumers where they shop, stocking its wares underneath checkouts, between self-checkouts, and at curbside pickups. We expect Hershey will increase sales in North America at a low- to mid-single-digit rate annually over the course of our 10-year explicit forecast.

Challenges Abroad Prompt Hershey to Reassess 2015 Guidance, Undergo Further Productivity Efforts 19 Jun 2015

Headwinds in China--which were called out during first-quarter earnings--continue to plague Hershey, causing management to lower its full-year outlook to 2.5%-3.5% reported sales growth (versus 4.5%-5.5% previously) and reported earnings per share of $3.62-$3.79 (versus $4.17-$4.28 previously). A portion of the EPS reduction reflects recently announced actions to extract costs from the operating platform, including the elimination of 300 positions. These plans will result in $100 million-$120 million in charges this year, but will drive $65 million-$75 million in annual savings starting in 2016. The company also disclosed that CFO Patricia Little will assume responsibility for mergers and acquisitions. We believe this indicates that Hershey is committed to expanding its international reach but recognizes that partnering with a local firm that understands a market's consumer base and distribution routes lowers the inherent risk.

We've long thought that Hershey may face challenges as it looks to extend abroad, but the headwinds appear to be greater than we initially anticipated. We intend to moderate our international sales forecast for this year, which will probably shave about 5% from our $109 fair value estimate, but we plan to hold the line on our forecast for 5% long-term top-line growth and operating margins approaching 22% over the course of our 10-year explicit forecast. We're encouraged that management intends to reinvest a portion of these savings to support its brand intangible asset, and we're maintaining our wide moat, negative trend rating. Hershey still benefits from economies of scale in its manufacturing and distribution as well as a stable of iconic brands, particularly in its core domestic market where growth persists. However, it has been unable to demonstrate that its brand can gain meaningful share in the consolidating global confectionery industry, especially given the varying tastes and preferences around the world.

We estimate Hershey's China business accounts for about 5% of consolidated sales, and while this news is far from a positive, management has been quick to call out that this is not reflective of a deterioration in Hershey's fundamental business but rather a marked deceleration in overall market growth and the firm's efforts to reduce trade inventories to match recent demand trends. We anticipate Hershey will look to extend its distribution platform in China, particularly in online sales channels. Further, investments behind its core brands, which in the aggregate amount to more than 8% of sales annually, or $600 million, are a positive but will probably take time before yielding measurable improvements.

Hershey's China Sales Sour, but Brand Intangible Asset Unwavering; Shares Look Attractive 23 Apr 2015

On the surface, Hershey's first-quarter results, which included 3% organic sales growth and 10 basis points of adjusted gross margin expansion to 46.6%, seemed fair. Digging deeper, however, the drastic slowdown realized in the China business, which we estimate accounts for about 5% of Hershey's consolidated sales, but where underlying sales contracted 47% year over year, was a notable negative for a firm that has generally proved to be a consistent operator. Management was quick to call out that this was not reflective of a deterioration in Hershey's fundamental

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Analyst Notes

business but rather a marked deceleration in overall market growth and the firm's efforts to reduce trade inventories to match recent demand trends. More specifically, Hershey disclosed that China's chocolate category ticked up a mere 4% in the first three months of the year, down from 8% growth in the fourth quarter and 10%-11% growth in the year-ago period.

In light of this performance, management lowered its full-year organic sales growth target to 3.5%-4.5%, versus 4%-6% growth previously. Adjusting our near-term top-line expectations (which will probably call for 5% consolidated sales growth, down from 7%, including just 5% growth in the international segment, down from 11%) shaves $2 from our $111 fair value estimate. However, with the shares off slightly, and given the strength that exudes from Hershey's solid brand intangible asset, we think the margin of safety in this wide-moat name is beginning to look attractive. While we've long surmised Hershey could face challenges as it looks to extend its reach abroad, we don't believe recent results reflect an erosion in its competitive edge, as we suspect that investments behind product innovation and marketing support (which in the aggregate amount to more than 8% of sales annually or $600 million) will ensure Hershey's brand intangible asset remains firmly in place.

Looking at Hershey's North America results (which account for 85% of its total sales base), underlying revenue increased 3.4%, as higher prices offset a minor contraction in volume, which partially reflected a shorter Easter selling season compared with a year ago. We note that competitive pressures across the snacking realm remain intense, and as such, we view positively Hershey's efforts to surgically remove costs from its business and reinvest those funds behind its core brands. While input cost challenges have abated to a modest degree, the firm's purchase of Krave will expand its commodity basket to other proteins and as such could increase raw material cost volatility in the years ahead.

The Hershey Co HSY (NYSE) | ★★★

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Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in December

Growth (% YoY)	3-Year Hist. CAGR	2012	2013	2014	*Forecast 2015*	*2016*	*5-Year Proj. CAGR*
Revenue	*6.9*	9.3	7.6	3.9	*2.4*	*3.6*	*3.7*
EBIT	*10.8*	9.7	17.5	5.7	*4.1*	*5.5*	*5.7*
EBITDA	*9.1*	7.6	14.2	5.6	*5.2*	*5.2*	*5.7*
Net Income	*12.0*	10.8	20.7	5.3	*5.1*	*5.6*	*6.1*
Diluted EPS	*12.9*	11.5	21.3	6.4	*6.0*	*7.4*	*7.8*
Earnings Before Interest, after Tax	*4.9*	-5.7	11.5	9.9	*-25.8*	*62.0*	*8.1*
Free Cash Flow	*-42.0*	113.4	32.9	-93.1	*763.7*	*83.4*	*83.0*

Profitability	3-Year Hist. Avg	2012	2013	2014	*2015*	*2016*	*5-Year Proj. Avg*
Operating Margin %	*18.6*	17.4	19.0	19.3	*19.7*	*20.0*	*20.5*
EBITDA Margin %	*21.5*	20.6	21.8	22.2	*22.8*	*23.2*	*23.6*
Net Margin %	*11.3*	10.4	11.7	11.8	*12.1*	*12.4*	*12.7*
Free Cash Flow Margin %	*7.2*	9.3	11.5	0.8	*6.4*	*11.4*	*11.1*
ROIC %	*29.1*	28.2	30.8	28.3	*25.1*	*25.3*	*26.7*
Adjusted ROIC %	*36.5*	35.4	38.7	35.6	*31.4*	*31.3*	*33.0*
Return on Assets %	*15.4*	14.4	16.2	15.4	*10.1*	*17.1*	*16.7*
Return on Equity %	*62.5*	70.1	62.1	55.4	*41.6*	*72.4*	*66.6*

Leverage	3-Year Hist. Avg	2012	2013	2014	*2015*	*2016*	*5-Year Proj. Avg*
Debt/Capital	*0.60*	0.65	0.55	0.60	*0.64*	*0.61*	*0.60*
Total Debt/EBITDA	*1.33*	1.40	1.26	1.33	*1.27*	*1.21*	*1.14*
EBITDA/Interest Expense	*16.57*	13.87	17.04	18.80	*19.05*	*19.26*	*20.15*

Valuation Summary and Forecasts

	2013	2014	*2015(E)*	*2016(E)*
Price/Fair Value	1.14	1.18	—	—
Price/Earnings	26.5	26.6	*22.2*	*20.6*
EV/EBITDA	14.7	15.1	*12.8*	*12.1*
EV/EBIT	16.9	17.3	*14.8*	*14.0*
Free Cash Flow Yield %	3.9	2.0	*2.4*	*4.5*
Dividend Yield %	1.8	1.9	*2.3*	*2.4*

Key Valuation Drivers

Cost of Equity %	7.5
Pre-Tax Cost of Debt %	5.8
Weighted Average Cost of Capital %	7.2
Long-Run Tax Rate %	34.5
Stage II EBI Growth Rate %	5.0
Stage II Investment Rate %	6.7
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	7,615	31.5	34.47
Present Value Stage II	6,833	28.2	30.93
Present Value Stage III	9,743	40.3	44.11
Total Firm Value	**24,191**	**100.0**	**109.51**
Cash and Equivalents	472	—	2.14
Debt	-2,184	—	-9.89
Preferred Stock	—	—	—
Other Adjustments	-586	—	-2.65
Equity Value	**21,892**	**—**	**99.10**
Projected Diluted Shares	221		
Fair Value per Share (USD)	—		

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.

The Hershey Co HSY (NYSE) | ★★★

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Morningstar Analyst Forecasts

Income Statement (USD Mil)
Fiscal Year Ends in December

				Forecast	
	2012	2013	2014	*2015*	*2016*
Revenue	**6,644**	**7,146**	**7,422**	***7,601***	***7,872***
Cost of Goods Sold	3,784	3,865	4,086	*4,104*	*4,243*
Gross Profit	**2,860**	**3,281**	**3,336**	***3,496***	***3,629***
Selling, General & Administrative Expenses	975	1,091	1,072	*1,140*	*1,161*
Research & Development	39	48	48	*38*	*39*
Advertising & Marketing	480	582	570	*585*	*606*
Depreciation & Amortization (if reported separately)	210	201	212	*238*	*246*
Operating Income (ex charges)	**1,156**	**1,358**	**1,435**	***1,494***	***1,576***
Restructuring & Other Cash Charges	45	19	46	*250*	*35*
Impairment Charges (if reported separately)	—	—	—	*300*	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**1,111**	**1,340**	**1,390**	***944***	***1,541***
Interest Expense	99	92	88	*91*	*95*
Interest Income	3	3	4	*3*	*3*
Pre-Tax Income	**1,016**	**1,251**	**1,306**	***857***	***1,450***
Income Tax Expense	355	431	459	*295*	*500*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	—	—	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	**661**	**820**	**847**	***561***	***949***
Weighted Average Diluted Shares Outstanding	228	227	225	*223*	*219*
Diluted Earnings Per Share	**2.89**	**3.61**	**3.77**	***2.52***	***4.34***
Adjusted Net Income	690	833	876	*921*	*972*
Diluted Earnings Per Share (Adjusted)	**3.02**	**3.67**	**3.90**	***4.13***	***4.44***
Dividends Per Common Share	1.49	1.73	1.96	*2.07*	*2.22*
EBITDA	**1,321**	**1,541**	**1,601**	***1,183***	***1,787***
Adjusted EBITDA	**1,366**	**1,559**	**1,647**	***1,733***	***1,822***

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Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in December	2012	2013	2014	*Forecast 2015*	*Forecast 2016*
Cash and Equivalents	728	1,119	472	*144*	*175*
Investments	—	—	—	—	—
Accounts Receivable	461	478	597	*604*	*618*
Inventory	633	660	801	*798*	*818*
Deferred Tax Assets (Current)	122	53	101	*101*	*101*
Other Short Term Assets	168	179	277	*283*	*293*
Current Assets	**2,113**	**2,487**	**2,247**	***1,930***	***2,005***
Net Property Plant, and Equipment	1,674	1,805	2,152	*2,304*	*2,430*
Goodwill	588	577	793	*793*	*793*
Other Intangibles	215	195	295	*284*	*274*
Deferred Tax Assets (Long-Term)	12	—	—	—	—
Other Long-Term Operating Assets	152	293	143	*146*	*151*
Long-Term Non-Operating Assets	—	—	—	—	—
Total Assets	**4,755**	**5,357**	**5,630**	***5,458***	***5,654***
Accounts Payable	442	462	482	*484*	*501*
Short-Term Debt	376	167	636	*450*	*450*
Deferred Tax Liabilities (Current)	—	—	—	—	—
Other Short-Term Liabilities	653	780	818	*838*	*868*
Current Liabilities	**1,471**	**1,408**	**1,936**	***1,772***	***1,818***
Long-Term Debt	1,531	1,795	1,549	*1,750*	*1,750*
Deferred Tax Liabilities (Long-Term)	36	104	99	*99*	*99*
Other Long-Term Operating Liabilities	136	138	142	*146*	*151*
Long-Term Non-Operating Liabilities	532	296	384	*384*	*384*
Total Liabilities	**3,706**	**3,741**	**4,110**	***4,151***	***4,202***
Preferred Stock	—	—	—	—	—
Common Stock	360	360	360	*360*	*360*
Additional Paid-in Capital	593	665	754	*754*	*754*
Retained Earnings (Deficit)	5,028	5,454	5,861	*5,961*	*6,424*
(Treasury Stock)	-4,559	-4,708	-5,161	*-5,476*	*-5,797*
Other Equity	-385	-167	-359	*-359*	*-359*
Shareholder's Equity	**1,037**	**1,605**	**1,455**	***1,241***	***1,383***
Minority Interest	12	11	64	*66*	*68*
Total Equity	**1,048**	**1,616**	**1,520**	***1,307***	***1,451***

The Hershey Co HSY (NYSE) | ★★★

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91.59 USD	102.00 USD	71.40 USD	137.70 USD	Medium	Wide	Negative	Standard	Consumer Packaged Goods

Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in December	2012	2013	2014	*Forecast 2015*	*2016*
Net Income	661	820	847	*561*	*949*
Depreciation	199	190	200	*228*	*236*
Amortization	11	11	11	*10*	*10*
Stock-Based Compensation	50	54	54	*58*	*59*
Impairment of Goodwill	—	—	—	—	—
Impairment of Other Intangibles	38	—	40	—	—
Deferred Taxes	14	7	19	—	—
Other Non-Cash Adjustments	-78	-106	-107	—	—
(Increase) Decrease in Accounts Receivable	-50	-17	-67	*-7*	*-14*
(Increase) Decrease in Inventory	27	-26	-88	*3*	*-20*
Change in Other Short-Term Assets	—	—	—	*-7*	*-10*
Increase (Decrease) in Accounts Payable	22	13	-14	*2*	*16*
Change in Other Short-Term Liabilities	202	240	-57	*20*	*30*
Cash From Operations	**1,095**	**1,188**	**838**	***868***	***1,256***
(Capital Expenditures)	-278	-351	-371	*-380*	*-362*
Net (Acquisitions), Asset Sales, and Disposals	-172	15	-395	—	—
Net Sales (Purchases) of Investments	—	—	-97	—	—
Other Investing Cash Flows	-23	-16	—	*0*	*0*
Cash From Investing	**-473**	**-352**	**-863**	***-380***	***-362***
Common Stock Issuance (or Repurchase)	-249	-158	-454	*-315*	*-321*
Common Stock (Dividends)	-341	-394	-440	*-461*	*-486*
Short-Term Debt Issuance (or Retirement)	78	54	118	*-186*	—
Long-Term Debt Issuance (or Retirement)	-95	0	2	*201*	—
Other Financing Cash Flows	21	51	56	*-56*	*-56*
Cash From Financing	**-587**	**-447**	**-719**	***-816***	***-863***
Exchange Rates, Discontinued Ops, etc. (net)	—	—	—	—	—
Net Change in Cash	**35**	**390**	**-744**	***-328***	***31***

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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	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Nestle SA NSRGY USA	0.88	14.2	22.2	20.6	15.7	14.3	13.4	13.4	25.7	24.3	3.3	3.3	3.2	2.5	2.6	2.5
Average		14.2	22.2	20.6	15.7	14.3	13.4	13.4	25.7	24.3	3.3	3.3	3.2	2.5	2.6	2.5
The Hershey Co HSY US	**0.90**	**26.6**	**22.2**	**20.6**	**15.1**	**12.8**	**12.1**	**49.1**	**41.2**	**22.5**	**15.8**	**16.2**	**14.5**	**3.1**	**2.6**	**2.6**

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Nestle SA NSRGY USA	133,450 CHF	—	—	—	18.1	18.7	19.7	21.8	14.8	15.5	11.4	7.8	8.2	3.0	3.1	3.2
Average		—	—	—	18.1	18.7	19.7	21.8	14.8	15.5	11.4	7.8	8.2	3.0	3.1	3.2
The Hershey Co HSY US	**5,630** USD	**28.3**	**25.1**	**25.3**	**35.6**	**31.4**	**31.3**	**55.4**	**41.6**	**72.4**	**15.4**	**10.1**	**17.1**	**1.9**	**2.3**	**2.4**

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Nestle SA NSRGY USA	91,865 CHF	-0.6	-0.4	3.4	-2.8	10.7	7.9	56.0	-33.0	7.5	52.2	-46.6	4.8	4.9	5.2	5.2
Average		-0.6	-0.4	3.4	-2.8	10.7	7.9	56.0	-33.0	7.5	52.2	-46.6	4.8	4.9	5.2	5.2
The Hershey Co HSY US	**7,422** USD	**3.9**	**2.4**	**3.6**	**5.7**	**4.1**	**5.5**	**6.4**	**6.0**	**7.4**	**-93.1**	**763.7**	**83.4**	**13.0**	**5.5**	**7.4**

The Hershey Co HSY (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 % 2014	2015(E)	2016(E)	EBITDA Margin % 2014	2015(E)	2016(E)	Operating Margin % 2014	2015(E)	2016(E)	Net Margin % 2014	2015(E)	2016(E)	Free Cash Flow Margin % 2014	2015(E)	2016(E)
Nestle SA NSRGY USA	15,738 CHF	48.2	48.5	49.0	17.3	18.8	19.5	14.0	15.5	16.2	17.1	11.5	11.8	18.7	10.0	10.2
Average		48.2	48.5	49.0	17.3	18.8	19.5	14.0	15.5	16.2	17.1	11.5	11.8	18.7	10.0	10.2
The Hershey Co HSY US	**876** USD	**45.0**	**46.0**	**46.1**	**22.2**	**22.8**	**23.2**	**19.3**	**19.7**	**20.0**	**11.8**	**12.1**	**12.4**	**6.3**	**6.4**	**11.4**

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity % 2014	2015(E)	2016(E)	Debt/Total Cap % 2014	2015(E)	2016(E)	EBITDA/Interest Exp. 2014	2015(E)	2016(E)	Total Debt/EBITDA 2014	2015(E)	2016(E)	Assets/Equity 2014	2015(E)	2016(E)
Nestle SA NSRGY USA	23,048 CHF	32.9	33.6	33.0	24.7	25.2	24.8	20.6	20.9	21.6	1.5	1.4	1.3	1.9	1.9	1.9
Average		32.9	33.6	33.0	24.7	25.2	24.8	20.6	20.9	21.6	1.5	1.4	1.3	1.9	1.9	1.9
The Hershey Co HSY US	**2,184** USD	**150.1**	**177.3**	**159.1**	**60.0**	**63.9**	**61.4**	**18.8**	**19.0**	**19.3**	**1.3**	**1.3**	**1.2**	**3.9**	**4.4**	**4.1**

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share 2014	2015(E)	2016(E)	Current Ratio 2014	2015(E)	2016(E)	Quick Ratio 2014	2015(E)	2016(E)	Cash/Short-Term Debt 2014	2015(E)	2016(E)	Payout Ratio % 2014	2015(E)	2016(E)
Nestle SA NSRGY USA	240,735 USD	2.33	2.71	2.78	1.02	1.05	1.06	0.74	0.77	0.78	0.85	0.96	0.97	47.5	68.5	67.0
Average		2.33	2.71	2.78	1.02	1.05	1.06	0.74	0.77	0.78	0.85	0.96	0.97	47.5	68.5	67.0
The Hershey Co HSY US	**20,093** USD	**2.10**	**0.65**	**0.80**	**1.16**	**1.09**	**1.10**	**0.75**	**0.64**	**0.65**	**0.74**	**0.32**	**0.39**	**52.0**	**82.1**	**51.2**

Research Methodology for Valuing Companies

Components of Our Methodology

- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

We believe 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: our assessment of the firm's economic moat, our estimate of the stock's fair value, our uncertainty around that fair value estimate and the current market price. This process ultimately culminates in our single-point star rating. Underlying this rating is a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's equity analysts.

The concept of the Morningstar Economic Moat™ Rating plays a vital role not only in our qualitative assessment of a firm's investment potential, but also in our actual calculation of our fair value estimates. We assign three moat ratings—none, narrow, or wide—as well as the Morningstar Moat Trend™ Rating—positive, stable, or negative—to each company we cover. Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns on invested capital over 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. The assumptions that we make about a firm's economic moat play a vital role in determining the length of "economic outperformance" that we assume in the terminal sections of our valuation model. To assess the sustainability of excess profits, analysts perform ongoing assessments of what we call 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.

At the heart of our valuation system is a detailed projection of a company's future cash flows. The first stage of our three-stage discounted cash flow model can last from 5 to 10 years and contains numerous detailed assumptions about various financial and operating items. The second stage of our model—where a firm's return on new invested capital (RONIC) and earnings growth rate implicitly fade until the perpetuity year—can last anywhere from one year (for companies with no economic moat) to 10-15 years (for wide-moat companies). In our third stage, we assume the firm's RONIC equals its weighted average cost of capital, and we calculate a continuing value using a standard perpetuity formula. In deciding on the rate at which to discount future cash flows, we use a building block approach,

Morningstar Research Methodology for Valuing Companies

Economic Moat
Financial Health
Stewardship
Uncertainty
Moat Trend

Morningstar Fair Value

Margin of Safety
Market Pricing

Morningstar Rating™ For Stocks
★★★★★

Source: Morningstar, Inc.

Detailed Methodology Documents and Materials*

- Comprehensive Equity Research Methodology
- Uncertainty Methodology
- Cost of Equity Methodology
- Morningstar DCF Valuation Model
- Stewardship Rating Methodology

*Please contact a sales representative for more information.

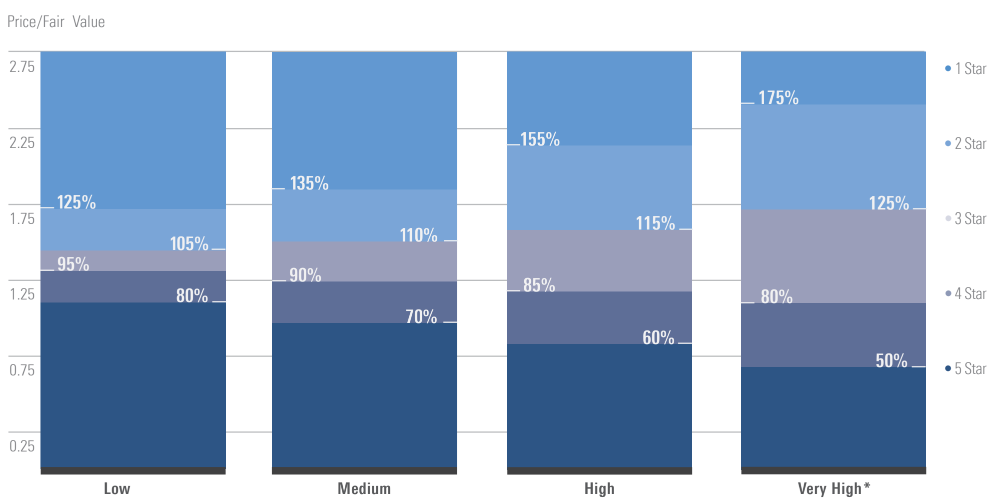
which takes into account expectations for market real return, inflation, country risk premia, corporate credit spread, and any additional systematic risk.

We also employ a number of other tools to augment our valuation process, including scenario analysis, where we assess the likelihood and performance of a business under different economic and firm-specific conditions. Our analysts model three scenarios for each company we cover, stress-testing the model and examining the distribution of resulting fair values.

The Morningstar Uncertainty Rating captures the range of likely potential fair values 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.

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 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.

Morningstar Margin of Safety and Star Rating Bands

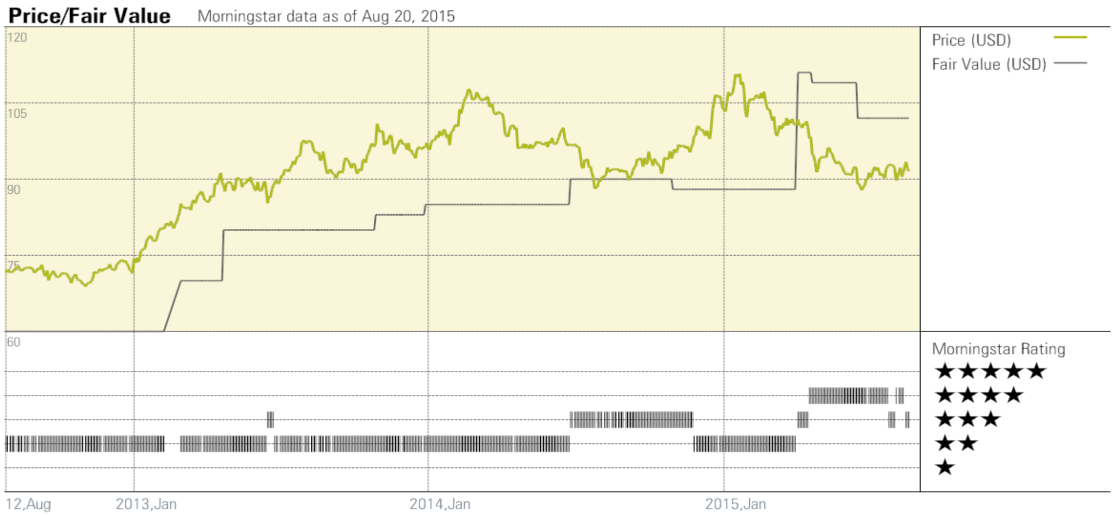


* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

Source: Morningstar, Inc.

The Hershey Co HSY (NYSE) | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
91.59 USD	102.00 USD	71.40 USD	137.70 USD	Medium	Wide	Negative	Standard	Consumer Packaged Goods



The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic value.

Five-star stocks sell for the biggest risk-adjusted discount whereas one-star stocks trade at premiums to their intrinsic value. Based on a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's Equity Analysts, four key components drive the Morningstar Rating: 1. Assessment of the firm's economic moat, 2. Estimate of the stock's fair value, 3. Uncertainty around that fair value estimate and 4. Current market price. Further information on Morningstar's methodology is available from http://global.morningstar.com/equitydisclosures.

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The Hershey Co HSY (NYSE) | ★★★

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