MORNINGSTAR®

Corporate Credit Spread Chartbook

Consumer Cyclical Industry

Morningstar Credit Research
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Contents

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Executive Summary

The average credit spread for consumer cyclical investment-grade issuers covered by Morningstar Credit Ratings, LLC tightened 8 basis points to +103 basis points over Treasuries while the Morningstar Corporate Bond Index widened 7 basis points to +105 basis points since our last consumer cyclical chartbook publication in November 2017.

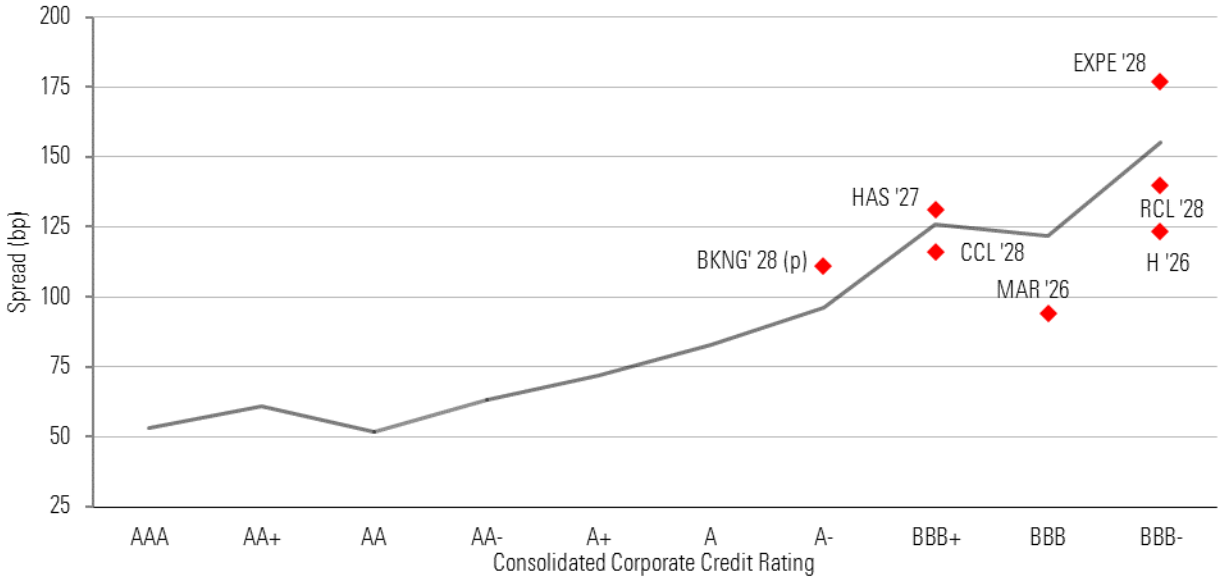
Over this same period Morningstar downgraded one issuer and affirmed 17 issuers in the consumer cyclical sector. Credit quality is expected to remain under pressure over the next year as indicated by the predominance of negative rating outlooks. Currently within Morningstar's consumer cyclical-rated universe, seven issuers have a negative outlook while only two issuers have a positive outlook. Credit trends remain somewhat negative in the department store, apparel, grocery, and discounter sectors. The gaming, travel, and lodging sectors contain the only two issuers with a positive rating outlook.

If we examine the past four quarters, the weakening trend in credit quality becomes more apparent. In fact, four upgrades occurred in the first half of this period, including Carnival Corp. (BBB+, Stable), Royal Caribbean Cruises LTD (BBB-, Stable), Marriott International Inc. (BBB, Stable), and Best Buy Co. Inc. (BBB-, Stable), while the two downgrades occurred in the back half of this period including Bed Bath & Beyond Inc. (BBB-, Stable), and Mattel Inc. (BB, Negative).

Spread Charts by Consumer Cyclical Sector

Lodging and Leisure

Exhibit 1 Lodging and Leisure Versus Morningstar Industrials Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of March 2, 2018
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends and Spreads

Overall credit trends in the gaming, travel, and leisure sector remain positive. Low unemployment, wages increases, and a strong stock market provide tailwinds for the sector. Online travel agencies, cruise lines, and hotel/casino operators have experienced solid bookings growth along with revenue and margin expansion. On average, bond spreads for investment-grade issuers in the sector tightened 7 basis points since our last chartbook publication in November 2017, primarily driven by Carnival Corp.'s (BBB+, Stable) 2028 bonds that tightened 26 basis points to +116 over Treasuries. On the other hand, online travel agents widened, including the 2028 bonds of Booking Holdings Inc. (A-, positive), which widened by 9 basis point to +111 and the 2028 bonds of Expedia Inc. (BBB-, Stable) which widened by 8 basis points to +177. Since the last chartbook, we revised Expedia's rating outlook to stable from positive. Going forward, Morningstar anticipates online travel agents will benefit from strong growth as online penetration rates of worldwide bookings remains low and online booking growth is more than double the total industry. Mattel's (BB, Negative) rating was recently lowered two notches, dropping it out of investment-grade, so it is no longer included in the gaming, travel, and leisure sector chart.

Issuer Highlights

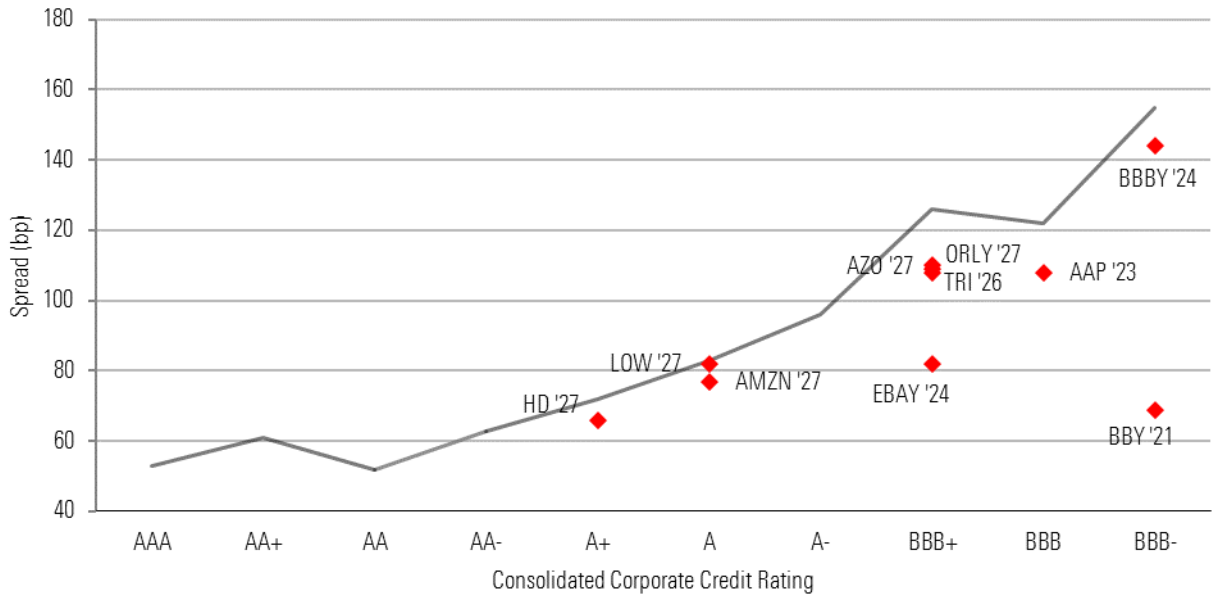
- Booking Holdings' (A-, Positive) rating was affirmed in March 2018 and a positive outlook was maintained. The affirmation reflects the company's leading position in online travel services, strong

profitability including return on invested capital in the high double digits, and excellent liquidity with cash and investments exceeding $17 billion. The positive outlook reflects the potential for an upgrade with further development of the company's competitive advantages. In addition, an upgrade would likely be predicated on confidence that the company's future financial policy will include the maintenance of its balance sheet strength.

- Expedia's (BBB-, Stable) rating was affirmed, while the outlook was revised to stable from positive in March 2018. The rating affirmation is based on Expedia's leading position in the evolving and increasingly competitive online travel industry, further supported by solid liquidity and a moderately leveraged balance sheet. The outlook revision to stable reflects a slowdown in profit and margin improvement, which will likely be delayed further as the company accelerates growth investments in its online platform.
- Royal Caribbean (BBB-, Stable) sold $300 million 2.65% 3-year senior unsecured notes at a spread of +80 basis points over Treasuries and $500 million 3.7% 10-year senior unsecured notes at a spread of +137.5 basis points over Treasuries in November 2017. Proceeds were used to repay down its $290 million term loan due 2018, a portion of the $540 million outstanding balance under its unsecured $1.4 billion revolving credit facility due 2020 and a portion of the $280 million outstanding balance under its unsecured $1.2 billion revolving credit facility due 2022.
- Mattel's (BB, Negative) rating was downgraded by two notches in February 2018 because of ongoing revenue and cash flow declines, weaker credit protection measures, and heightened uncertainty regarding future operating performance. A negative outlook reflects the potential for a lower rating if Mattel is unable to sustain its competitive position, stabilize revenue, and improve margins and debt protection metrics, which otherwise could result in a weakened Business Risk and Cash Flow Cushion. During December 2017, Mattel issued $1.0 billion 6.75% Senior Notes due 2025. Proceeds were used in part to repay commercial paper borrowings and to allow it to replace its unsecured revolver with a new $1.6 billion secured credit facility.
- MGM Resorts' (BB-, Positive) outlook reflects an improving credit profile based on strengthening fundamentals in Las Vegas, a recovery in its Macau operations, and an expected substantial reduction in capital spending after expansion projects are completed. The rating could be raised within the next couple of years with higher free cash flow generation coupled with the maintenance of its targeted net leverage goal of 3-4 times.

Specialty Retail and Other

Exhibit 2 Specialty Retail and Other Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of March 2, 2018
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends and Spreads

The credit quality of specialty retailers remained relatively stable since the last chartbook, with the rating of several issuers affirmed. Nevertheless, the average bond spread for issuers in the sector tightened by 6 basis points over the relevant Treasury. All three issuers in auto parts retailing improved. Advance Auto Parts' (BBB, Stable) 2023 bonds were the outlier, having tightened 29 basis points. Morningstar continues to believe certain store-based retailers possess modest defenses against online threats, such as auto-parts retailers and home centers, which provide in-store service expertise and low-cost distribution capabilities that can deliver a breadth of inventory within hours. Bed Bath & Beyond's (BBB-, Stable) 2024 bonds also significantly outperformed in the sector, tightening by 22 basis points to +144. Also, noteworthy, Best Buy's (BBB-, Stable) short-dated 2021 bonds tightened 11 basis points after posting strong store-level operating results for the holidays.

Issuer Highlights

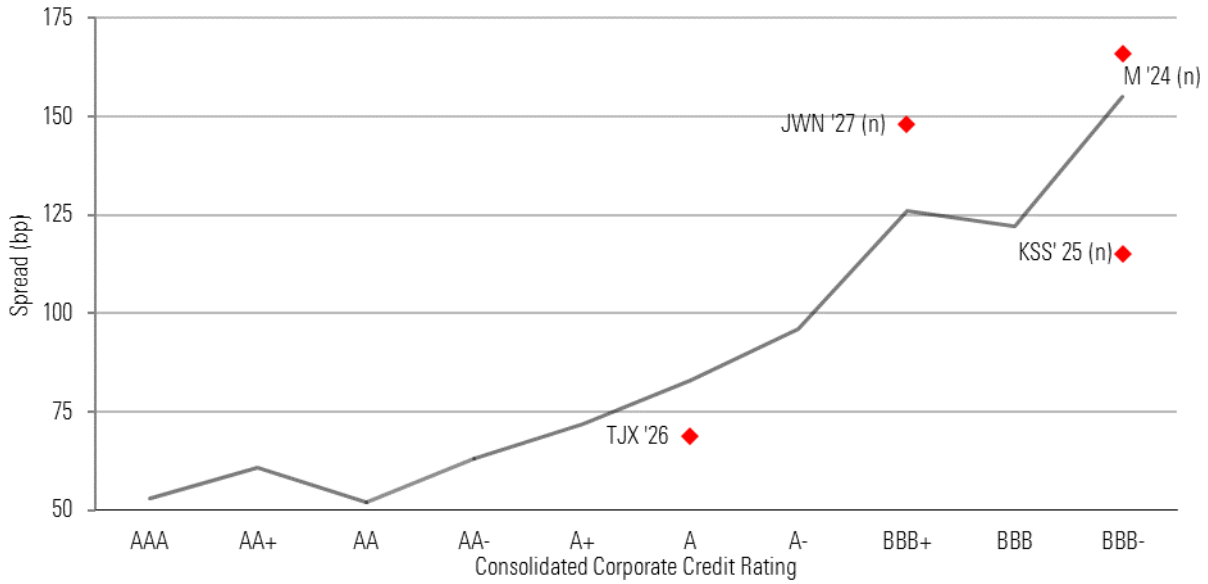
- Amazon.com's (A, Stable) rating was affirmed in February 2018, reflecting the company's dominant, market-leading competitive position, solid, but volatile, returns on invested capital, and adherence to a conservative balance sheet despite the absence of an articulated financial policy. Historically, Amazon has maintained a conservative balance sheet, with adjusted net debt well below 1 times EBITDAR. Amazon raised $16 billion of new debt to finance the $13 billion all-cash acquisition of Whole Foods Market last August, which increased adjusted net debt to 1.7 times at year-end 2017, a full turn higher

from last year. We expect Amazon to continue its policy of paying no dividends with virtually no share repurchases. However, notwithstanding strong liquidity and a conservative balance sheet, we believe Amazon's rating remains constrained by the absence of an articulated long-term financial policy. The stable outlook is based on the continued enhancement of an already-strong competitive position, along with double-digit revenue growth that will support improvement in return on invested capital despite the recent acceleration in investment spending.

- eBay's (BBB+, Stable) rating was affirmed in February 2018 based on the strength of its position in the e-commerce retail marketplace, solid return on invested capital, and the maintenance of excellent liquidity. Management indicated it may consider a substantial, leveraging acquisition given the company's strong liquidity and cash flow. In the past, eBay has suggested that its current credit profile could allow it to increase debt leverage up to 3.5 times. The stable rating outlook reflects Morningstar's expectation that eBay has the ability and the willingness to maintain its current liquid balance sheet and credit metrics, despite margin pressure, share repurchases, and the potential for a sizable acquisition.
- AutoZone's (BBB+, Stable) rating was affirmed in February 2018, due to the company's leading competitive position, strong profitability and return on invested capital, along with a prudent debt profile. The stable rating outlook reflects Morningstar's expectation that AutoZone will continue to manage to a conservative balance sheet, including adjusted leverage of 2.8 times while maintaining steady growth in revenue and EBITDA.
- O'Reilly Automotive's (BBB+, Stable) rating was affirmed in February 2018. The affirmation is based on O'Reilly's leading competitive position among auto parts retailers as evidenced by strong returns on invested capital and further supported by the maintenance of moderate leverage. O'Reilly possesses brand awareness, inventory breadth and availability, geographic coverage, and cost advantages that smaller players find difficult to replicate. The stable outlook reflects the expectation that O'Reilly will continue to maintain its competitive industry market position, supported by high return on invested capital, along with managing debt leverage within its stated target range of 2.00–2.25 times.
- Advance Auto Part's (BBB, Stable) rating was affirmed in February 2018, reflecting its leading market position in auto parts retailing offset by ongoing expenses related to supply chain investments and leverage that is above its long-term targets. A recently installed new management team with significant supply chain experience began to execute on a five-year transformation plan in 2017 that is designed to increase in-store parts availability, reduce inventory, and lower overall costs. The stable outlook reflects Morningstar's expectation that in 2018 operating profitability will stabilize, including demonstrated improvement exiting the year, while strong free cash flow generation will lead to progress in returning leverage toward management's 2.5 times target.
- Thomson Reuters (BBB+, Stable) rating was affirmed in February 2018, based on the company's competitive position in business information services, stable cash flows, and a moderate capital structure. The rating incorporates the recent announcement by Thomson Reuters that it would sell 55% of its financial and risk business to private equity funds managed by Blackstone. As a part of the transaction, Thomson Reuters plans to reduce outstanding debt by $3 billion, which management calculates will result in pro forma net debt/adjusted EBITDA of 2.1 times, below its long-term target of 2.5 times. The stable outlook reflects Morningstar's expectation that Thomson Reuters will maintain competitive advantages in its legal and regulatory, and tax and accounting, businesses, along with maintaining debt leverage within stated balance sheet targets.

► **Department Stores**

Exhibit 3 Department Stores Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of March 2, 2018
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends and Spreads

Over the past several quarters, the credit profiles of traditional store-based retailers have improved. Issuers have generally posted strengthening sales and margins, in part due to better conditions for the consumer, and due to strategic actions various companies have implemented. These initiatives included increasing investments in stores, online distribution, inventory management, asset sales, and debt reduction. While Morningstar maintains a negative outlook on the credit rating for most issuers in the sector, the average credit spread bonds tightened 45 basis points since the last chartbook. Macy's (BBB-, Negative) 2024 bonds tightened by 91 basis points to +166 basis points over Treasuries, representing the largest move of any issuer in the entire consumer cyclical sector, driven by asset sales, debt reduction, strong fourth-quarter results in 2017, and solid profit guidance for 2018. After recently reporting improving results, Kohls' (BBB-, Negative) 2025 bonds and Nordstrom's (BBB+, Negative) 2027 bonds also improved, tightening by 46 and 37 basis points, respectively.

Issuer Highlights

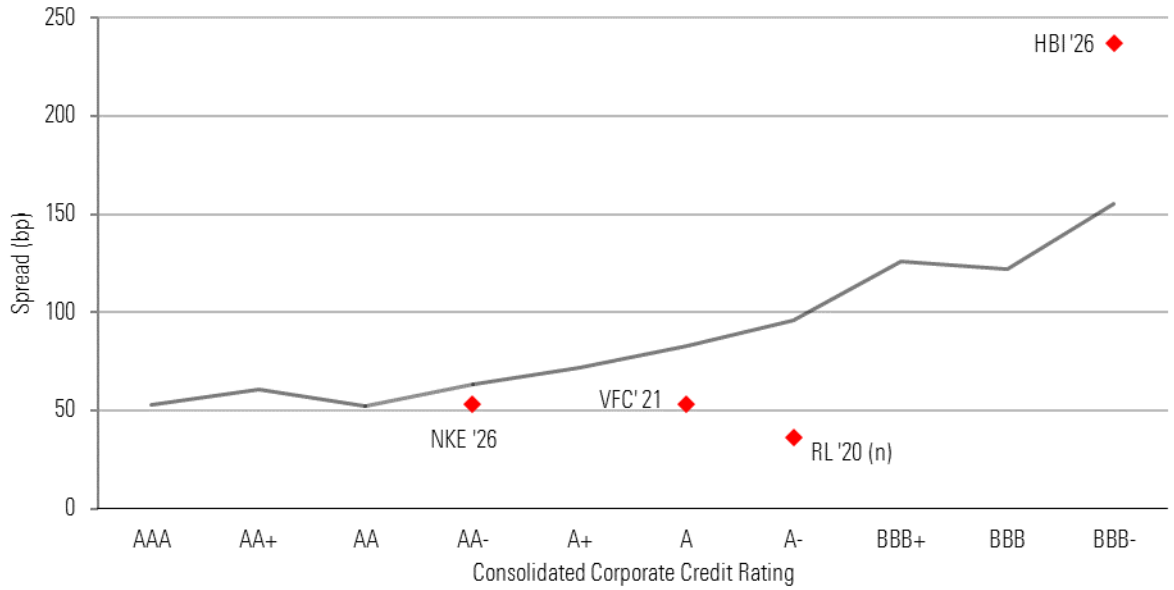
- TJX's (A, Stable) rating was affirmed in December 2017, given a strong competitive position among off-price retailers, solid and consistent cash flow, and excellent liquidity. TJX has posted strong performance over the past several years, including mid- to high-single-digit revenue growth. In 2018, the company is expected to post low-single-digit positive same-store sales in each of its major store brands.

A stable rating outlook reflects the sustainability of TJX's competitive advantages, resulting in solid margins and excellent returns, along with healthy liquidity.

- Nordstrom's (BBB+, Negative) rating outlook remains negative, reflecting the possibility of the rating being lowered if initiatives fail to stabilize profitability. Nordstrom's outlook was revised to negative from stable in March 2017 following ongoing earnings weakness. Nordstrom's rating continues to reflect its solid competitive market position and financial policies that target the maintenance of a moderate net adjusted leverage near 2 times, despite recent profit weakness.
- Kohl's (BBB-, Negative) rating outlook has remained negative since March 2017 when it was revised from stable after reporting a trend of lower revenue and margins. Kohl's rating still reflects its good position as a low-cost provider of branded apparel, the ability to generate solid free cash flow despite EBITDA margin deterioration, and the expectation that management will maintain a moderately leveraged capital structure despite ongoing share repurchases.
- Macy's (BBB-, Negative) rating outlook remains negative, and the rating could be lowered if management's efforts fail to stabilize profitability and leverage. Macy's outlook was revised to negative from stable in March 2017 after its 2016 operating results included ongoing profit weakness and higher debt leverage. Macy's rating reflects a sizable, yet weakened competitive position in department store retailing, management's commitment to reduce debt leverage to within its targeted range of 2.5–2.8 times, and the company's efforts to stabilize ongoing revenue and EBITDA declines.

Apparel Retailers

Exhibit 4 Apparel Retailers Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of March 2, 2018
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends and Spreads

Increasing online competition continues to have an impact on apparel manufacturers, challenging profitability. While these issuers generally benefit from strong brands that can generate a premium price, companies have had to make strategic adjustments to account for the growing consumer demand of nonbranded merchandise, greater price transparency, and a decline in store-based inventory and foot traffic. Apparel manufacturers thus increased investments in distributing product via their own websites and have focused on lowering supply chain costs and speeding time to market. The average credit spread in the apparel manufacturing sector widened by only three basis points since the last chartbook publication. However, this metric masks slight tightening by most issuers in the sector, except for Hanesbrands (BBB-, Stable), whose 2026 bonds substantially underperformed, as the spread widening 25 basis points to +237 over Treasuries.

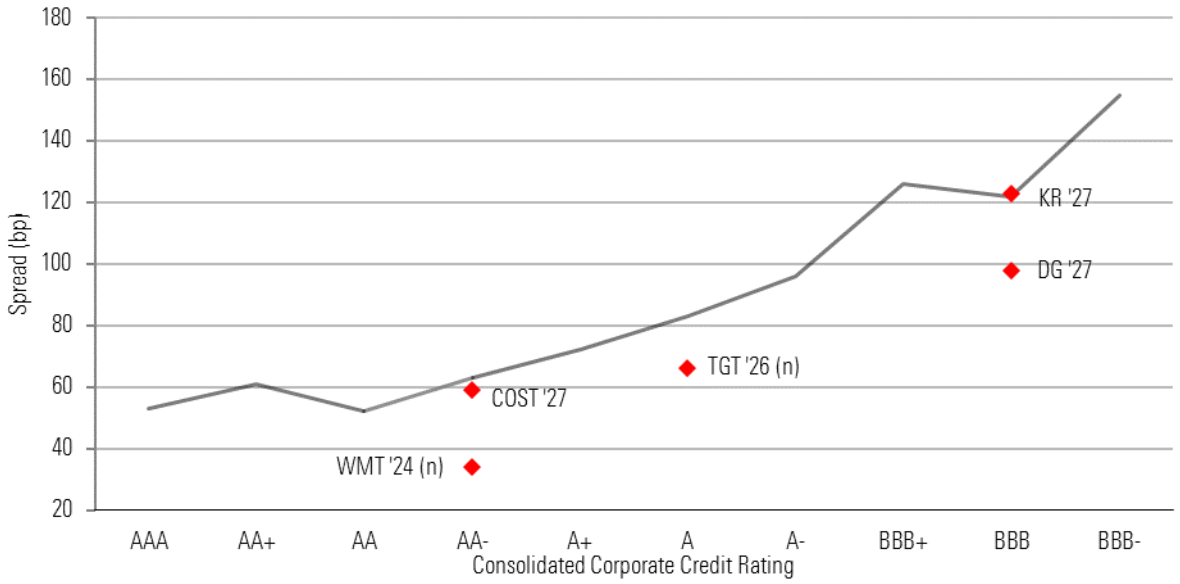
Issuer Highlights

- Nike's (AA-, Stable) rating was affirmed and considered its leading position in the athletic footwear and apparel industry, along with strong cash flow and a conservative balance sheet. The company's position is supported by various premium brands that enable Nike to maintain higher prices than competitors. Nike's rating is also well supported by a strong Solvency Score, which is driven by high margins and returns. A stable outlook reflects Nike's financial strength and consistently high margins and returns.

- VF Corp.'s (A, Stable) rating was affirmed in December 2017, reflecting VFC's strong brand portfolio and a growing digital platform that generates high returns, coupled with a moderately leveraged balance sheet. The recent $800 million cash acquisition of Williamson-Dickie and the divestiture of Nautica has elevated the brand portfolio. A stable outlook reflects our expectation that VFC will maintain leverage near its target range despite the potential for debt financed acquisitions.
- Ralph Lauren's (A-, Negative) rating was affirmed in December 2017, reflecting Ralph Lauren's solid competitive position and the maintenance of balance sheet strength during its restructuring. The negative outlook was maintained reflecting the expectation that revenue and EBITDA will continue to decline during its Way Forward restructuring program and despite margin improvement over the past two quarters. Ralph Lauren's rating could be lowered if the company is unable to stabilize profitability through these restructuring efforts.
- L Brand's (BB+, Stable) sold $500 million 5.25% senior notes due in 2028 during January 2018. Proceeds were utilized for the redemption of its 8.5% senior notes due 2019. A stable rating outlook reflects the expectation that L Brands will stabilize profitability and returns albeit at somewhat lower-than-historical levels.

Discounters and Grocery

Exhibit 5 Discounters and Grocery Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of March 2, 2018
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends and Spreads

Over the past year big-box discounters and grocers have made progress with addressing changes in the retail landscape, which have included initiatives to lower prices to maintain market share as well as to increase investments in e-commerce. Credit spread changes in the sector have been minimal since the last chartbook, with the average credit spread tightening by three basis points. Most of this move was driven by Kroger (BBB, Stable), whose 2027 bond spreads tightened 16 basis points to +123 over Treasuries.

Issuer Highlights

- Costco's (AA-, Stable) rating was affirmed in January 2018 based on its position as the second-largest retailer in the world, along with a low-cost operating model and a valuable brand. While EBITDA margin expansion may slow due to increasing competitive pressures, a stable outlook reflects Morningstar's expectation that Costco will continue to generate strong returns consistent with its competitive position and conservative balance sheet. Costco's rating could be raised with further improvements in profitability and returns on invested capital, which along with limited balance sheet leverage could improve its Solvency Score.
- Wal-Mart's (AA-, Negative) rating was affirmed in January 2018, reflecting its leading competitive position as the world's largest retailer, providing it with a tremendous cost advantage and purchasing

power. Wal-Mart has increased investments in its e-commerce business, which has been supported by significant acquisitions of online retailers, including Jet.com. The outlook remains negative, reflecting the potential for the rating on Wal-Mart to be lowered if investments in existing stores and e-commerce do not sustain comparable sales growth or stabilize operating margins and returns on invested capital.

- Target's (A, Negative) rating was affirmed in January 2018, which considered the company's solid market position among discount retailers, along with support from a sound liquidity position and the maintenance of a modest leverage profile. The company is one year into a three-year $7 billion capital investment plan that includes accelerated investments in its existing store base, its e-commerce platform, the rollout of a new smaller-store urban format, and improvements in customer fulfillment. The rating also incorporates the expected margin pressure over the next couple years due to higher investment spending, and its negative impact on the company's Cash Flow Cushion score. The outlook remains negative, indicating the rating could be lowered if the company fails to stabilize its competitive position, including a recovery or stabilization in revenue, margins, and return on capital.
- Kroger's (BBB, Stable) rating was affirmed in December 2017 based on Kroger's position as the second-largest grocer in the United States along with the maintenance of a moderately leveraged capital structure. Morningstar forecasts that the margins will remain under pressure with increased competition from large discounters and as online retailers expand grocery offerings. A stable rating outlook reflects an expectation that the Restock Kroger plan will be able to stabilize recently moderated identical-store sales growth and EBITDA margin declines. In addition, the rating contemplates that debt leverage will be returned and maintained within targets with higher free cash flow generation and cash from the sale of its convenience stores, despite moderate share repurchases.
- Dollar General's (BBB, Stable) rating was affirmed in December 2017 based on the company's leading market position in the discount convenience store sector. Dollar General has grown to where it now covers most of the under-served rural community with its 14,000 stores, with about 75% of the population located within five miles of a store. Morningstar believes the dollar store format is somewhat insulated from big-box discounters that risk cannibalizing their own sales if they open smaller stores nearby. Also, most e-commerce players have minimum order sizes and either charge shipping fees or membership fees. A stable rating outlook reflects Morningstar's expectation that Dollar General will balance its growth capital spending and share repurchases within the context of managing to an adjusted debt leverage ratio (debt/EBITDAR) of 3 times.

Exhibit 6 Consumer Cyclical Coverage

Issuer	Rating	Outlook	Rating Date	Direction	Coupon	Maturity	Bid	YTW	STW
Apparel									
Ralph Lauren Corp.	A-	Negative	12/22/2017	Affirmation	2.63%	8/18/2020	99.89	2.67%	36
VF Corp.	A	Stable	12/21/2017	Affirmation	3.50%	9/1/2021	101.68	2.95%	53
Nike Inc.	AA-	Stable	12/26/2017	Affirmation	2.38%	11/1/2026	92.72	3.35%	53
Gap Inc.	BB+	Stable	6/1/2017	Affirmation	5.95%	4/12/2021	106.34	3.59%	122
HanesBrands Inc.	BBB-	Stable	10/17/2017	Affirmation	4.88%	5/15/2026	98.00	5.18%	237
L Brands Inc.	BB+	Stable	10/17/2017	Affirmation	5.63%	10/15/2023	95.29	5.88%	297
Department Stores									
TJX Cos Inc.	A	Stable	12/22/2017	Affirmation	2.25%	9/15/2026	90.83	3.50%	69
Kohls Corp.	BBB-	Negative	3/29/2017	Affirmation	4.25%	7/17/2025	101.99	3.93%	115
Nordstrom Inc.	BBB+	Negative	3/20/2017	Affirmation	4.00%	3/15/2027	97.75	4.30%	148
Macy's Retail Holdings Inc.	BBB-	Negative	3/28/2017	Affirmation	3.63%	6/1/2024	95.95	4.37%	166
Discounters & Grocery									
Wal-Mart Stores Inc.	AA-	Negative	1/25/2018	Affirmation	3.33%	4/22/2024	101.44	3.03%	34
Costco Wholesale Corp.	AA-	Stable	1/24/2018	Affirmation	2.35%	5/18/2022	96.47	3.45%	59
Target Corp.	A	Negative	1/24/2018	Affirmation	2.50%	4/15/2026	93.23	3.46%	66
Dollar General Corp.	BBB	Stable	12/14/2017	Affirmation	4.15%	11/1/2025	100.26	3.84%	98
Kroger Co.	BBB	Stable	12/13/2017	Affirmation	3.50%	2/1/2026	96.96	4.09%	123
Gaming, Lodging & Leisure, Casino									
Marriott International Inc.	BBB	Stable	8/29/2017	Upgrade	3.13%	6/15/2026	95.58	3.75%	94
Booking Holdings Inc.	A-	Positive	3/12/2018	Affirmation	3.60%	6/1/2026	96.33	4.00%	111
Carnival Corp.	BBB+	Stable	3/15/2017	Upgrade	6.65%	1/15/2028	120.55	4.09%	116
Hyatt Hotels Corp.	BBB-	Stable	8/28/2017	Affirmation	4.85%	3/15/2026	105.47	4.02%	123
Hasbro Inc.	BBB+	Stable	10/17/2017	Affirmation	3.50%	9/15/2027	94.64	4.19%	131
Royal Caribbean Cruises LTD	BBB-	Stable	3/14/2017	Upgrade	3.70%	3/15/2028	95.22	4.29%	140
NCL Corp. LTD	BB	Stable	3/14/2017	Affirmation	4.75%	12/15/2021	102.13	3.93%	157
Expedia Inc.	BBB-	Stable	3/12/2018	Affirmation	3.80%	2/15/2028	93.00	4.68%	177
MGM Resorts International	BB-	Positive	6/20/2017	Affirmation	4.63%	9/1/2026	97.50	4.99%	218
Wynn Las Vegas	BB-	Stable	4/13/2017	Affirmation	5.50%	3/1/2025	100.25	5.46%	270
Mattel Inc.	BB	Negative	2/09/2018	Downgrade	3.15%	3/15/2023	100.87	6.56%	384
Information Services & Publishing									
Thomson Reuters Corp.	BBB+	Stable	2/26/2018	Affirmation	3.35%	5/15/2026	96.17	3.90%	109
Specialty Retail									
Home Depot Inc.	A+	Stable	5/27/2017	Affirmation	3.00%	2/12/2026	94.15	3.53%	66
Best Buy Co. Inc.	BBB-	Stable	3/20/2017	Upgrade	5.50%	3/15/2021	106.47	3.05%	69
Amazon.com Inc.	A	Stable	2/22/2018	Affirmation	3.80%	12/5/2024	96.18	3.63%	77
Lowe's Companies Inc.	A	Stable	5/27/2017	Affirmation	3.10%	5/3/2027	95.58	3.67%	82
eBay Inc.	BBB+	Stable	2/22/2018	Affirmation	3.45%	8/1/2024	99.40	3.56%	82
O'Reilly Automotive Inc.	BBB+	Stable	2/27/2018	Affirmation	3.55%	3/15/2026	97.20	3.96%	108
Advance Auto Parts Inc.	BBB	Stable	2/27/2018	Affirmation	4.50%	12/1/2023	103.75	3.74%	108
AutoZone Inc.	BBB+	Stable	2/20/2018	Affirmation	3.75%	6/1/2027	98.77	3.97%	110
Bed Bath & Beyond Inc.	BBB-	Stable	10/2/2017	Downgrade	3.75%	8/1/2024	97.63	4.17%	144

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Morningstar® Credit Research

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