Apple manufactures PCs, MP3 players, smartphones, tablet computers, software and peripherals for a worldwide customer base. Its products include the Macintosh line of desktop and mobile PCs, the iPod MP3 line, the iPhone, the iPad, and various consumer products, including Apple TV. Apple also owns and operates iTunes, the world’s largest vendor of recorded music. Apple derives 40%-45% of its revenue from the Americas, 20%-25% from Europe/MEA, 12%-16% from Asia-Pacific, and 15%-18% from its own retail stores.

**Analyst’s Notes**

*Analysis by Jim Kelleher, CFA, March 21, 2016*

**ARGUS RATING: BUY**

- New tweener phone seeks global mid-tier
- At its March 21 launch event, Apple introduced the iPhone 5SE, which replaces the 5S. The new phone is aimed at mid-tier customers in both emerging and mature economies.
- The 5SE contains some of the features of the iPhone 6S, but lacks certain high-end features. Apple also introduced a refreshed iPad Pro in the original size - a needed upgrade for a product that has been marginalized by smaller (Mini) and larger (Pro) versions.
- The iPhone 7 will be launched in September. In our view, the new phone will need to address frequent customer complaints by including greater base memory, increased battery life, and wireless charging.
- AAPL remains attractive on priced-based comparables and discounted free cash flow valuation. We are reiterating our BUY rating to a 12-month target price of $135.

**INVESTMENT THESIS**

BUY-rated Apple Inc. (NGS: AAPL) has broken with its usual iPhone launch pattern to introduce a mid-tier phone, the iPhone 5SE. The new 4-inch model replaces the iPhone 5S, while incorporating some of the features of the iPhone 6 line. Up-to-date features include Touch ID and a camera upgrade from the 5S. We believe that Apple is using this mid-tier phone to target middle class consumers in emerging economies. But the phone will also likely generate sales in mature economies from consumers who wish to join or remain in the Apple ecosystem at a reduced price.

Apple also refreshed its standard-sized iPad, which has been overshadowed both by the iPad Mini and the larger iPad Pro. Apple always fills out these events with software upgrades and tweaks. But investors are plainly focused on the potential of Apple’s new tweener phone. Apple has refreshed its flagship iPhone on a two-year cycle, with the number model followed the next year by the ‘S’ refresh. With each new iteration of the iPhone, the falloff in year two has worsened. Introducing the 5SE may change this.
predictable downcycle, in a move beneficial both to Apple and its suppliers, including BUY-rated Qualcomm, Broadcom, and Analog Devices.

The iPhone 5SE will not arrive in time or be sufficient to save the current quarter from the decline in iPhone 6S demand ahead of the expected September 2016 launch of the iPhone 7. Still, Apple generates enormous revenue even in seasonally weaker quarters, which drives cash flow and EPS growth. Even after recovering with the market, Apple’s positives are not fully reflected in the share price, while the familiar negatives (currency & commodities) are fully discounted. In our view, AAPL remains attractive on priced-based comparables and discounted free cash flow valuation. We are reiterating our BUY rating to a 12-month target price of $135.

RECENT DEVELOPMENTS

AAPL is up 1% thus far in 2016, slightly below the 2% year-to-date gain for the peer group of computing & information-processing companies in Argus coverage. In 2015, AAPL fell 5% (after holding a 12% gain as of early November), its first down year in a decade; the peer group declined 16%. AAPL shares rose 38% in 2014, ahead of the peer group’s 16% gain and the 11.4% capital appreciation (13% total return) for the S&P 500.

AAPL fell about 5% on 1/27/16 after reporting above-consensus fiscal 1Q16 results, but guiding for fiscal 2Q16 revenue of $50-$53 billion, which at the guidance midpoint would be down 11% annually (mostly due to unfavorable currency). We note the current quarter comes in the final innings of an ‘S’ iPhone year, which is historically consistent with tapering demand.

Since making a 2016 low in the mid-$90s in February, however, AAPL shares have recovered by more than $10 and are now just above break-even for the year. The bulk of the gain likely reflects recovery in the broad market, where leadership has swung to economically sensitive sectors, including technology. AAPL investors have contended with a mixed outlook, which includes weak guidance from key suppliers such as Jabil Circuit, but also reports of rising demand in key emerging markets. The least influential driver in the share price, in our view, has been the March 21 Apple event.

As usual heading into the event, Apple’s top-secret plans were the worst-kept secret in Silicon Valley. But Apple always manages to pull a few surprises. The company led off the presentation with several health-oriented apps, including Carekit. The first products shown were new Apple Watch bands, including nylon woven bands, in time for summer. Almost incidentally, Apple announced Apple Watches for $299 (specifically the Apple Watch Sport), the first price cut for this formerly $349 product. And CEO Tim Cook showed off some of the more than 5,000 apps now available for Apple TV.

Half an hour into the event, Apple finally got to the main menu: the iPhone 5SE. Apple’s Greg Joswiak noted that amid all the reports of rising demand in key emerging markets. The least influential driver in the share price, in our view, has been the March 21 Apple event.

Financial & Risk Analysis

GROWTH RATES (%)

GROWTH ANALYSIS

($ in Millions, except per share data)

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
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<tbody>
<tr>
<td>Revenue</td>
<td>108,249</td>
<td>156,508</td>
<td>170,910</td>
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<tr>
<td>COGS</td>
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<td>87,846</td>
<td>106,606</td>
<td>109,347</td>
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<tr>
<td>Gross Profit</td>
<td>43,818</td>
<td>68,662</td>
<td>64,304</td>
<td>66,688</td>
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<tr>
<td>SG&amp;A</td>
<td>7,599</td>
<td>10,040</td>
<td>10,830</td>
<td>11,303</td>
<td>13,068</td>
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<tr>
<td>R&amp;D</td>
<td>2,429</td>
<td>3,381</td>
<td>4,475</td>
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<td>7,102</td>
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<tr>
<td>Operating Income</td>
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<td>55,241</td>
<td>50,287</td>
<td>63,971</td>
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<tr>
<td>Interest Expense</td>
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<tr>
<td>Pretax Income</td>
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<td>55,763</td>
<td>51,105</td>
<td>64,936</td>
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<td>Income Taxes</td>
<td>8,283</td>
<td>14,030</td>
<td>13,938</td>
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<td>Tax Rate (%)</td>
<td>24</td>
<td>25</td>
<td>26</td>
<td>26</td>
<td>26</td>
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<tr>
<td>Net Income</td>
<td>25,922</td>
<td>41,733</td>
<td>37,037</td>
<td>47,808</td>
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<td>Diluted Shares Outstanding</td>
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<td>6,522</td>
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<td>EPS</td>
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<tr>
<td>Dividend</td>
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<td></td>
<td></td>
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<td>0.47</td>
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GROWTH RATES (%)

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<tr>
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<tr>
<td>Revenue</td>
<td>66.0</td>
<td>44.6</td>
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<td>Operating Income</td>
<td>83.8</td>
<td>63.5</td>
<td>-11.3</td>
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<tr>
<td>Net Income</td>
<td>85.0</td>
<td>61.0</td>
<td>-11.3</td>
<td>6.7</td>
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<tr>
<td>EPS</td>
<td>82.6</td>
<td>59.5</td>
<td>-9.9</td>
<td>13.6</td>
<td>42.8</td>
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<tr>
<td>Dividend</td>
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<td></td>
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<td></td>
<td>321.3</td>
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<tr>
<td>Sustainable Growth Rate</td>
<td></td>
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<td></td>
<td>31.2</td>
<td>36.3</td>
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VALUATION ANALYSIS

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<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<tbody>
<tr>
<td>Price/High</td>
<td></td>
<td>$61,298.96</td>
<td>$49,538.25</td>
<td>$72,824.10</td>
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<tr>
<td>Price/Low</td>
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<td>$44,655.64</td>
<td>$33,826.59</td>
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<td>$104.00</td>
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<tr>
<td>Price/Sales: High-Low</td>
<td>-9,591.8</td>
<td>-1,888,890.3</td>
<td>-1,290,532.9</td>
<td>-1,521.2</td>
<td>3.6 - 2.8</td>
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<tr>
<td>P/E: High-Low</td>
<td>-9,719.0</td>
<td>-7,081.271.5</td>
<td>-5,953,929.6</td>
<td>-6,780.7</td>
<td>14.4 - 11.3</td>
</tr>
<tr>
<td>Price/Cash Flow: High-Low</td>
<td>-7,467.0</td>
<td>-4,484.4</td>
<td>9.5 - 7.4</td>
<td></td>
<td></td>
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</tbody>
</table>
Analyst's Notes...Continued

iPhone 6/6Plus hoopla, last year Apple sold 30 million phones in the 4-inch format (the iPhone 5S), mainly to first-time iPhone buyers. Visually, Apple did not do much to update the appearance of the phone, though the new 5SE comes in the popular rose gold option.

Internally, there are upgrades from the 5S, including a 64-bit A9 processor and M9 motion coprocessor. The iPhone 5SE also has a 12-megapixel camera and the ‘live photo’ option included with the 6S. The new mid-tier phone supports Apple Pay. 5SE, in fact, packs most features of the 6 and 6S models, but not 3D Touch. The phone is priced at $399 for a 16 GB model and $499 for a 64 GB model. Apple also promised ‘incredible’ battery life, although iPhone batteries are often overhyped and usually disappointing.

The phone will be available for pre-order beginning 3/24/16 and available for physical pick-up on 3/31/16. The 5SE will be available in 100 countries by the end of May. We believe the target markets will include major emerging economies such as Indonesia and Malaysia.

The iPhone 5ES presentation took less than 10 minutes, with Mr. Joswiak shifting to a discussion of iOS 9.3. Phil Shiller followed in rapid-fire fashion to discuss the iPad, including the strong reception for the iPad Pro and its 12.9-inch screen. Mr. Shiller introduced the ‘second member’ of the iPad Pro family, which like original iPad, has a 9.7-inch screen. Apple has sold 200 million iPads in this format.

The new smaller Pro has screen technology that is 40% less reflective and 25% brighter than the iPad Air 2. True Tone technology adapts screen brightness to ambient light. Like the larger Pro, this unit comes with Apple Pencil. The smaller Pro starts at $599 and runs up to $899. The larger Pro starts at $799 and goes up to $1,099 depending on memory configuration. 3D Touch was not mentioned, suggesting it won’t be on the revised iPad Pro. That absence was not surprising on the iPhone 5SE; it is modestly surprising on the iPad Smaller Pro (the naming convention on iPad Pro leaves something to be desired).

Compared with the past pomp and circumstance of Apple events, this one was cut-and-dried and no-nonsense, belitting the small scale of the releases. Our takeaways are that the repositioning of a second-tier phone was a logical strategic move; that the original form factor for the iPad may not regain past sales momentum; and that the price cut on the Apple Watch won’t extend to the second iteration, whenever that is released.

The most useful strategic move was to breathe new life into what is now a more clearly defined middle-tier phone. Apple has refreshed its flagship iPhone on a two-year cycle, with the ‘number’ model followed the next year by the ‘S’ refresh. With each new iteration of iPhone, the falloff in year two has worsened. Introducing the 5SE may break up this predictable downcycle, in a move beneficial both to Apple and its suppliers, including BUY-rated Qualcomm, Broadcom Ltd., and Analog Devices.

For iPhone 7 to make an impact, we believe it needs to address three key customer complaints. These are base memory, battery

Peer & Industry Analysis

The graphics in this section are designed to allow investors to compare AAPL versus its industry peers, the broader sector, and the market as a whole, as defined by the Argus Universe of Coverage.

- The scatterplot shows how AAPL stacks up versus its peers on two key characteristics: long-term growth and value. In general, companies in the lower left-hand corner are more value-oriented, while those in the upper right-hand corner are more growth-oriented.
- The table builds on the scatterplot by displaying more financial information.
- The bar charts on the right take the analysis two steps further, by broadening the comparison groups into the sector level and the market as a whole. This tool is designed to help investors understand how AAPL might fit into or modify a diversified portfolio.
life, and wireless charging. Apple’s own software is so memory-intensive that 16 GB model is soon overwhelmed with a small library of photos, songs, and apps. 32 GB should be the new base. In addition, iPhone batteries tend to degrade over time, and that is an issue because they are not readily replaceable. Finally, the reduced number of pins on the lightning charger means that the charging connection wears out quickly; wireless charging would put that issue to rest. Unfortunately, Apple’s engineer-driven culture has always excelled in listening to its own ideas and being tone-deaf to customer complaints.

**EARNINGS & GROWTH ANALYSIS**

Given the difficulty in predicting the early reception of the iPhone 5SE and other new products, we are making no changes in our FY16 or FY17 estimates at this time. We expect AAPL to report fiscal 2Q16 (calendar 1Q16) results in late April 2016.

For fiscal 1Q16 (calendar 4Q15), Apple reported revenue of $75.9 billion, which was up 1.7% annually and 47% sequentially in a normal seasonal pattern for the holiday quarter. Revenue came in below the midpoint of management’s $75.5-$77.5 billion guidance range and missed the $76.6 billion consensus forecast.

The GAAP gross margin expanded sequentially to 40.1% in fiscal 1Q16 from 39.9% in fiscal 4Q15, while rising from 39.9% a year earlier. Operating income totaled $24.2 billion, down from $24.2 billion a year earlier.

GAAP EPS totaled $3.28 in fiscal 1Q16, compared to $1.96 in fiscal 4Q15; EPS rose 7% from $3.06 in fiscal 1Q15. Although Apple does not provide specific EPS guidance, based on line-item projections, the consensus forecast was $3.23 per diluted share.

For all of FY15, revenue of $233.7 billion advanced 28% from $182.8 billion in FY14. Apple earned $9.19 per share, which was up 43% from $6.44 in FY14.

Apple guided for fiscal 2Q16 revenue of $50-$53 billion, which at the guidance midpoint would be down 11% annually; we believe that most of that impact is currency-related. It projects a gross margin of 39.0%-39.5%, operating expense of $6.0-$6.1 billion, and a tax rate of 25.5%. Based on our analysis and those inputs, we are modeling GAAP earnings of $2.12 per diluted share for fiscal 2Q16.

Our FY16 forecast for Apple is $9.45 per diluted share. Our preliminary fiscal 2017 EPS forecast is $10.67 per diluted share. With no significant adjustments, events or charges in any period, our GAAP and non-GAAP earnings estimates are identical. Our long-term EPS growth rate forecast for AAPL is 13%.

**FINANCIAL STRENGTH & DIVIDEND**

Our financial strength rating on Apple is High, the top of our five-point scale.

Cash was $216 billion at the end of 1Q16. Cash was $206 billion at the end of fiscal 2015, representing $35.50 per share. Cash & investments were $155.3 billion at the end of FY14, $146.7 billion at the end of FY13, and $121 billion at the end of FY12. Cash & investments were $81 billion at the end of FY11, $65.8 billion at the end of 2Q11, $51 billion at the end of FY10, and $33.9 billion at the end of FY09.

Debt was $66.5 billion at the end of 1Q16. Debt was $64.5 billion at the end of fiscal 2015, up from $49.9 billion at the close of 3Q15. Apple increased its debt & commercial paper to $32.3 billion during the second half of FY14 from $16.96 billion as of midyear 2014. The use of debt gives the company operating flexibility without the need to bring back cash from overseas at onerous tax rates. Approximately $137 billion, or 84% of cash, was offshore as of the end of 3Q14. Net cash was $133 billion at the end of 3Q14, up from $130 billion at the end of FY13.

Cash flow from operations was $81.3 billion in fiscal 2015, while free cash flow was an estimated $70.0 billion. Cash flow from operations was $59.7 billion in FY14, while free cash flow was an estimated $50.1 billion. Cash flow from operations was $53.7 billion in FY13, $50.8 billion in FY12, $37.5 billion in FY11, $18.6 billion in FY10, and $10.2 billion in FY09.

In April 2015, Apple announced a $70 billion increase in its capital return program. Apple is committed to returning $200 billion to shareholders by the end of March 2017; as of the end of fiscal 2015, Apple had completed $143 billion of that $200 billion program.

Also within the new capital allocation program, in April 2015, Apple hiked its quarterly dividend by 11% to $0.52 per share. Previously, it raised its dividend by 8% in April 2014 and by 15% in April 2013. In April 2012, Apple declared its first quarterly dividend. We expect a 10% dividend hike to be announced in April 2016. Based on timing of the forecast hike, our dividend forecasts are $2.18 for FY16 and $2.40 for FY17.

**MANAGEMENT & RISKS**

Timothy Cook has served as CEO since industry legend Steve Jobs passed away in October 2011. Former Apple controller and former Xerox CFO Luca Maestri became CFO in September 2013, succeeding Peter Oppenheimer. Phil Schiller is the head of worldwide marketing, and Jon Ivey is the chief of design. Apple has a deep bench of executive, engineering and marketing talent. We think that it will continue to attract high-quality talent, both from an engineering perspective as well as in the corporate leadership ranks.

Despite its enormous revenue base, Apple continues to grow phone units and revenue at a double-digit pace. The shares are always at risk from the perception that growth could slow as the law of large numbers catches up with Apple. The company has mitigated that risk, in our view, with very aggressive shareholder return policies, which will likely remain paramount for Apple. Despite the company’s growing largesse, we expect institutional investors to continue to demand more aggressive dividend growth and a larger share repurchase plan.

**COMPANY DESCRIPTION**

Apple manufactures PCs, MP3 players, smartphones, tablet computers, software and peripherals for a worldwide customer base. Its products include the Macintosh line of desktop and mobile PCs, the iPod MP3 line, the iPhone, the iPad, and various consumer products, including Apple TV. Apple also owns and operates iTunes, the world’s largest vendor of recorded music. Apple derives 40%-45% of its revenue from the Americas, 20%-25% from Europe/MEA, 12%-16% from Asia-Pacific, and 15%-18% from its own retail stores.

**INDUSTRY**

Our rating on the Technology sector is Over-Weight. We believe that CIOs and IT managers are becoming more accustomed to transformative technology, including mobile broadband and enterprise mobility; social networking and the explosion in bi-directional data traffic; Analytics, including Big Data and business intelligence; Cloud, including multiple variants (public,
private, and hybrid); and enabling technologies such as Network Function Virtualization, Software-Defined (SD) Networking, Storage, Data Center, and Software/Platform/Infrastructure-as-a-service.

Sector valuations remain attractive, while growth prospects remain highly positive. For the long term, we expect the technology sector to increase its weighting within the S&P 500 from the current 20% level to 22%-23%, based on pervasive digitization across the economy, greater acceptance of transformative technologies, and the development of the Internet of Things (IoT). Healthy company and sector fundamentals are also positive. For individual companies, these include high cash levels, low debt, and broad international business exposure.

In terms of performance, the sector rose 4.3% in 2015, above the market average, after gaining 18.2% in 2014. The sector is slightly underperforming thus far in 2016.

Fundamentals for the Technology sector look reasonably balanced. By our calculations, the P/E ratio on projected 2016 earnings is 15.6, below the market multiple of 16.3. Earnings are expected to grow 14.9% in 2016 following growth of 2.8% in 2015 and 10.2% in 2014. The sector’s debt ratios are below the market average, as is the average dividend yield of 1.8%.

**VALUATION**

AAPL trades at 11.3-times our FY16 EPS forecast and at 10.7-times our FY17 forecast; the five-year (FY11-FY15) trailing multiple is 13.1. Over the past five years, AAPL has traded at an average 10% discount to the market multiple. The stock currently trades at a 33% discount to the market on a two-year-average forward basis.

Less cash per share, AAPL trades at an average of 6.7-times non-GAAP EPS for FY16 and FY17, or at about 50% of the market multiple - at a time when AAPL is among the principal components of S&P 500 EPS.

AAPL also trades at discounts to the technology hardware peer group, despite prospects for growth recovery later in FY16 and into FY17. We believe that a significant peer-group premium is justified given Apple’s ability to expand globally and to generate healthy demand for its products in every kind of economy. Currency is likely to remain a near-term headwind, however.

Our more forward-looking, two-stage discounted free cash flow model renders a value north of $250 per share. Our blended fundamental valuation model points to a price above $235, in a rising trend. Appreciation to our 12-month target price of $135, along with the current annual dividend yield of about 1.9%, implies a risk-adjusted total return exceeding our 12-month forecast for the broad market.

On March 21, BUY-rated AAPL closed at $105.91, down $0.01.
About Argus

Argus Research, founded by Economist Harold Dorsey in 1934, has built a top-down, fundamental system that is used by Argus analysts. This six-point system includes Industry Analysis, Growth Analysis, Financial Strength Analysis, Management Assessment, Risk Analysis, and Valuation Analysis.

Utilizing forecasts from Argus’ Economist, the Industry Analysis identifies industries expected to perform well over the next one-to-two years.

The Growth Analysis generates proprietary estimates for companies under coverage.

In the Financial Strength Analysis, analysts study ratios to understand profitability, liquidity, and capital structure.

During the Management Assessment, analysts meet with and familiarize themselves with the processes of corporate management teams.

Quantitative trends and qualitative threats are assessed under the Risk Analysis.

And finally, Argus’ Valuation Analysis model integrates a historical ratio matrix, discounted cash flow modeling, and peer comparison.

THE ARGUS RESEARCH RATING SYSTEM

Argus uses three ratings for stocks: BUY, HOLD, and SELL. Stocks are rated relative to a benchmark, the S&P 500.

- A BUY-rated stock is expected to outperform the S&P 500 on a risk-adjusted basis over a 12-month period. To make this determination, Argus Analysts set target prices, use beta as the measure of risk, and compare expected risk-adjusted stock returns to the S&P 500 forecasts set by the Argus Market Strategist.
- A HOLD-rated stock is expected to perform in line with the S&P 500.
- A SELL-rated stock is expected to underperform the S&P 500.

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