The Dow Chemical Company

SUMMARY

We are downgrading our recommendation on Dow Chemical to Underperform, factoring in uncertainties associated with currency and oil prices. The company’s profit for the fourth-quarter 2014 tumbled year over year, hurt by a sizable loss related to abandonment of a facility. Adjusted earnings, however, surpassed the Zacks Consensus Estimate. Revenues were flat year over year and missed expectations. The company said that it will remain focused on pursuing portfolio management and productivity actions. While Dow expects its strategic actions to enhance shareholder value this year, its performance plastics business remains exposed to near-term challenges given lower oil prices. The company also faces currency headwinds, pricing pressure, challenges in Western Europe and a still soft commercial construction end market.

SUMMARY DATA

- Risk Level: Average
- Type of Stock: Large-Blend
- Industry: Chem-Diversifd
- Zacks Industry Rank: 206 out of 267

ZACKS CONSENSUS ESTIMATES

Revenue Estimates
(In millions of $)

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1 (Mar)</th>
<th>Q2 (Jun)</th>
<th>Q3 (Sep)</th>
<th>Q4 (Dec)</th>
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<td>2016</td>
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Earnings Per Share Estimates
(EPS is operating earnings before non-recurring items, but including employee stock options expenses)

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<th>Year</th>
<th>Q1 (Mar)</th>
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<td>2016</td>
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*Note: EPS in 2014 do not add up to annual figure due to rounding-off.
Projected EPS Growth - Next 5 Years %

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Headquartered in Michigan, The Dow Chemical Company (DOW) is the second-largest chemical manufacturer in the world, offering a range of chemical, plastic and agricultural products and services. The company has a global footprint across 160 countries and employs over 52,000 people. It has 197 manufacturing sites in 36 countries and produces around 5,000 products. As many as 42 manufacturing sites are located in the U.S. The rest are in Europe and other regions including the Middle East, Africa and Asia. In 2014, the company derived 37% of its revenues from North America, 34% from Europe, Middle East and Africa (EMEA), 16% from Asia Pacific and 13% from Latin America.

Dow is a global capacity leader in propylene oxide (PO) and propylene glycol (PG) manufacturing, with global PO capacity of more than 2,000 KTA and global PG capacity of more than 700 KTA. Dow currently has five global PG manufacturing facilities—one of the world's highest capacity plants in Germany; two facilities in North America; a facility in Brazil and another in Australia.

Dow, in Nov 2014, announced the realignment of its reporting segments to better reflect its strategy and improve peer comparison capabilities. The new operating segment structure maximizes Dow's integration benefits either through molecular and value chain alignment or via the benefits derived from an enhanced, innovation-driven market focus. With the realignment, Dow's reporting segments now has changed to five from six. The revised segments are as follow:

**Agricultural Sciences (13% of 2014 sales):**

- The division will continue to operate under the same structure comprised of crop protection and seeds. Dow's AgroSciences business provides agricultural and plant biotechnology products, pest management solutions and healthy oils.

**Consumer Solutions (8%):**

- Earlier part of Electronic and Functional materials unit, and includes Consumer Care, Dow Automotive Systems, and Dow Electronic Materials. In the electronic material category, Dow manufactures materials for chemical mechanical planarization (a process to smoothen surfaces with the combination of chemical and mechanical forces), used in the production of electronic displays. Dow's automotive systems provides plastics, adhesives, glass bonding systems, emissions control technology, films, fluids, structural enhancement and acoustical management solutions to original equipment manufacturers, tier, aftermarket and commercial transportation customers.

**Infrastructure Solutions (15%):**

- Earlier called Coatings and Infrastructure Solutions, and is comprised of Dow Building and Construction, Dow Coating Materials, Energy and Water Solutions and Performance Monomers. The building and construction business consist of Dow Building Solutions and Dow Construction Chemicals – which provides insulation, house wrap, sealant and adhesive products and systems, as well as construction chemical solutions. Dow coating materials supplies raw materials for architectural paints and industrial coatings as well as technologies used in industrial coatings, including packaging, pipelines, wood, automotive, marine, maintenance and protective industries. Dow water and process solutions develop cost-effective technologies for water purification, desalination and separation solutions for specialty applications. The performance monomers business makes specialty monomer products that are used in several applications including cleaning materials, personal care products, paints, coatings and inks.
Performance Materials & Chemicals (26%):

- Includes Chlor-Alkali and Vinyl, Chlorinated Organics, Epoxy, and Industrial Solutions and Polyurethanes. The chlor-alkali/chlor-vinyl business focuses on the production of chlorine for consumption by of downstream Dow derivatives, as well as production of ethylene dichloride, vinyl chloride monomer and caustic soda. Dow is the world's largest producer of both chlorine and caustic soda. The chlorinated organics business supplies chlorinated organic products and services used in the production of fluoropolymers, refrigerants, methyl cellulose, quaternary ammonium compounds and silicones. It also offers solvents that are used as process agents in chemicals manufacturing, surface preparation, dry cleaning and pharmaceuticals. Moreover, it provides closed-loop delivery systems used to help manage risks associated with chlorinated solvents. The epoxy business produces epoxy resins and intermediates. Epoxies provide good adhesion and coating protection over a range of environmental conditions, making them ideal for applications such as transportation, marine and civil engineering. The polyurethanes business produces polyurethane raw materials, which are used in appliance, athletic equipment, automotive, bedding, construction, decorative molding, furniture and shoe soles.

Performance Plastics (38%):

- Comprised of the company's earlier Performance Plastics business unit, however now also includes key raw material inputs through the energy and hydrocarbons business groups that were formerly included in the Feedstocks and Energy segment. Dow's performance plastics business offers elastomers, polyethylene, polypropylene, electrical and telecommunications and packaging and converting solutions. Dow's elastomers business produces performance elastomers and plastomers, specialty copolymers, synthetic rubber, specialty resins, and films and plastic additives that are used in adhesives, transportation, building and construction, packaging and consumer durables. The polyethylene business supplies polyethylene-based solutions. Polypropylene business supplies polypropylene as DOW homopolymer polypropylene resins; DOW impact copolymer polypropylene resins, DOW random copolymer polypropylene resins, INSPIRE performance polymers; UNIPOL PP process technology; SHAC and SHAC ADT catalyst systems. Dow's electrical and telecommunications business offers products, technology, solutions and expertise that set standards for reliability, longevity, efficiency, ease of installation and protection used by the power and telecommunications industries. Dow's packaging and converting business makes sticking and bonding solutions and specialty films for a vast range of applications, including adhesive tapes and paper labels, flexible packaging, film substrates, industrial and consumer films and foams, leather, rigid packaging, and textile and imaging. The hydrocarbons business is engaged in obtaining raw materials including fuels, natural gas liquids and crude oil based raw materials, as well as the supply of monomers, power and steam, principally for Dow's global operations. The energy business supplies power, steam and other utilities, mainly for use in the company's global operations.

In addition to segment changes, Dow also changed the allocation of specific costs earlier reported within its Corporate segment, which will better reflect operating performance and profitability at the segment level. All leveraged functional costs will now be fully allocated to the segments.
**Others**

Activist investor Dan Loeb’s Third Point hedge fund bought a major stake in Dow in January 2014. While Third Point did not specify the number of shares it purchased, it said that Dow is its biggest investment yet. Moreover, Third Point urged Dow to spin off its sluggish petrochemicals business and focus instead on high-margin, fast-growing businesses including agricultural science and electronics and functional materials. The entity, which has roughly $14 billion in assets under management, reportedly forked out $1.3 billion for the stake buy.

Dow and Third Point reached a crucial agreement in Nov 2014, under which, the former agreed to add four new, independent directors to its board (including two suggested by Third Point), thus avoiding the possibility of a proxy battle between them. All four new directors will be included in Dow’s nominations for election at the 2015 annual meeting.

**REASONS TO SELL**

- Dow continues to witness sluggish global economic activity, largely due to challenging economic conditions in Europe and political uncertainties. These factors are contributing to a still soft demand environment across a number of markets, something which may continue moving ahead.

- While electronics and construction end-markets have stabilized of late, they are still not out of the woods. Building and construction sales remain impacted by lower volume in Europe and recovery in electronics remains affected by the prevailing uncertainty in Europe. Moreover, Dow is still facing challenges in Western Europe due to weak economic conditions. Construction market in general remains weak in Europe. The company is also seeing pricing pressure in Europe reflected by a double-digit decline in the region in the most recent quarter.

- While the results from the performance materials business in the most recent quarter are encouraging, the Epoxy business is still struggling with tough competition and industry overbuilding (especially in China). Moreover, the company’s plastics business is exposed to headwinds stemming from reduced oil prices. Lower oil prices may lead to constricted margins for ethane-based plastics and affect volumes in the near term. The company saw some margin compression associated with declining oil prices in the most recent quarter, which is expected to continue in 2015.

- Dow faces pension and currency headwinds in 2015. The company expects pension costs to increase more than $100 million year over year this year, partly due to lower discount rate. Moreover, Dow sees unfavorable currency translation to impact its EBITDA in 2015 and continue to weigh on pricing in the near term.

- Dow’s performance has been dampened by global industry overcapacity. Although demand for ethylene, PE resins and chlorine are showing some improvement, it remains below historical levels.

- Dow sells its broad range of products and services in a competitive, global environment and competes worldwide on the basis of quality, price, technology and customer service. Increased levels of competition could result in lower prices or lower sales volume, which would have a negative impact on the company’s results of operations.
RISKS

- Dow also remains committed to invest in attractive regions through highly-accrative projects including the expansions in the U.S. Gulf Coast and Sadara joint venture in the Middle East. The company expects the start-up of the first units in Sadara and its PDH unit in Texas in 2015. Dow expects its strategic investments, including Sadara and U.S. Gulf coast, to help it achieve EBITDA of over $10 billion.

- Dow remains actively focused on seeking opportunities to optimize its portfolio by selectively spinning off or selling its underperforming assets and gradually shift focus to high growth businesses. The company sees $2 billion in proceeds from divestments of non-core assets and businesses signed or completed in 2014. The divestments are part of Dow's ongoing efforts to deliver $7 billion to $8.5 billion in gross proceeds from assets sale by mid-2016.

- Dow continues to focus on offering incremental returns to its shareholders leveraging its healthy cash flows. Dow returned $6 billion to its shareholders through dividends and share repurchases in 2014 and also completed its $4.5 billion buyback program. The company also raised its dividend twice in 2014 and its board also approved an additional $5 billion share repurchase program. The company also remains committed to its productivity improvement actions and has announced an additional $1 billion three-year productivity program. The company expects to generate around $300 million improvements by end-2015.

RECENT NEWS

**Dow Chemical’s Q4 Earnings Top on Volume Gains** – January 29, 2015

Dow’s earnings for fourth-quarter 2014 bested expectations on broad-based volume gains, but its profits slid year over year in the quarter, hurt by a sizable loss associated with abandonment of a facility in Clarksville, TN, by its joint venture – Dow Coming.

The company recorded profits of $734 million or $0.63 per share in the reported quarter, a roughly 24% drop from $963 million or $0.79 per share recorded a year ago.

Barring one-time items including $500 million (pre-tax) in site abandonment loss, earnings of $0.85 per share outstripped the Zacks Consensus Estimate of $0.68, marking the fifth straight quarter of positive surprise.

Dow recorded higher EBITDA margin (as adjusted) in the quarter with gains witnessed across all reporting segments, especially Agricultural Sciences. The company benefited from higher demand across major end-use markets and productivity improvement actions.

For the full year, adjusted earnings of $3.11 per share also came ahead of the Zacks Consensus Estimate of $2.95.

Dow registered net sales of $14,384 million in the quarter, flat year over year, as higher volumes across developed and emerging markets were masked by price decline in Europe. Dow saw higher volumes in most segments, especially Agricultural Sciences (up 9%) and Performance Materials and Chemicals (up 7%). Sales missed the Zacks Consensus Estimate of $14,410 million.
For 2014, sales rose 1.9% year over year to $58,167 million, but fell short of the Zacks Consensus Estimate of $58,293 million.

**Segment Analysis**

**Agricultural Sciences**

Sales went up 5% year over year to $1.9 billion in the quarter as gains witnessed in all geographies, especially in Latin America. Crop protection revenues rose 3% on gains across all geographies. Sales increased in herbicides, insecticides and fungicides. New crop protection products sales climbed 23% while sales of seeds moved up 9% in the quarter.

**Consumer Solutions**

Revenues from the division were $1.1 billion, flat year over year, as double-digit gains in North America were neutralized by declines in other regions. Sales rose in Automotive Systems on sustained growth of structural adhesives and strength in North America. Continued mobile device growth in semiconductor technologies was witnessed in Electronic Materials. This was more than offset by declines in display technologies.

**Infrastructure Solutions**

Sales from the division fell 4% to $2 billion in the quarter on declines in Europe, Middle East, Africa and India (EMEAI). Energy and Water Solutions benefited from higher demand for microbial control and reverse osmosis technologies. This was offset by soft construction related demand in Building and Construction and Coating Materials in Western Europe.

**Performance Materials & Chemicals**

Revenues rose 5% to $3.9 billion in the quarter with gains witness across all geographic regions. Gains across all regions led to a double-digit rise in polyurethanes sales. Gains witnessed in all geographies on higher Epoxy demand and productivity actions. This was, however, more than offset by declines in Industrial Solutions.

**Performance Plastics**

Sales fell 3% to $5.5 billion in the quarter on lower Hydrocarbons and Energy sales. Packaging and Specialty Plastics recorded flat sales as higher volumes in pipe and hygiene and medical market sectors was offset by unfavorable currency impact. Hydrocarbons and energy sales fell on softer conditions in oil and gas markets.

**Financials and Shareholder Returns**

Dow exited the quarter with cash and cash equivalents of roughly $5.7 billion, down around 5% year over year. Long-term debt increased around 12% year over year to roughly $18.8 billion. Operating cash flow for the quarter was $2.8 billion.

Dow returned $1.6 billion to its shareholders through dividends and share repurchases in the quarter and also completed its $4.5 billion buyback program.
Outlook

Dow envisions favorable demand fundamentals amid an uncertain operating backdrop and currency headwinds. CEO Andrew N. Liveris said that Dow's advantaged global cost positions are allowing it to increase asset utilization and its differentiated technologies and end-markets will enable it to boost returns in markets that are less vulnerable to price volatility.

Dow will continue to aggressively pursue portfolio management and productivity actions while effectively managing its cash, assets and markets for long-term growth. Liveris also added that falling oil prices will actually act in favor of the company. Dow also remains committed to invest in attractive regions through highly-accrative projects including the expansions in the U.S. Gulf Coast and Sadara joint venture in the Middle East.

Dow Chemical’s Q3 Earnings Trump Estimates – October 22, 2014

Dow's profit surged year over year in third-quarter 2014, thanks to strong results across its Performance Plastics and Electronic and Functional Materials divisions.

The company recorded profits of $852 million or $0.71 per share in the reported quarter, a 43% jump from $594 million or $0.49 per share recorded a year ago. Barring costs associated with the separation of a major portion of the company's chlorine business, earnings of $0.72 per share topped the Zacks Consensus Estimate by $0.05, marking the fourth straight quarter of positive surprise.

Dow recorded higher EBITDA margin (as adjusted) in the quarter, aided by gains from productivity actions. The company also benefited from higher pricing as demand tightened in major regions.

Revenues rose 5% year over year to $14,405 million in the quarter on gains across performance materials, performance plastics and electronics, aided by increased pricing. Sales rose across all geographic regions in the quarter. Revenues also came ahead of the Zacks Consensus Estimate of $14,304 million.

Sales in the emerging markets moved up 6% on strength in plastics business in Latin America. North America saw a 7% gain.

Segment Review

Electronic and Functional Materials

Revenues rose 3% year over year to $1.2 billion in the reported quarter. Electronic Materials gained from higher foundry demand in semiconductor technologies, offset by declines in display technologies. Functional materials sales also rose in the quarter on the back of gains in North America.

Coatings and Infrastructure Solutions

The division saw flat sales of $1.8 billion in the quarter as gains across North and Latin America was offset by lower sale in other regions. Coating materials sales were boosted by gains in epoxy coatings. Water and Process Solutions benefited from higher demand for ion exchange and reverse osmosis technologies in North America, but saw declines Asia Pacific and EMEA.
Agricultural Sciences

Sales were flat year over year at $1.4 billion as gains in seeds were offset by lower crop protection sales. Crop protection revenues clipped 1% on weakening market conditions in North America. Sales of seeds rose 5% on gains in both soybeans and sunflower across North and Latin America.

Performance Materials

Revenues rose 8% to $3.6 billion in the quarter with gains witness across all geographic regions. Gains across consumer comfort, appliance and industrial markets led to a double-digit rise in polyurethanes sales.

Propylene oxide/propylene glycol registered record sales, backed by gains in major markets. Sales gains were also witnessed across oil, gas and mining and automotive systems businesses.

Performance Plastics

Sales went up 8% to $3.9 billion in the quarter with higher sales witnessed in all regions. Packaging and specialty plastics recorded higher sales on double-digit gains in the hygiene and medical and pipe market sectors, supported by growth in the food and specialty packaging market. Sales rose in the elastomers business on higher demand in transportation and hot-melt adhesives.

Feedstocks and Energy

Revenues moved up 2% to $2.4 billion on higher pricing in olefins and aromatics.

Financials and Shareholder Returns

Dow exited the quarter with cash and cash equivalents of roughly $5.8 billion, up roughly 9% year over year. Total long-term debt increased around 6% year over year to roughly $19.3 billion. Operating cash flow for the quarter was $1.8 billion. Dow has returned $4.4 billion to its shareholders through dividends and share repurchases so far this year.

Outlook

Dow will continue to focus on its operating priorities that are delivering healthy results amid a volatile global marketplace. CEO Andrew N. Liveris said that the company will continue to aggressively pursue actions to drive returns on capital and boost cash flows through effective portfolio management. The company will also remain focused on maximizing shareholder returns.

VALUATION

Dow Chemical's current trailing 12-month earnings multiple is 15.1X, compared to the 21.4X average for the peer group and 18.6X for the S&P 500. Over the last five years, the company's shares have traded in a range of 8.1X to 48X trailing 12-month earnings. The stock is trading at a discount to the peer group, based on estimated earnings for 2015 and 2016. Our Underperform recommendation indicates that it will perform below the market. Our price target of $43 is based on 13.9x our 2015 earnings estimate.
# Key Indicators

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<th>P/E 5-Yr High (TTM)</th>
<th>P/E 5-Yr Low (TTM)</th>
<th>P/E F1</th>
<th>P/E F2</th>
<th>Est. 5-Yr EPS Gr%</th>
<th>P/CF (TTM)</th>
<th>P/E (TTM)</th>
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TTM is trailing 12 months; F1 is 2015 and F2 is 2016, CF is operating cash flow
Earnings Surprise and Estimate Revision History

[Graph showing earnings surprise and estimate revision history for DOW Chemical Co.]
DISCLOSURES & DEFINITIONS

The analysts contributing to this report do not hold any shares of DOW. The EPS and revenue forecasts are the Zacks Consensus estimates. Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts' personal views as to the subject securities and issuers. Zacks certifies that no part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report. Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Because of individual objectives, the report should not be construed as advice designed to meet the particular investment needs of any investor. Any opinions expressed herein are subject to change. This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. Zacks or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. Zacks uses the following rating system for the securities it covers. Outperform- Zacks expects that the subject company will outperform the broader U.S. equity market over the next six to twelve months. Neutral- Zacks expects that the company will perform in line with the broader U.S. equity market over the next six to twelve months. Underperform- Zacks expects the company will underperform the broader U.S. Equity market over the next six to twelve months. The current distribution of Zacks Ratings is as follows on the 1120 companies covered: Outperform - 15.6%, Neutral - 77.0%, Underperform – 6.7%. Data is as of midnight on the business day immediately prior to this publication.

Our recommendation for each stock is closely linked to the Zacks Rank, which results from a proprietary quantitative model using trends in earnings estimate revisions. This model is proven most effective for judging the timeliness of a stock over the next 1 to 3 months. The model assigns each stock a rank from 1 through 5. Zacks Rank 1 = Strong Buy. Zacks Rank 2 = Buy. Zacks Rank 3 = Hold. Zacks Rank 4 = Sell. Zacks Rank 5 = Strong Sell. We also provide a Zacks Industry Rank for each company which provides an idea of the near-term attractiveness of a company's industry group. We have 264 industry groups in total. Thus, the Zacks Industry Rank is a number between 1 and 264. In terms of investment attractiveness, the higher the rank the better. Historically, the top half of the industries has outperformed the general market. In determining Risk Level, we rely on a proprietary quantitative model that divides the entire universe of stocks into five groups, based on each stock’s historical price volatility. The first group has stocks with the lowest values and are deemed Low Risk, while the 5th group has the highest values and are designated High Risk. Designations of Below-Average Risk, Average Risk, and Above-Average Risk correspond to the second, third, and fourth groups of stocks, respectively.