

Morningstar Corporate Credit Research Highlights

Risk assets enter a short-term holding pattern.

Morningstar Credit Ratings, LLC
23 January 2017

Credit Market Insights

- ▶ Market data and insights.

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Credit Rating Actions

- ▶ Rating Changes

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Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Wal-Mart Stores WMT	AA-	AA
EOG Resources EOG	BBB+	A
Masco MAS	BBB	BBB-

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Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Target TGT	A	A
Roger Communications RCI	BBB-	BBB-
Costco COST	AA-	AA-
Mondelez International MDLZ	BBB	BBB
Campbell Soup CPB	A-	A-
Heineken HEINY	A-	A-
Eli Lilly LLY	AA	AA
Novartis NVS	AA	AA
Johnson & Johnson JNJ	AAA	AAA
Pentair PNR	BBB	BBB

Recent Notes Published by Credit Analysts

- ▶ **Terex** in the market offering \$550 million 8NC3 senior notes to call existing bonds.
- ▶ **Kroger** offering new 30-year bonds to refinance commercial paper.
- ▶ **Bank of America** offering multitranche new issue of senior holding company notes.
- ▶ Fixed-income trading results contribute to another solid quarter for **Morgan Stanley**.
- ▶ An extra week benefits **CSX**'s 4Q earnings.
- ▶ **Canadian Pacific** reports record operating ratio, but results overshadowed by management shuffle.
- ▶ **Goldman**'s solid 4Q results supported by strong fixed-income trading and expense control.
- ▶ **Netflix** catches 4Q subscriber growth tailwind but guides to higher cash burn in 2017.
- ▶ Fresh off solid 4Q earnings, **U.S. Bancorp** issues 5-year notes.
- ▶ **Union Pacific** finishes 2016 on solid footing and guides to better 2017.
- ▶ **Mallinckrodt** reduces litigation overhang, but pricing concerns remain.
- ▶ **Western Union**'s 4Q charge a short-term negative, but ultimately neutral to our rating.
- ▶ **Kansas City Southern** ends 2016 on mixed note, while uncertainty reverberates into 2017.
- ▶ More.

Credit Market Insights

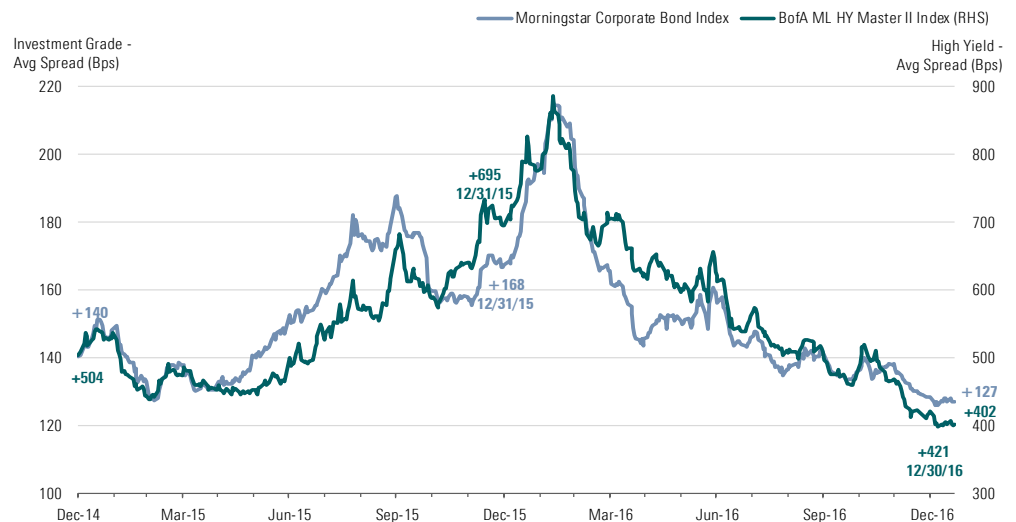
Risk Assets Enter a Short-Term Holding Pattern

Between the uncertainty driven by the change in the administration and the arrival of fourth-quarter earnings season, risk assets entered into a short-term holding pattern last week. The average corporate credit spread of the Morningstar Corporate Bond Index, our proxy for the investment-grade bond market, was unchanged at +127 last week. In the high-yield market, the credit spread of the Bank of America Merrill Lynch High Yield Master Index was also unchanged at +402. In the equity markets, the S&P 500 was essentially unchanged for the week, declining 0.10%. Price action in the commodity markets was mixed, but overall price changes were modest.

A significant portion of investors' caution toward the corporate bond market is the acknowledgment that corporate credit spreads are trading at very tight levels compared with recent and historical averages. The current level is the tightest that credit spreads have registered since late 2014 and significantly tighter than long-term averages. The average spread of the Morningstar Corporate Bond Index is 41 basis points tighter than the long-term average of +168 since the end of 1998. The average spread of the Bank of America Merrill Lynch High Yield Master Index is currently 178 basis points tighter than its long-term average of +580 basis points since the end of 1996.

Fourth-quarter earnings releases began last week with the global banking sector reporting first, and the pace in other sectors will ramp up this week. While fourth-quarter results will help investors gauge near-term corporate credit risk, the real focus will be on 2017 guidance and any potential changes in capital-allocation policies. In addition to the volatility that earnings can generate, with the change in the administration, many investors are trading cautiously in the market until there is greater clarity regarding the policies that President Donald Trump will pursue in the near term. As such, defensive issuers generally traded better last week, although there did not appear to be a significant sector rotation toward a defensive portfolio posture.

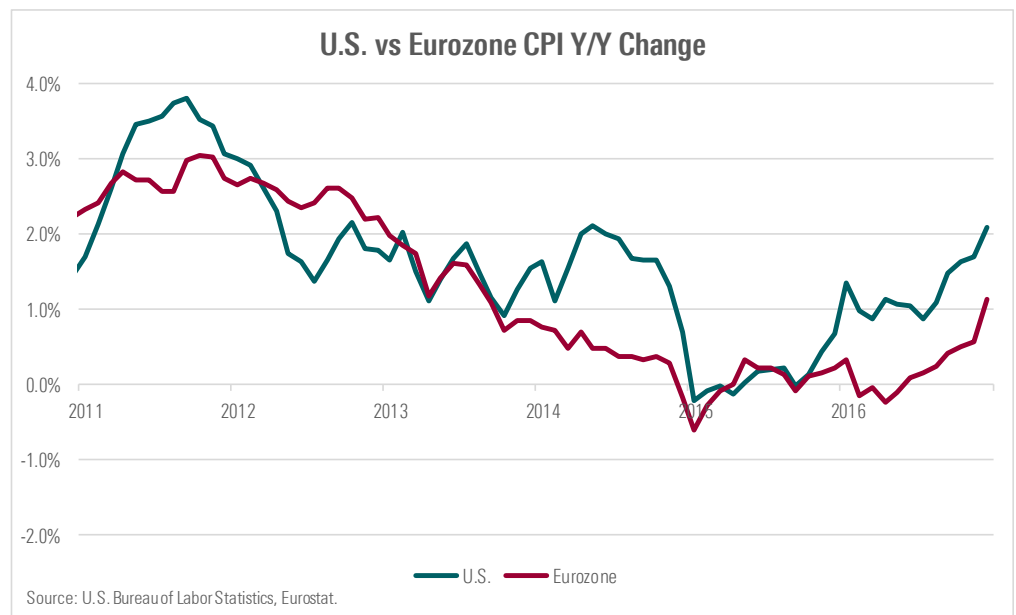
Corporate Bond Credit Spreads



Source: Morningstar, Inc., BofA Merrill Lynch Global Indexes. Data as of 01/20/2017.

Global Inflation Showing Signs of Life

After declining the prior week, interest rates bounced slightly higher in the United States and are nearly unchanged year to date. However, interest rates in Europe continue to rise toward their highest levels of the past year as inflation in the eurozone is showing signs of accelerating. Eurostat reported that annual inflation in the euro area accelerated 1.1% in December 2016. That compares with 0.6% in November and 0.2% in the year-ago period. The inflation rate in Germany (the single largest economy in Europe) rose 1.7%. The yield on 10-year German bonds rose to 0.42%, the highest since January 2016. Comparatively, inflation in the U.S., as measured by the Consumer Price Index, rose 2.1% for the 12 months ended December 2016. In his first-quarter 2017 outlook, Robert Johnson, Morningstar's director of economic analysis, forecast that inflation will continue to accelerate over the course of the year. Currently, he projects that the U.S. core inflation rate will rise to 2.4%-2.6% by the end of this year.



After reaping double-digit returns last year and with greater short-term uncertainty building, investors decided to reduced their exposure to the high-yield asset class last week. For the first time in over two months, high-yield exchange-traded funds suffered from an outflow as over \$1.0 billion in assets were redeemed out of the asset class.

Estimated Weekly High-Yield Bond Fund Flows and High Yield Credit Spreads

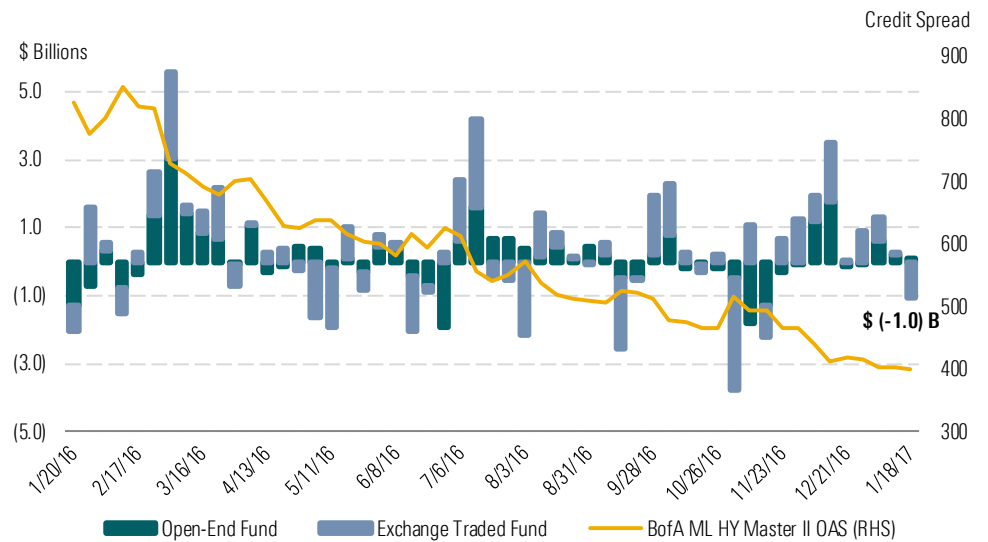


Exhibit 1 Morningstar Credit New Issue Monitor

Week ended Jan. 20, 2017

(000,000s \$ unless otherwise noted)

Issuer			Issue				
Name	Ticker	Morningstar Corporate Rating	Size	Coupon	Description	Maturity	Approx Spread to US Treasuries
Bank of America	BAC	BBB	\$1,500	3.12%	Senior Unsecured	2023	+130
Bank of America	BAC	BBB	\$750	L+116	Senior Unsecured	2023	NA
Bank of America	BAC	BBB	\$2,500	3.82%	Senior Unsecured	2028	+150
Bank of America	BAC	BBB	\$2,000	4.44%	Senior Unsecured	2048	+150
Kroger	KR	BBB	\$1,000	4.45%	Senior Unsecured	2047	+150
Morgan Stanley	MS	BBB	\$1,750	L+118	Senior Unsecured	2022	NA
Morgan Stanley	MS	BBB	\$3,000	3.63%	Senior Unsecured	2027	+143
Morgan Stanley	MS	BBB	\$2,250	3.75%	Senior Unsecured	2047	+148
Terex	TEX	BB-	\$600	5.63%	Senior Unsecured	2025	+337
US Bancorp	USB	A+	\$1,250	2.63%	Senior Unsecured	2022	+70
US Bancorp	USB	A+	\$250	L+116	Senior Unsecured	2022	NA
US Bank NA	USB	A+ ⁽¹⁾	\$1,100	2.00%	Senior Unsecured	2020	+55
US Bank NA	USB	A+ ⁽¹⁾	\$400	FLT	Senior Unsecured	2020	NA
Wells Fargo	WFC	A	\$3,750	3.07%	Senior Unsecured	2023	+125
Wells Fargo	WFC	A	\$1,250	L+111	Senior Unsecured	2023	NA

Source: Advantage Data, Company SEC filings.

(1) Morningstar's issuer credit rating is assigned at the holding company level.

Exhibit 2 Morningstar, Inc. Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	Spread (bps)	MTD Spread Chg (bps)	YTD Spread Chg (bps)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	A-	4,620	6.7	127	(2)	(2)	0.20	0.20
FINANCIAL	A-	1,423	5.4	122	(0)	(0)	0.09	0.09
Bank	A-	881	5.0	123	1	1	(0.01)	(0.01)
Finance	A	254	5.7	117	(4)	(4)	0.30	0.30
Insurance	A	209	7.6	119	(3)	(3)	0.35	0.35
REITs	BBB+	71	6.0	131	(4)	(4)	0.34	0.34
INDUSTRIAL	A-	2,648	7.4	129	(2)	(2)	0.20	0.20
Basic Industries	BBB+	229	7.4	169	(11)	(11)	1.02	1.02
Consumer Products	A-	285	7.5	108	1	1	0.03	0.03
Energy	A-	409	7.0	156	1	1	0.18	0.18
Healthcare	A-	406	7.6	114	(2)	(2)	0.13	0.13
Manufacturing	A-	377	6.2	106	(4)	(4)	0.26	0.26
Media	BBB+	193	8.2	157	(1)	(1)	0.14	0.14
Retail	A-	165	7.9	111	3	3	(0.32)	(0.32)
Technology	A+	271	7.1	102	(3)	(3)	0.29	0.29
Telecom	BBB+	150	8.3	158	(0)	(0)	0.08	0.08
Transportation	BBB+	122	9.1	131	(2)	(2)	0.38	0.38
UTILITY	BBB+	505	8.3	145	(7)	(7)	0.70	0.70
Electric Utilities	A-	303	8.6	131	(5)	(5)	0.58	0.58
Gas Pipelines	BBB+	194	7.7	167	(9)	(9)	0.88	0.88

Rating Bucket

AAA Bucket		100	7.5	67	1	1	0.02	0.02
AA Bucket		536	5.9	82	(2)	(2)	0.16	0.16
A Bucket		1,764	6.8	106	(0)	(0)	0.10	0.10
BBB Bucket		2,220	6.9	161	(3)	(3)	0.32	0.32

Term Bucket

1-4	A-	1,440	2.3	88	(5)	(5)	0.23	0.23
4-7	A-	1,136	4.6	113	(3)	(3)	0.27	0.27
7-10	A-	874	7.1	138	1	1	0.00	0.00
10PLUS	A-	1,170	13.5	176	1	1	0.25	0.25

Data as of 01/20/2017

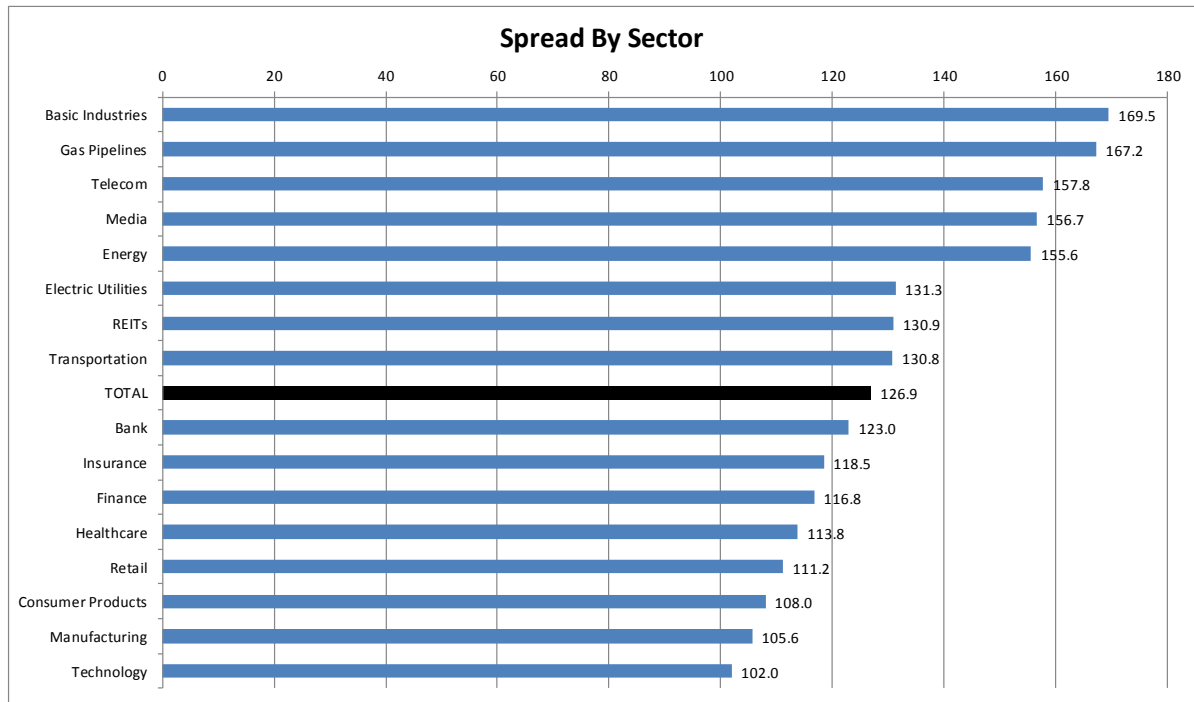
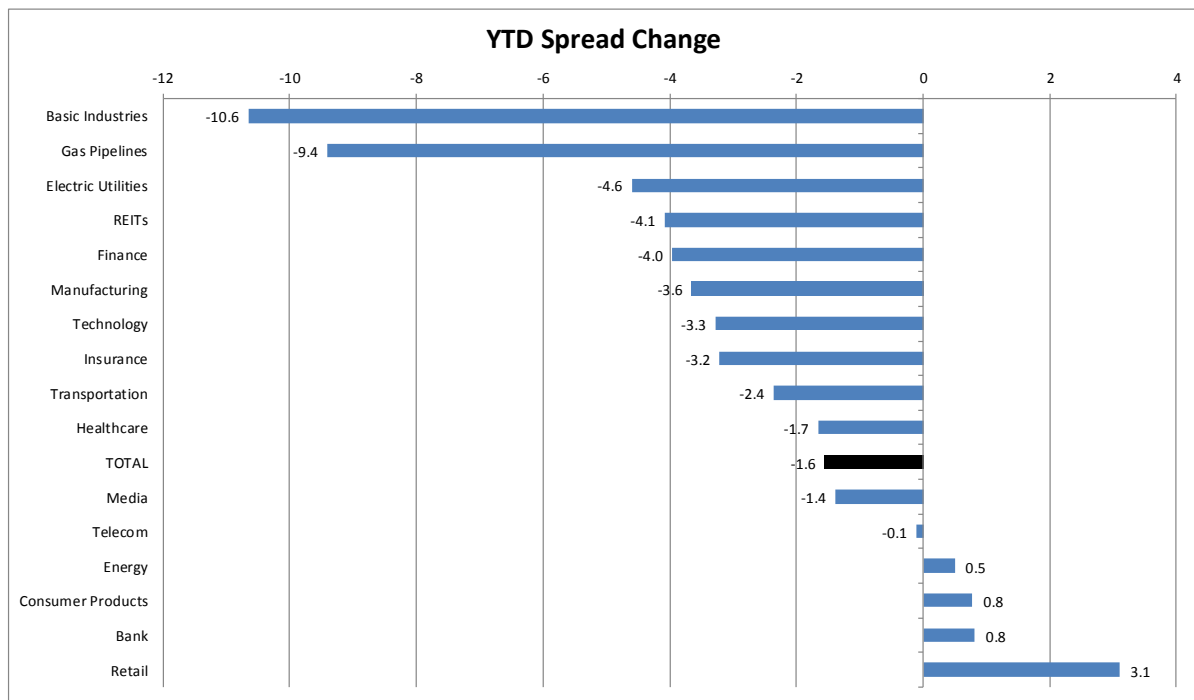
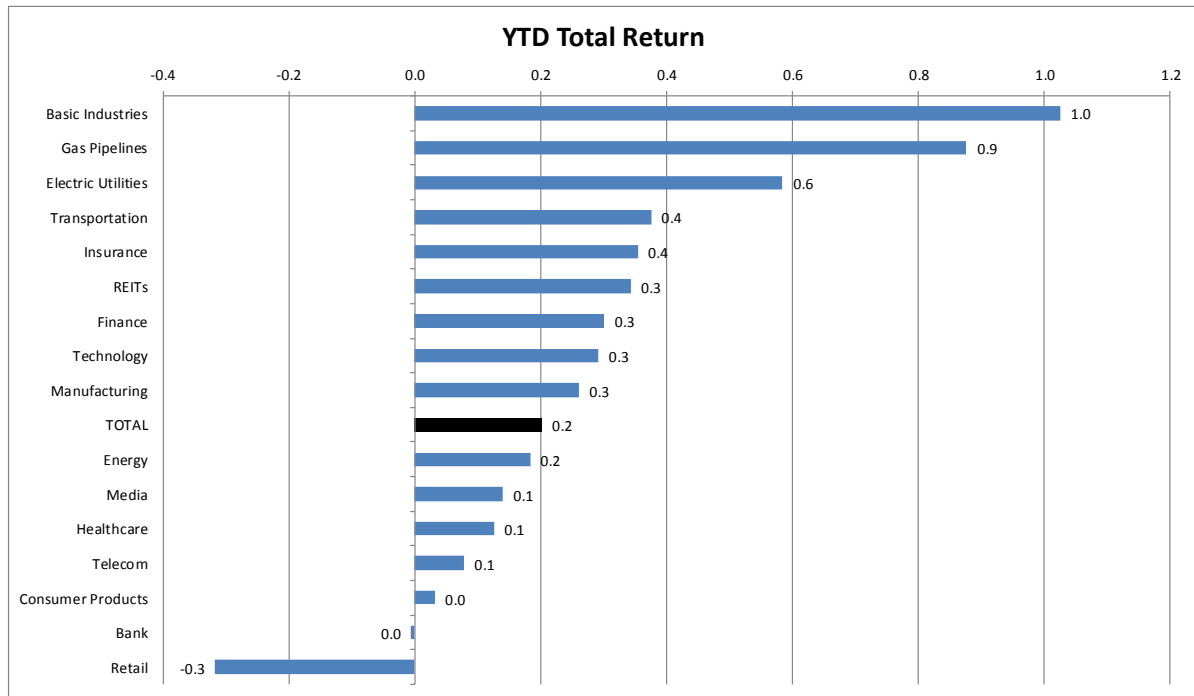
Exhibit 3 Morningstar, Inc. Corporate Bond Index Spread by Sector**Exhibit 4** Morningstar, Inc. Corporate Bond Index YTD Spread Change

Exhibit 5 Morningstar, Inc. Corporate Bond Index YTD Return

Credit Rating Actions

► Rating Changes

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Costco COST	AA-	AA-
Mondelez International MDLZ	BBB	BBB
Campbell Soup CPB	A-	A-
Heineken HEINY	A-	A-
Eli Lilly LLY	AA	AA
Novartis NVS	AA	AA
Johnson & Johnson JNJ	AAA	AAA
Pentair PNR	BBB	BBB

Wal-Mart's Rating Downgraded to AA- on Competitive and Profit Pressures; Negative Outlook

Morningstar Credit Ratings, LLC is downgrading Wal-Mart's credit rating one notch to AA- and assigning a negative outlook. The downgrade is based on multiyear erosion in profitability as evidenced by lower margins and returns due to increased competition. In response to pressures from alternative discount-store formats and online-only retailers, Wal-Mart has increased investments in order maintain same-store sales growth and everyday low pricing. While MCR's rating contemplates stabilization in profitability, it does not forecast a return to historical margins or returns in the near future. Wal-Mart's rating continues to be supported by a very strong competitive position, substantial free cash flow generation, and moderate debt leverage.

Wal-Mart derives a tremendous cost advantage as a result of the purchasing power it commands as the world's largest retailer, with more than \$480 billion in annual global sales. The company uses this leverage to obtain the most favorable terms from suppliers, vendors, and manufacturers. In addition, Wal-Mart has developed an intangible brand asset through its deep customer trust that it provides everyday low prices. Wal-Mart is increasing investments in e-commerce, which generates strong double-digit digital sales. These initiatives include leveraging its massive store base as points of distribution for delivery, using mobile payment systems, testing free shipping, and the recent closing of the \$2.4 billion acquisition of Jet.com. Morningstar's Equity Research Group has assigned a wide economic moat rating to Wal-Mart.

Historically, Wal-Mart has posted positive same-store sales growth in the low single digits. Nevertheless, profitability has weakened over the past several years. EBIT margins declined to 5.0% in fiscal 2016, which are over 100 basis points lower than five years earlier. Capital expenditures are projected to be approximately \$11.0 billion, or about \$2 billion below more recent levels, as the company

moderates new store openings, accelerates the pace of remodels, and invests in labor and e-commerce initiatives. Wal-Mart generates substantial discretionary free cash flow after annual dividends of \$6.3 billion and share repurchases that increased to \$8.6 billion for the last 12 months ended with the third quarter of fiscal 2017.

Management maintains a moderately leveraged balance sheet. Leverage as measured by lease-adjusted debt/EBITDAR has remained in the 1.9-2.0 times range over the past five years. Wal-Mart's slightly below average Solvency Score reflects this leverage, as well as a decline in the return on invested capital over the past several years. Wal-Mart maintains excellent liquidity, including generally \$9 billion of balance sheet cash at year-end (roughly half of which is held outside the U.S.) as well as a \$6 billion undrawn revolver that matures in 2020 and a \$9 billion undrawn 364-day revolver, both used to support commercial paper borrowings. Over the next five years, MCR projects modest 2% annual revenue growth, a stabilization in EBIT margins (albeit at a lower range), continued strong free cash flow generation, and the maintenance of adjusted leverage at or below historical levels.

The negative outlook on Wal-Mart's credit rating reflects the potential for ratings to be lowered if the company's investments in existing stores and e-commerce do not result in improvements in comparable sales growth along with stabilization in operating margins and returns on invested capital. A rating upgrade is unlikely in the near term given the negative outlook. A rating downgrade could also occur if management allocates substantially more of its free cash flow toward shareholder distributions, resulting in heightened debt levels.

EOG Resources' Rating Downgraded to BBB+, Stable Outlook Initiated; Solid FCF Supports Credit

Morningstar Credit Ratings, LLC is downgrading the corporate credit rating of EOG Resources by two notches to BBB+ and establishing a stable outlook. Our rating reflects EOG's large inventory of repeatable, low-risk, oil-weighted drilling opportunities in the Permian Basin and Eagle Ford Shale of Texas; estimated organic production growth of about 15% per year for the next few years; the cyclicity of exploration and production (upstream) activity; cost and production growth-related synergies from the recent acquisition of privately held Yates Petroleum (stock and cash transaction), especially, rich acreage in the Permian and Powder River Basins; and excellent liquidity and moderate debt leverage. The rating outlook incorporates our expectation that operating margins will gradually increase in light of cyclically rebounding oil and natural gas price realizations over the next several quarters, but not to the level commensurate with our previous rating. Our rating also reflects the view of Morningstar's Equity Research Group that EOG does not benefit from an economic moat, which negatively affects our Business Risk score.

When the sharp decline in oil and gas prices began in the fall of 2014, EOG refocused its resources on the best acreage and undertook aggressive cost-reduction measures. These actions include ongoing field and capital efficiency gains and capture of deflation in exploration and production, or E&P, supply-chain inputs, resulting in a steadily declining cash operating cost per barrel of oil equivalent. Further, tactical acquisitions have helped the company block up acreage in key plays. The issuance of \$1.0 billion in long-term debt in January helped fund 2016 investing activities, including the redemption of existing debt and for capital expenditures.

We regard EOG's liquidity as excellent. EOG ended the September quarter with approximately \$1.0 billion in cash and equivalents (pro forma for the Yates acquisition, closed Oct. 4) and full availability on its \$2.0 billion unsecured revolving credit facility. EOG has forecast capital expenditures of \$2.6 billion to \$2.8 billion for 2016, which is nearly 50% lower than the prior year. After adjusting for capital expenditures, dividends, acquisitions, divestments, and debt and equity issuances, we estimate positive free cash flow for EOG in 2016 and thereafter. Steady debt maturities beginning in 2017 and a moderate dividend tend to cap our Cash Flow Cushion score.

In our base forecast, we estimate the company's EBITDAX margin gradually rising to 52% by 2020, after bottoming at about 38% in 2016. Commensurate with this, we estimate the ratio of total debt/trailing EBITDAX to have peaked at nearly 3 times in 2016, declining back to around 1 time by 2018. Our base operating forecast incorporates an average 2017 price assumption of \$3.50 per million British thermal units for U.S. natural gas and \$55/barrel for West Texas Intermediate oil. Our forecast incorporates natural gas pricing in line with or slightly above the futures price curve (as of Jan. 11) through 2020. For oil (WTI basis), our yearly forecast is 6%-12% above the futures price curve through 2020, at the top end of our range for the last two years of our forecast. Furthermore, we have incorporated \$625 million net proceeds in 2016 from the sale of noncore assets. After 2016, we assume sale of noncore acreage inventory of \$400 million per year. The company realized \$193 million in proceeds from asset divestitures in 2015, \$569 million in 2014, and \$761 million in 2013.

Our rating outlook is stable and assumes that the company is able to incrementally reduce leverage from higher price realizations that should come about from the gradual improvement in oil and gas supply/demand fundamentals. However, if spot pricing continues to languish, further squeezing margins and pressuring the Solvency Score, we may consider a further downgrade of the credit rating. Alternatively, if oil and gas supply/demand fundamentals and the pricing outlook improve more quickly than our current expectation, we would consider raising the credit rating as we would expect improvement in our Cash Flow Cushion and Solvency Scores.

Masco's Credit Rating Upgraded One Notch to BBB on Improving Credit Metrics; Stable Outlook

Morningstar Credit Ratings, LLC is upgrading Masco's corporate credit rating one notch to BBB and assigning a stable outlook. The rating upgrade is based on Masco's improving financial picture and expected ongoing deleveraging, combined with favorable end-market fundamentals.

Our rating reflects Masco's solid portfolio of four product lines and improving financial metrics. After a portfolio review and spin-off of its highly cyclical installation business (primarily exposed to the new-home construction market) in 2015, Masco now has a portfolio of market-leading brands focused primarily on the less-cyclical repair and remodel market. These range from Delta faucets to Behr paint to Milgard windows to KraftMaid cabinets. The strength of the plumbing and paint segments in particular drives the firm's narrow economic moat, as assigned by Morningstar's Equity Research Group, a positive for our Business Risk assessment. Still, a modest degree of cyclicity and management's desire to continue to make bolt-on acquisitions tempers that score.

Masco has delivered strong deleveraging over the past several years since gross leverage peaked at over 8 times in 2011. Total debt has since been reduced to \$3 billion from \$4 billion and leverage has declined to under 3 times. Meanwhile, the company continues to maintain healthy liquidity, with cash exceeding \$1 billion and an undrawn \$750 million revolver available. Our Cash Flow Cushion reflects the solid cash balances and accelerating free cash flow, modest debt maturities until 2020, but growing dividends. The company's capital allocation policy now also includes over \$400 million in annual share repurchases over the next couple of years, which, along with dividends, should consume nearly all free cash flow. We expect bolt-on acquisitions to be of modest size but to possibly be funded with excess cash. Overall, we forecast mid-single-digit top-line growth over the next five years, with steady margin expansion leading to EBITDA growth in the high single digits. Masco's growth profile is largely in line with underlying residential repair and remodel growth, which is driven by an expected increase in existing-home sales and overall housing values.

Masco's credit rating could improve should it generate growth above our expectations due to strong end-market demand along with modest acquisitions, as this could improve our Business Risk score. Growth that drives operating margins higher and gross leverage to 2 times or lower could improve our Solvency Score and warrant an upgrade. Should the firm make a large debt-funded acquisition or sell existing assets with proceeds returned to shareholders, the rating could be lowered.

Target's Credit Rating Affirmed at A and Stable Outlook Assigned

Morningstar Credit Ratings, LLC is affirming Target's A credit rating and assigning a stable outlook. The rating affirmation is based on Target's solid competitive position, strong free cash flow generation, and modest debt leverage.

Target's above-average Business Risk score is based on a strong competitive position derived from a well-known brand, convenient locations, and considerable scale. Target generates higher margins than its largest store based peers including Wal-Mart, Kroger, and Costco. Target focuses largely on higher-margined product categories including apparel, home decor, and baby/kids. Target's business improvement plans include accelerated investments in e-commerce, rolling out its new smaller-store urban format, and additional cost-cutting. Still, Target faces increasing competition from e-commerce retailers, which may make it difficult for the firm to sustain traffic and volume in its higher-margin discretionary categories. Further, Target's grocery offerings lack scale compared with the largest discounters and grocers. Morningstar's Equity Research Group does not assign Target an economic moat.

Comparable store sales have been flat year to date through the third quarter ended Oct. 29, with similar results expected for the full year. Nevertheless, operating results have improved due to substantial cost-cutting efforts over the past two years. Meanwhile, gross margins have benefited slightly from the sale of its pharmacy business. For the last 12 months ended with the third quarter, EBITDA margins were 11.4%, a 90 basis points increase compared with full-year 2015 and a 220 basis point improvement compared with 2014. Over the next several years MCR expects comparable store sales to reflect a more historical 2% growth rate along with modest margin expansion.

Target maintains a moderately leveraged balance sheet with adjusted debt/EBITDAR at 1.8 times for the 12 months ended Oct. 29. In addition, leverage has declined on a gross basis from 2.1 times at year-end fiscal 2014. Adjusted debt of \$13.8 billion includes only \$1.2 billion of obligations related to operating leases, reflecting Target's mostly owned store base. Target maintains good liquidity including \$1.2 billion of cash at the end of the third quarter and a \$2.5 billion revolving credit facility (expiry in October 2021). Cash balances are typically at their low point at the end of the third quarter due to working capital requirements ahead of the holiday season. Nevertheless, recent shareholder distributions have exceeded cash flow. Over the last 12 months, free cash flow was \$3.4 billion while Target paid out \$1.4 billion in dividends and \$4.2 billion of share repurchases. MCR anticipates management would reduce share repurchase activity, if necessary, to maintain historical debt leverage.

A stable rating outlook reflects MCR's expectation that Target will maintain historical profit metrics and adjusted debt leverage ratios. Target's rating could be raised most likely through a higher Solvency Score, which could improve if Target retains substantially more of its cash flow, improving balance sheet leverage and liquidity, or by continued improvements in profitability and returns. The rating could be lowered if competitive threats pressure profitability and returns, or if there is a sustained increase in debt leverage above historical ranges.

**Rogers Communications' Rating Affirmed at BBB-, Outlook Stable;
Credit Remains Pressured by Leverage**

Morningstar Credit Ratings, LLC is affirming its BBB- corporate credit rating on Rogers Communications and maintaining a stable outlook. Our rating reflects Rogers' elevated leverage and near-term capital market dependence. The wireless spectrum acquisition in 2014 pushed Rogers' leverage well above management's stated long-term target of 2.5 times and resulted in pressure on its Cash Flow Cushion. A decline in returns on invested capital in recent years has also put pressure on our Solvency Score. However, Rogers' Business Risk remains supported by its strong market position in both wireless and fixed-line communications throughout Canada. Morningstar's Equity Research Group assigns the company a narrow economic moat.

We expect returns on invested capital to recover over the next few years, though growing competitive pressure is likely to keep capital spending elevated. We also believe that material debt reduction may be a few years off, depending on Rogers' ability to increase EBITDA and cash flow from its recent spectrum investments.

At the end of September 2016, Rogers reported CAD 17 billion of debt at par value (excluding the offset from derivative hedges), supported by CAD 2.2 billion of marketable investments. Of this, we estimate that readily marketable securities represent approximately CAD 1 billion, based on the company's disclosure in 2015. By our calculation, net debt ended the quarter at 3.1 times EBITDA, up from 2.4 times at year-end 2013. Leverage has increased primarily due to CAD 4.5 billion of acquisitions over the past two years, involving CAD 3.7 billion of debt issuance. Over the most recent 12-month period, the carrier reported free cash flow of CAD 1.3 billion, while the dividend consumed CAD 988 million. Management remains committed to restoring net leverage to around 2.5 times EBITDA.

Our outlook is stable and assumes revenue growth of around 3.5% per year and a moderate increase in operating margin over the next five years. Our forecast assumes Internet access accounts will expand at a steady annual rate, providing a partial offset to ongoing declines in traditional pay-TV and phone services. Barring additional spectrum or other material acquisitions, we expect net leverage to end our five-year forecast period above this target, but below its current level of 3.1 times.

We may consider an upgrade of the rating if management is able to bring leverage down materially toward its long-range target and improve its returns on capital. We may consider further negative rating action if leverage moves materially higher from its current level for an extended period as a result of a decline in cash flow, an acquisition event, or a combination of the two.

Costco's Rating Affirmed at AA- and Stable Outlook Assigned

Morningstar Credit Ratings, LLC is affirming Costco's AA- credit rating and assigning a stable outlook. The rating affirmation is based on Costco's strong competitive position, healthy free cash flow, and conservative financial policies.

Costco's very strong Business Risk score is based on its position as the second-largest retailer in the world along with benefits from its low cost advantage and intangible brand asset. Costco has been assigned a wide economic moat by Morningstar's Equity Research Group. Costco's low cost advantage is derived from its no-frills warehouse store and by focusing its bargaining power on only 3,700 products. A concentrated product offering results in quick-turning inventory and very high sales per square foot that exceeds \$1,000. Costco's working capital needs are reduced as well, as it typically sells inventory before it pays the supplier. Costco's brand intangible asset is validated by the high-90% renewal rate of its members. Membership fee revenue increased 4.5% in fiscal-year 2016 (ended Aug. 28), totaling \$2.65 billion or over 70% of operating profit. Costco provides value by limiting price mark-ups to the very low-double-digit range, and the recent switch to a new Visa card provides customers with rewards opportunities of up to 4%. Costco's gasoline offering and certain loss-leader product categories somewhat insulate the company from the growing impact of online retailers.

Costco has posted consistently strong profitability, however, gasoline deflation and foreign exchange had a negative impact on recent results. Excluding this impact, same-store sales increased 4% for fiscal 2016 and 2% in the first quarter of fiscal 2017. For the LTM period ended with the first quarter of fiscal 2017, EBITDA increased 6.2% to \$5.5 billion while margins expanded 15 basis points to 4.61%. Margins have increased over 50 basis points compared with three years ago. MCR forecasts that over the next several years Costco can grow revenue in the mid- to high-single-digit range including a 4% annual increase in new stores and square footage, while EBITDA margins could expand another 20 to 30 basis points.

Costco's conservative financial policies are reflected in a liquid balance sheet and low debt leverage. The company ended the first quarter of fiscal 2017 on Nov. 20 with strong liquidity including \$6.1 billion in cash and short-term investments, minimal adjusted net debt, and strong interest coverage that is reflected in its above average Solvency Score. Bank credit facilities provide \$400 million of additional borrowing capacity. Costco has maintained adjusted debt/EBITDAR within the range of 1.3-1.5 times

over the past four years and was 1.4 times at the end of the first quarter of fiscal 2017. Adjusted gross debt of \$8.1 billion included \$2.0 billion of obligations related to operating leases. Historically, Costco generates \$2 billion of free cash flow annually, including minimal working capital requirements. In the LTM period through the first quarter of fiscal 2017 Costco generated \$2.7 billion of free cash flow and made nearly \$1 billion of dividend payments and \$500 million in share repurchases.

A stable rating outlook reflects MCR's expectation that Costco's strong competitive position will be maintained along with adherence to a conservative balance sheet. Costco's rating could be raised most likely through a higher Solvency Score, which could increase with continued improvements in profitability and returns or if Costco retains substantially more of its cash flow, improving balance sheet leverage and liquidity. Costco's rating could be lowered if erosion in its competitive advantages leads to deterioration in margins and returns, negatively impacting the Business Risk and Solvency Score.

Mondelez's BBB Rating Affirmed; Outlook Positive on Improved Credit Profile

Morningstar Credit Ratings, LLC is affirming its BBB rating on Mondelez International, Inc. and initiating a positive outlook. Mondelez maintains global leading market positions in biscuits, chocolates, and candy derived from its well-known brands and derives economies of scale from its expansive worldwide network. Approximately 75% of revenue is derived from outside of North America, with about 40% from fast-growing emerging markets. Mondelez has seven brands with annual sales of over \$1 billion each and holds the number-one global market share positions in biscuits, chocolates, and candy and the number-two position in gum. These attributes have resulted in the assignment of a wide economic moat rating by Morningstar's Equity Research Group.

Mondelez continues to face headwinds from weak macroeconomic environments in Europe and emerging markets. The company is balancing pricing to recover commodity cost inflation with maintaining market share, all while improving operating margins and cash flows through its comprehensive supply chain productivity initiatives and its overhead cost-reduction program. We expect the company to achieve its \$1.5 billion goal in cost savings by 2018.

Mondelez's positive outlook is a result of improvements in its Solvency Score, which offsets its low Cash Flow Cushion score. Barring a sizable acquisition, we estimate that Mondelez will grow its top line low to midsingle digits, expand adjusted operating margins to 17-18%, which should gradually improve debt/EBITDA (declining below 3.5 times) and grow interest coverage to the high single digits. We expect the firm will use free cash flow to reinvest in the business, conduct share repurchases, and make bolt-on acquisitions. The proposed financing for the company's unsuccessful bid for The Hershey Co. (A+, negative), which included 50% equity, demonstrated management commitment to maintain an investment-grade rating. If Mondelez were to conduct a large or strategic acquisition, we would expect Mondelez to rapidly reduce leverage and restore its credit measures. For the latest 12 months ended Sept. 30, 2016, total debt/adjusted EBITDA was 3.7 times, adjusted EBITDA/interest was 8.3 times, and free cash flow (cash flow from operations less capital expenditures and dividends) was \$1.1 billion.

Mondelez had \$17 billion of debt at Sept. 30, 2016, composed of \$13 billion of long-term debt and \$4.0 billion of short-term debt and current maturities, of which \$2.2 billion was commercial paper. The

company's debt maturities are manageable, and we anticipate that a substantial portion of the proceeds from Mondelez's October 2016, \$3.75 billion notes offering were used to refinance a portion of its long-term debt. Liquidity is provided by Mondelez's cash balance, which was \$1.7 billion at Sept. 30, 2016. Financial flexibility is afforded by the company's \$4.5 billion multiyear senior unsecured revolving credit facility that expires in October 2021 and its uncommitted credit lines of \$1.8 billion utilized by its international subsidiaries for short-term working capital needs. The revolver was undrawn at period-end, while \$315 million was drawn on uncommitted lines at Sept. 30, 2016.

Approximately 45% of Mondelez's long-term debt is denominated in foreign currency as about 75% of the company's revenue and 67% of its operating income is derived from outside of the U.S.; therefore, we expect the majority of the company's refinancing to be denominated in foreign currencies. Mondelez's pension plan had a projected benefit obligation of \$11.1 billion and plan assets of \$9.0 billion (19% underfunded) as of Dec. 31, 2015, the last period reported. Mondelez made contributions totaling \$498 million during the first nine months ended Sept. 30, 2016, of which \$100 million was a nonrecurring contribution related to merging legacy Cadbury plans in the U.K.

During the first nine months ended Sept. 30, 2016, Mondelez spent \$1.7 billion and had \$3.7 billion remaining under an expanded \$13.7 billion share repurchases program that expires Dec. 31, 2018. Mondelez is committed to maintaining a dividend payout ratio of at least 30%, which will likely grow with its cash earnings. The company targets an investment-grade rating with access to Tier 2 commercial paper. We anticipate that Mondelez will maintain a capital structure consistent with its target and do not expect shareholder remunerations to result in higher leverage.

Maintaining a capital structure consistent with an investment-grade rating and achieving its \$1.5 billion cost-reduction goal should improve Mondelez's operating margins, Cash Flow Cushion, and Solvency Score, resulting in a positive rating action. A meaningful extension of its debt maturities would positively affect the company's Dependency on Capital Markets score and could have a positive impact on the rating. The inability to recoup commodity cost inflation, whereby operating margins deteriorate, negatively affecting the company's Cash Flow Cushion, would cause a re-evaluation of our positive outlook. Similarly, a sizable debt-financed acquisition that weakens the company's Cash Flow Cushion and its Solvency Score could result in a negative rating action.

Campbell Soup's A- Rating Affirmed; Stable Outlook Initiated

Morningstar Credit Ratings, LLC is affirming its A- rating on the Campbell Soup Company and initiating a stable outlook. Campbell's rating is supported by its name-brand strength and the profitability of its leading U.S. soup business (approximately 59% market share), diversification into adjacent food categories, and moderate usage of leverage. The strong intangible assets of Campbell's portfolio and economies of scale have resulted in the assignment of a wide economic moat rating by Morningstar's Equity Research Group. However, we recognize that the trend of the firm's economic moat is negative, as we believe that heightened competition and a change in consumer taste and preference have weakened the company's brand strength in its major product category.

Similar to many other packaged-food companies, Campbell is experiencing competitive pressures from retailers, private-label producers, and branded players, as each vies for consumers' limited dollars. Campbell's efforts to reignite its struggling U.S. soup business have been slow to take hold. However, we believe the introduction of a new soup line early in fiscal 2017, free of artificial colors and flavors, and the expanded distribution of its organic soup line better align with consumers' demand for more natural food products. Campbell's dominant competitive position, as well as investments to reshape and enlarge its portfolio, should ultimately enable Campbell to continue generating solid cash flows over the long term.

Campbell's credit measures strongly position the company in the rating category. For the latest 12 months ended Oct. 30, 2016, debt/adjusted EBITDA was 2.0 times, adjusted EBITDA/interest was 16 times, and free cash flow (cash flow from operations less capital expenditures and dividends), was significant at \$683 million. Barring a sizable acquisition, we expect Campbell's leverage to remain stable. Due to a high level of short-term debt, including bond maturities over the next few years, Campbell's Cash Flow Cushion is currently weak; however, this is offset by the stability of the firm's operating earnings and its above average Business Risk score. After spending \$143 million in fiscal 2016, Campbell plans to increase its share repurchases in fiscal year 2017, and although we anticipate that the amount may be significant, as \$112 million was spent in the first quarter of fiscal 2017, we do not expect it to weaken the company's credit profile. Approximately \$350 million remain available under Campbell's \$1.0 billion share repurchase program.

At Oct. 30, 2016, Campbell had total debt of \$3.6 billion composed of \$1.3 billion of short-term borrowings, of which \$428 million was current maturities and \$862 million commercial paper. Long term debt maturities were as follows: \$300 million in 2019, \$700 million in 2021, and \$1.3 billion thereafter. The company's cash balance was \$290 million at Oct. 30, 2016. Financial flexibility is provided by the company's \$2.2 billion committed revolving credit facility that matures in Dec. 2018 and a smaller Canadian facility. The U.S. facility, which supports the company's commercial paper program, remained substantially unused at quarter-end. Campbell has the ability to increase the commitment under the U.S. facility up to an additional \$500 million. The Canadian committed revolving credit facility totaling CAD 280 million (\$215 million) matures in July 2019, of which borrowings were \$183 million at Oct. 30, 2016.

Campbell's successful diversification into adjacent product categories and the stabilization of its market share in the soup category could result in a rating upgrade. Also, a meaningful extension of its debt maturities would positively affect the company's Dependency on Capital Markets score and its Cash Flow Cushion and also support a positive rating action. Conversely, the inability to achieve revenue growth or offset commodity cost inflation may result in a weakening of the company's operating earnings and Cash Flow Cushion and could negatively affect its rating.

Heineken NV Rating Affirmed at A-; Negative Outlook Initiated on Weaker Credit Profile

Morningstar Credit Ratings, LLC is affirming its A- corporate credit rating on Heineken N.V. and initiating a negative outlook. Our rating of Heineken reflects the strength of the company's intangible assets generated by its global beer portfolio, its premium namesake brand, and balanced diversification between developed and emerging markets. These elements provide stability to Heineken's operating

earnings and cash flows that supports our moderate Business Risk score and creates a narrow economic moat rating as assigned by Morningstar's Equity Research Group.

Heineken's negative outlook is due to higher leverage resulting from acquisitions, which has weakened the company's Cash Flow Cushion and Solvency Score. In December 2016, Heineken announced that it would acquire a portfolio of 1,900 pubs across the United Kingdom for a total enterprise value of approximately EUR 1.4 billion. For the fiscal year ended Aug. 20, 2016, this portfolio of pubs reported preliminary revenue of EUR 289 million and underlying EBITDA of EUR 130 million.

Heineken intends to fully integrate these pubs into its U.K. pub operations. The transaction is subject to regulatory approvals and is expected to close by the end of the first half of 2017. Combining this portfolio of pubs with Heineken's Star Pubs & Bars business, which consists of 1,049 leased and tenanted pubs, will significantly increase the company's presences in the U.K. market. The company expects to realize operational synergies, economies of scale, and a larger platform to improve visibility and increase the sales of its U.K. beer and cider brands.

Heineken's global market share of about 9% places it in second place behind Anheuser-Busch InBev SA/NV, the industry's behemoth, that acquired SAB Miller plc for approximately \$120 billion in October 2016. Heineken is the second-largest brewer in Western Europe and owns one of the best-selling imported brand in the U.S. In addition, Heineken controls a significant percentage of the Mexican beer market and 10% of the Brazilian beer segment, and is expanding distribution of its premium branded beers in these countries. Its strategy to penetrate fewer, but larger, markets allows the firm to leverage its volume and obtain economies of scale.

Heineken is a better operator than many of its smaller peers; however, the performance gap between Heineken and the leading global brewer is clear as AB InBev's operating margin is approximately double Heineken's. Yet Heineken's moat trend is positive, reflecting its positioning as the leader in the international premium segment, which should deliver above-average long-term improvements to returns on capital and narrow the profitability gap. In addition, over the past few years, Heineken has made several acquisitions to better position itself in the growing Asian and emerging markets. We are forecasting over our five-year forecast period, low- to mid-single-digit revenue growth and operating margins improving to just over 16%.

Heineken's total debt was EUR 14.6 billion, including commercial paper and bank overdrafts of EUR 1.8 billion at June 30, 2016. The company has EUR 4.6 billion of debt maturing, or 31.5% within the five-year forecast period, which constrains its Cash Flow Cushion. Liquidity is provided by Heineken's cash balance of EUR 2.6 billion at period-end, and financial flexibility is afforded by the company's committed EUR 2.5 billion revolving credit facility that matures in 2021. The credit facility acts as a backstop to Heineken's EUR 1.0 billion commercial paper program that further diversifies the company's funding source.

At June 30, 2016, the company disclosed that its net debt/EBITDA was 2.4 times. In the near term, we expect that Heineken will likely exceed its targeted net debt/EBITDA of below 2.5 times, reflecting the

the acquisition of the pub portfolio. In the absence of acquisitions, we expect Heineken to return to its targeted leverage.

An upgrade of Heineken's credit rating is unlikely considering its negative outlook; however should the company strengthen its operating margins, achieve low- to mid-single-digit revenue growth, and reduce leverage such that its Solvency Score and Cash Flow Cushion improve, a positive rating action would be considered. Conversely, a rating downgrade could occur if Heineken's operating margins or its revenue growth rate decline, negatively affecting its Cash Flow Cushion, or if the company maintains leverage higher than its target of net debt/EBITDA of 2.5 times.

Eli Lilly's AA Rating Affirmed; Outlook Stable as New Products May Offset Nearing Patent Cliff

Morningstar Credit Ratings, LLC is affirming Eli Lilly's AA credit rating and stable outlook to reflect the firm's strong growth prospects in the attractive pharmaceutical industry and its proven financial discipline. Our outlook is informed by Lilly's industry-leading commitment to research and its diversified portfolio of human and animal medicines, which we see helping the firm successfully navigate a looming patent cliff starting in 2017.

Lilly scores very well from a Business Risk perspective, given a wide moat assigned by Morningstar's Equity Research Group stemming from the firm's historically significant investment (topping 20% of revenue) in its research program, which has cultivated a range of novel medicines since 2014. We expect that these relatively recent product introductions may offset a looming patent cliff beginning in 2017, when market exclusivity potentially ends for the cancer medicine Alimta, erectile dysfunction drug Cialis, ADHD treatment Strattera, and anticoagulant Effient, which collectively represents about 30% of total sales. Potential blockbusters launched since 2014--Jardiance and Trulicity (diabetes), Cyramza (cancer), and Taltz (autoimmune disorders)--may provide enough momentum to sustain a positive sales growth trajectory in the midsingle digits through the end of the decade. Moreover, operating leverage driven by effective cost containment should boost EBITDA in the high single digits through 2020 compounded annually. Management looks to decrease overall operating expenses to 50% of sales by 2018 from nearly 57% in 2015, which we think is attainable.

As Lilly works its way through the patent challenges over the next few years, we anticipate its financial flexibility to improve from rising free cash flow, which we expect to reach \$5 billion in 2020 from \$2.5 billion for the 12 months ended September. With a light debt maturity schedule over the next five years, solid liquidity should allow the company to pursue tuck-in acquisitions while rewarding shareholders with annual dividends of more than \$2 billion supplemented by share repurchases. Active business development, which includes the recent acquisition of Boehringer Ingelheim Vetmedica's U.S. feline, canine, and rabies vaccines portfolio and the purchase of Novartis' animal health business in March 2015, has stretched the firm's balance sheet above historical levels. The debt load has increased to \$9.3 billion at the end of September from \$5.2 billion in 2013, prior to the acquisition activity. Accordingly, gross debt leverage rose to 1.8 times for the 12 months ended September and 1.5 times in 2015 from 0.7 times at the end of 2013. Despite operational headwinds from drug patent expirations, we see the company returning gross debt leverage close to pre-acquisition levels over the next five years mainly

through solid EBITDA growth. Any improvement to our Cash Flow Cushion and Solvency Score is weighed down by heavy shareholder returns and the firm's presently higher debt load.

Lilly operates at the low end of the AA rating category, and any hiccups in its strategy to reduce expenses and increase revenue in the face of a significant patent cliff, such that EBITDA generation is impaired and debt leverage increases to more than 2 times on a sustained basis, could lead to a downgrade. On the other hand, Lilly's position in the rating could strengthen from successfully overcoming the patent headwinds in the coming years, contributing to gross debt leverage returning to a historical level around 1 times.

Novartis' Rating Affirmed at AA; Outlook Stable as the Firm Offsets Gleevec Generics

Morningstar Credit Ratings, LLC is affirming Novartis' AA credit rating and stable outlook to reflect its leadership across the pharmaceutical sector, together with its conservatively managed balance sheet. Novartis' diversified human pharmaceutical portfolio spanning the brand-name and generic drug sectors should help it withstand key patent expirations, which informs our stable outlook.

After refining its corporate portfolio over the past few years, Novartis is solely focused on areas of strength--patent-protected pharmaceuticals, generic drugs, and eye-care therapies. The bulk of revenue and earnings continue to be derived from human medicines, including a leading position in cancer therapies, helped by the acquisition of GlaxoSmithKline's oncology product lines in 2015. The Sandoz and Alcon businesses provide offsets to the firm's reliance on innovative drugs, contributing to a very good Business Risk pillar. We see Novartis overcoming the U.S. patent expirations of top-selling drugs--Gleevec in February 2016, Gilenya in 2019, and Afinitor in 2020--with its diversified portfolio and new drug introductions, notably the potential blockbusters Cosentyx (for autoimmune conditions) and Entresto (for heart failure). Decent sales growth in the low single digits compounded annually through 2020 may leverage a leaner operating cost base to drive EBITDA expansion in the midsingle digits over the same time frame as the firm keeps a sharp eye on expense management.

Novartis historically balanced capital allocation among internal investment, shareholder actions, and mergers and acquisitions, but since 2014, the firm has stretched the balance sheet with aggressive share repurchasing and significant acquisition activity. Due to the corporate reshuffling, including the purchase of GlaxoSmithKline's oncology assets in 2015, net debt has risen to \$18.8 billion (total financial debt of \$26.6 billion less cash and short-term investments of \$7.8 billion) at the end of September 2016 from \$7 billion in 2014. The higher debt load, together with weaker operational performance stemming from a struggling Alcon unit, has pushed net debt leverage to 1.4 times for the 12 months ended in September, up from 0.5 times in 2014. However, when we consider Novartis' long-term financial assets of \$1 billion and investment in associates of \$15 billion, specifically its 6% interest in Roche and 36.5% ownership of the GlaxoSmithKline consumer joint venture, net leverage falls by more than a full turn to 0.2 times, which we view as more reflective of the AA rating. Even so, we expect leverage to strengthen over the next five years, primarily through EBITDA growth, likely achieved by returning Alcon to growth and effective cost-containment. Free cash flow averaging \$13 billion annually through 2020, in our estimation, is sufficient to meet a light debt maturity schedule that includes significant debt repayment isolated in 2019 (\$3 billion) and in 2020 (\$1 billion). However, heavy dividends of more than \$6 billion

annually, supplemented by aggressive share repurchases, have consumed nearly all free cash flow since 2014, which has pressured our Cash Flow Cushion. While share repurchasing has eased in 2016, a return to aggressive shareholder returns could constrain any attempts to accelerate deleveraging via debt reduction and limit improvement to our Solvency Score.

Novartis' elevated debt load and weaker operational performance gives us pause for any positive ratings momentum in the next year or so. However, we can envision ratings improvement if the firm successfully counters its drug patent challenges while effectively controlling its operating cost base so that the firm maintains a net cash position (including long-term financial assets and investment in associates). On the other hand, we could see a lower rating if the firm fails to reset growth prospects for the Alcon division and key pharmaceuticals, namely Cosentyx and Entresto, do not reach our expectations, causing net debt leverage (including long-term financial assets and investment in associates) to rise and stay above 0.5 times.

Johnson & Johnson's Rating Affirmed at AAA; Outlook Negative

Morningstar Credit Ratings, LLC is affirming Johnson & Johnson's AAA credit rating to reflect its well-diversified corporate portfolio and exceptional financial flexibility. Our expectation that this flexibility may be compromised over the next few years from aggressive capital deployment while J&J battles key drug patent expirations through 2019 informs our negative outlook.

Diverse operations that span pharmaceuticals, medical devices, and over-the-counter medicines (representing roughly 45%, 35%, and 20% of total sales, respectively) buffer J&J from weakness in a particular segment at any given time. Diversification is an important cog in our top-tier Business Risk pillar and gives us confidence that the firm can withstand losses of market exclusivity for multiple blockbuster drugs (Remicade, Velcade, Invega Sustenna, Zytiga, and Prezista) over the next three years that currently represent around 18% of total revenue. Biosimilar competition has arisen in the U.S. to the firm's best-selling pharmaceutical, Remicade, which represents about 10% of company sales, as Pfizer (AA-, stable) launched its version, Inflectra, in November 2016 at a 15% discount. A highly productive drug research program that plans to ready 10 potential blockbusters for regulatory registration through 2019 may help offset the expected patent losses, leading to growth in the low single digits through 2020 compounded annually. J&J's earnings growth prospects fall at the low end of the large pharmaceutical industry, with EBITDA rising in the low single digits through 2020 compounded annually, in our estimation, which may be prompting a step-up in external investment and shareholder distributions.

J&J manages an impeccable balance sheet even after it tapped the credit markets during 2016 for \$7.5 billion in domestic funding and EUR 4 billion in European debt. As a result, the firm's debt load rose to \$27 billion at the end of September from nearly \$20 billion in 2015, leading to gross leverage of 1.1 times for the trailing 12 months compared with 0.8 times in 2015. J&J remained in a net cash position at the end of September as cash and investments of more than \$40 billion far outweighed total debt, supporting our Cash Flow Cushion and Solvency Score pillars. Proceeds from the new debt helped fund the firm's share repurchase programs, reduce commercial paper borrowings (\$4.6 billion at year-end 2015), and repay near-term debt maturities. We believe J&J can easily manage well-laddered long-term debt maturities, with substantial free cash flow averaging nearly \$17 billion annually over the next five

years. Capital deployment is traditionally balanced between mergers and acquisitions and returning substantial value to shareholders through dividends and share repurchases, but management's commitment to satisfy 75% of its \$10 billion share repurchase program (initiated in November 2015) in 2016 has skewed investment toward shareholder rewards. We recognize that annual dividends of more than \$8 billion and share repurchases of over \$9 billion have consumed all free cash flow for the 12 months ended in September, digging into J&J's industry-leading financial flexibility.

Capital deployment that has become more aggressive, with significant debt-funded repurchasing and heightened asset purchasing coupled with increased patent expiration risk over the next three years, pressures J&J's credit profile. While we see reduced financial flexibility over the next few years, we would need to see larger debt-funded repurchases or acquisitions to make a cut in J&J's very strong credit rating, which is the reason for our negative outlook.

Pentair Rating Affirmed at BBB with a Stable Outlook

Morningstar Credit Ratings, LLC is affirming its BBB corporate credit rating on Pentair PLC. Our rating balances Pentair's decent competitive advantage with its challenging financial results, high leverage, and potential M&A aspirations. We think the positive credit enhancement from its valves and controls divestment will prove fleeting, so we are assigning a stable outlook on the firm because we expect the rating will remain at the current level over the next few years.

Morningstar's BBB rating incorporates Pentair's competitive position offset by its financial leverage and M&A desires. Pentair is a leading player in the water and electrical businesses. The firm's engineering equipment creates high switching costs, resulting in a narrow economic moat, as assigned by Morningstar's Equity Research Group, that benefits its Business Risk score pillar. However, Pentair sells mostly within the general manufacturing sector, thus hurting the customer concentration and cyclicity component. Pentair has had mixed success monetizing its competitive position into strong returns on invested capital including goodwill, in part because the decline in energy prices hurt its valves and controls segment. Still, we expect the sale of this business should result in improving profitability going forward, which will help improve its Solvency Score. We forecast that pro-forma Pentair will generate free cash flow of around \$900 million (18% of sales), but we expect it to pay annual dividends of nearly \$300 million and look to growth via acquisitions. Pentair also faces a meaningful debt maturity schedule over the next five years, although this is mitigated by its plans to use \$1.5 billion of the \$2.6 billion net valves and controls proceeds to reduce debt. Combined, these factors weigh on the firm's Cash Flow Cushion score.

Despite the proposed debt reduction, which will lower gross leverage to 2.9 times from around 3.9 times, we expect our rating to remain at the current level. Pentair has indicated \$1.4 billion in M&A capacity post the divestiture. Should Pentair abandon its M&A policy and further reduce leverage, then we could potentially upgrade our rating. Alternatively, if Pentair pursues a material debt-funded acquisition, then we expect pressure on the Solvency and Cash Flow Cushion scores to result in a downgrade.

Recent Notes Published by Credit Analysts

Terex in the Market Offering \$550 Million 8NC3 Senior Notes to Call Existing Bonds

Market News and Data

Terex Corporation (rating: BB-/UR+) is in the market offering \$550 million in senior notes due 2025, which first become callable in 2020. Proceeds will be used to effectively retire the remaining outstanding balance (expected to be \$550 million) of 6.00% senior notes due 2021. The new notes will be subordinated to secured bank debt. According to pricing service Advantage Data, pricing on other industrials sector BB- credits are as follows:

USG Corp's (rating: BB+, stable) 5.50% senior notes due 2025 (and first callable in 2020) yield 4.70% to the 2023 par call, offering a spread to worst of +263 basis points.

Anixter International Inc's (rating: BB, stable) 5.50% senior notes due 2023 yield 4.67% to maturity, offering a spread of +254 basis points.

WESCO International Inc's (rating: BB, stable) 5.375% senior notes due 2024 (and first callable in 2019) yield 4.97% to the 2022 par call, providing a spread to worst of +299 basis points.

Group 1 Automotive Inc's (rating: BB, stable) 5.25% senior notes due 2023 (and first callable in 2018) yield 5.16% to the 2021 par call, providing a spread to worst of +326 basis points.

Finally, the Merrill Lynch U.S. High Yield BB Index is indicated at a yield to worst of 4.52% and a spread to worst of +257 basis points.

MCR Credit Risk Assessment

Terex is finalizing a number of transactions that will transform the business and capital structure. On Jan. 4, the firm completed the sale of its material handling and port solutions business to Konecranes for net adjusted proceeds of about \$740 million and 25% of Konecranes (worth approximately \$0.6 billion). The firm then announced it was using proceeds to redeem its \$300 million 6.50% senior notes due 2020 on or before April 3 and engaging in a partial redemption for \$300 million of the \$850 million outstanding 6.00% senior notes due 2021. Pro forma for all of these transactions, Terex would have only the \$550 million of new senior notes outstanding, plus secured bank debt. As of Sept. 30, the company had about \$444 million of senior secured term loans due 2021, roughly evenly split between a U.S. dollar portion and a euro portion, along with \$70 million drawn on its revolver. Pro forma total debt is about \$1.1 billion. The company guided to pro forma net leverage of about 1.9 times for 2016 but targets an average net leverage metric of 2.5 times through the cycle.

Our rating review will focus on the new capital-allocation policy and targeted leverage through the cycle along with Terex' new strategic focus to take cost out of the business and drive margins higher. With several years of mergers, acquisitions, and divestitures apparently behind the company, we believe Terex's focus on rightsizing operations of the remaining core businesses can yield dividends. Terex will be left with three business units that manufacture cranes, aerial work platforms, and materials processing equipment. This enterprise should have operating margins meaningfully higher than the predecessor company and generally top-three share positions in its end markets. Although the remaining business will generate 30% less revenue, Terex will retain a more consistent dealer-centric distribution strategy. Furthermore, with only 40%-50% of its manufacturing capacity currently utilized,

management will have the opportunity to focus on facility rationalization. Still, end markets generally remain weak, the company remains highly cyclical, and 2017 may represent trough results.

Kroger Offering New 30-Year Bonds to Refinance Commercial Paper

Market News and Data

Kroger (rating: BBB, stable) is reportedly in the market this morning with a 30-year, senior-unsecured notes offering. The firm is expected to use the proceeds to reduce outstanding commercial paper balances, which totaled \$2.2 billion as of Nov. 5, 2016, and for general corporate purposes. Kroger has filed a preliminary prospectus supplement to the prospectus dated Dec. 14, 2016.

According to the pricing service Advantage Data, Kroger's \$500 million 3.875% notes due 2046 recently traded at +143 basis points. Pricing on Kroger and its other comparable BBB-rated issuers in the consumer cyclical sector include (longest maturity available):

Kroger's 2.65% notes due 2026 are indicated at +113 basis points.

Dollar General's (rated: BBB, stable) 4.15% notes due 2025 are indicated at +149 basis points.

AutoZone's (rating: BBB) 3.125% notes due 2026 are indicated at +124 basis points.

O'Reilly Automotive's (rating: BBB) 3.55% notes due 2026 are indicated at +120 basis points.

Finally, the Morningstar Industrials BBB Corporate Bond Index is at a spread of +158 basis points.

MCR Credit Risk Assessment

Kroger's credit rating reflects the firm's strong position in the U.S. grocery market and moderately leveraged capital structure. Kroger's above-average Business Risk score is based on competitive advantages including leading market positions, intangible brand asset, efficient cost structure, and moderate insulation from economic cyclicalities. Kroger is the second-largest grocer in the U.S. with \$114 billion in annual sales and has the number-one or -two share in 90% of its major markets. Kroger's narrow economic moat, as assigned by Morningstar's Equity Research Group, is driven by cost advantages and a brand intangible asset. Kroger operates nearly 2,800 supermarkets and multidepartment stores, using various formats that are clustered to create strong regional market share positions, allowing it to operate with the most efficient cost structure. Its brand intangible asset is evidenced by the successes of its private-label products, which approximate 30% of total units sold and typically carry higher margins. Kroger's competitive position is supported by offering fuel at over half of its locations, insulating it from competitors that use gasoline as a loss leader. The rating acknowledges margins will remain under pressure as consumers can easily switch within the grocery industry and competition has increased as large discounters and online retailers expand grocery offerings. Kroger's adjusted debt to EBITDAR was 3.2 times at the end of the third quarter (ended Nov. 5). Management's calculation of net total debt/adjusted EBITDA was 2.35 times, and is forecast to be at the high end of its targeted range of 2.0-2.2 times at year-end.

Bank of America Offering A Multi-Tranche New Issue of Senior Holding Company Notes

Market News and Data

Bank of America (rating: BBB, stable outlook) is in the market, with an offering of benchmark sized tranches of 6-year, 11-year, and 31-year senior unsecured holding company notes. According to a

preliminary prospectus filed by the company on Jan. 17, each tranche is callable one year before maturity. We understand this structure to be beneficial to the issuer's ability to manage its liability structure and comply with various regulatory requirements including its total loss absorbing capacity (TLAC) and net stable funding ratio (NSFR). According to pricing service Advantage Data, bonds with maturities similar to the new issuance for Bank of America and key comparables are indicated over the nearest Treasury as follows:

5-year area:

Bank of America 2.503% notes due 2022 at +111 basis points.
 Morgan Stanley (rating: BBB, stable outlook) 2.625% notes due 2021 at +105 basis points.
 Goldman Sachs (rating: BBB+, stable outlook) 2.35% notes due 2021 at +108 basis points.
 JPMorgan Chase (rating: A-, stable outlook) 2.972% notes due 2023 at +100 basis points.
 Citigroup Inc (rating: A-, stable outlook) 2.35% notes due 2021 at +102 basis points.

10-year area:

Bank of America 3.248% notes due 2027 at +140 basis points.
 Morgan Stanley (rating: BBB, stable outlook) 3.125% notes due 2026 at +135 basis points.
 Goldman Sachs (rating: BBB+, stable outlook) 3.75% notes due 2026 at +140 basis points.
 JPMorgan Chase (rating: A-, stable outlook) 2.95% notes due 2026 at +121 basis points.
 Citigroup Inc (rating: A-, stable outlook) 3.887% notes due 2028 at +147 basis points.

30-year area:

Bank of America 4.875% notes due 2044 at +140 basis points.
 Morgan Stanley (rating: BBB, stable outlook) 4.30% notes due 2045 at +133 basis points.
 Goldman Sachs (rating: BBB+, stable outlook) 4.80% notes due 2044 at +145 basis points.
 JPMorgan Chase (rating: A-, stable outlook) 4.85% notes due 2044 at +118 basis points.
 Citigroup Inc (rating: A-, stable outlook) 4.65% notes due 2045 at +138 basis points.

MCR Credit Risk Assessment

Morningstar's credit rating for Bank of America reflects weak profits and average capital levels, the negative effects of which are partially offset by improving credit quality and a diverse business mix. B of A is the most domestically focused of the large banks. Only 14% of loans are considered non-U.S. in nature. Retail banking generated around 40% of 2016 earnings--31% from wholesale banking, 23% from Global Markets, and the remainder from wealth management activities. While profitability has begun to improve, large legal and legacy costs stemming from the 2008 financial crisis continue to constrain profits. For the year ended December, return on assets was a modest 0.7%, while return on equity was just 6.8% by our calculations. These results trail those of key peers. While both rates improved from the prior year, they remain well below those of stronger global peers. For instance, JPMorgan reported a return on average assets of 0.9% in 2016 and a return on common equity of 10.0% while Wells Fargo reported a ROA of 1.1% and a ROE of 11.5%. At the same time, asset quality has improved during the year. Nonperforming loans are around 0.2% lower than the year-earlier period, representing 0.85% of total loans while annual charge-offs represent 0.4%. These measures are comparable to those reported by peers. Reserves are adequate and continue to cover over 145% of nonperforming loans. Capital ratios

have improved during the year but continue to trail global banking peers. At year-end, Bank of America's fully-phased common equity Tier 1 ratio is 10.8%, below a peer average around 11%. However, tangible common equity represents 8.1% of tangible assets, which is near average for the peer group.

Fixed-Income Trading Results Contribute to Another Solid Quarter for Morgan Stanley

MCR Credit Risk Assessment

Morgan Stanley (rating: BBB, stable outlook) added another solid quarter to calendar year 2016, reporting net income available to common shareholders of \$1.5 billion in the fourth quarter. While the results compare favorably with relatively weak results reported a year earlier of \$0.8 billion, they are broadly consistent with results reported in the prior quarter. Similarly, net income available to common shareholders for calendar year 2016 of \$5.5 billion decreased 2.9% compared with the prior year. Profitability, as measured by return on common equity, was 8.7% for the quarter which was in line with that reported in the prior quarter and significantly improved from 4.4% reported in the year-earlier quarter. For the quarter, revenue increased 14.7% compared with year-earlier adjusted revenue mainly due to stronger trading results that increased 90.4%. Higher compensation costs, which increased 11.9% year over year, detracted from results. However, results benefited from a discrete tax benefit of \$135 during the quarter. At the segment level, higher sales and trading revenue accounted for most of the improvement relative to the year-earlier quarter, increasing 48.9%. Fixed-income trading was the standout, increasing 219% on improved market conditions and higher client volume. Equity trading also improved during the quarter, increasing 9.5% year over year. Investment banking revenue increased 4.9% year over year on higher fixed-income underwriting and financial advisory that both increased 21.7% compared with the year-earlier quarter. Equity underwriting, which is comparatively smaller than the other investment banking business lines, decreased 36.1%. Wealth management revenue increased 6.4% on higher client investment flows from liquidity products.

Morgan Stanley reported strong regulatory common equity Tier 1 capital levels at quarter-end that were largely unchanged compared with the prior quarter but significantly higher than the year-earlier quarter. The firm's common equity Tier 1 capital ratio finished the year at an impressive 16.8% on a transitional basis and 15.9% on a fully phased basis, levels that materially exceed peer averages around 12%. Capital measures benefited more from lower risk-weighted assets compared to a year earlier which reflects the firm's shift in emphasis to wealth and investment management from trading and the overall de-risking of the firm than from higher capital levels. By contrast, tangible capital measures actually trail peer averages at 7.4% of tangible assets compared to a peer average around 8% which represents a negative factor in our Solvency Score assessment.

Market Data

Soon after its fourth-quarter earnings call, Morgan Stanley announced a multi-tranche benchmark sized bond issue consisting of 5-year floating rate notes, 10-year fixed-rate notes, and 30-year fixed rate senior holding company notes. Given its business model as an investment bank, Morgan Stanley can be compared most directly to peer Goldman Sachs (rating: BBB+, stable) as well as to global banks that include significant investment banks in their overall operations. According to pricing service Advantage Data Inc., Morgan Stanley's 3.125% notes due 2026 recently traded at +138 basis points over the nearest Treasury. By comparison, similar-maturity notes of Goldman Sachs are indicated at +143 basis

points. JPMorgan Chase's (rating: A-, stable) 2.95% due 2026 are indicated at +126 basis points while Citigroup's (rating: A-, stable) 3.20% notes due 2026 are indicated at +146 basis points. Meanwhile, 10-year notes of Bank of America Corp. (rating: BBB, stable) are indicated at +139 basis points.

Extra Week Benefits CSX's 4Q Earnings

MCR Credit Risk Assessment

CSX (rating: BBB+, stable outlook) capped off a challenging 2016 on solid footing, albeit in part due to the inclusion of a 14th week and one-time items. Management expects a healthier 2017 and projects that its business, excluding coal (12% of 2016 volume), should revert to growth alongside the economy and will focus on strong pricing.

Revenue increased 9.2% compared with the same period last year, with volume growth of 5% on 4% higher revenue per unit. However, excluding the additional week, adjusted volume declined 5%. Adjusted volume weakness was widespread, with declines in six of the nine categories--a seventh produced flat volume. Surprisingly, coal volume increased 3%, although the absolute levels are down substantially from the last few years. Profitability benefited from companywide efficiency gains, which totaled \$430 million, and \$175 million of volume-related cost savings. Excluding the one-time gains and the benefit of the extra week, we estimate that EBITDA increased 7% to \$1.2 billion. Compared with last year, CSX generated higher operating cash flow and reduced capital spending, helping reduce the cash flow burn to negative \$255 million compared with \$443 million from last year. The firm paid \$167 million in dividends, repurchased \$278 million in shares, and called \$1.4 billion in high-coupon debt through a \$2.2 billion offering. As such, cash and short-term investments increased \$265 million sequentially to \$1 billion and debt increased by \$774 million to \$11.3 billion. Accordingly, rent-adjusted leverage increased 0.1 turns to 2.6 times.

Supporting the firm's growth outlook, CSX noted that 29% of its volume has favorable trends and 49% has neutral trends, with only 22% (chemicals and domestic coal) showing unfavorable trends. The company is targeting \$150 million in further efficiency gains that should work to offset cost inflation. The firm is also projecting to reduce capital investments by \$500 million to \$2.2 billion, which should boost its free-cash-flow generation.

We compare CSX (rating: BBB+, stable outlook) to rails Canadian Pacific (rating: BBB+, stable outlook), Norfolk Southern (rating: BBB+, negative outlook), and Kansas City Southern (rating: BBB, stable outlook). CSX's rent-adjusted leverage of 2.6 times compares favorably with Canadian Pacific's at 2.9 times and Norfolk Southern's at 2.8 times, while Kansas City Southern operates with similar leverage.

Market Data

The following bond prices are provided by pricing service Advantage Data:

The CSX 2.60% notes due 2026 have recently traded at +90 basis points.
 The Canadian Pacific 3.70% notes due 2026 are indicated at +93 basis points,
 The Norfolk Southern 2.90% notes due 2026 are indicated at +101 basis points.
 Kansas City Southern 3.125% notes due 2026 are indicated at +139 basis points.

Canadian Pacific Reports Record Operating Ratio, but Results Overshadowed by Management Shuffle

MCR Credit Risk Assessment

Canadian Pacific (rating: BBB+, stable outlook) capped off a challenging 2016 with its lowest-ever fourth-quarter operating ratio and a record-low annual operating ratio. However, we think the bigger news is the announced retirement of CEO Hunter Harrison. According to the release, Harrison agreed to forfeit substantially all benefits and perquisites entitled to him--valued at CAD 118 million--and terminate all roles he has or would have with Canadian Pacific including the previously agreed consulting agreement. In return, Canadian Pacific has agreed to a limited waiver of Mr. Harrison's non-competition obligations. Although not privy to any discussion, we note that he previously tried merging with two rails--CSX (rating: BBB+, stable outlook) and Norfolk Southern (rating: BBB+, negative outlook).

For the quarter, revenue decreased 3% versus the year-ago period, driven by a 3% decline in revenue ton miles and flat freight revenue per revenue ton mile. Volume was down across many categories, but the largest detractor was crude oil. Crude oil, which represented 10% of revenue ton miles last year, collapsed 74% this year. Excluding crude, revenue ton miles increased 4.8%. Canadian Pacific delivered strong fourth-quarter operational improvements despite weather issues, helping the operating ratio to improve 370 basis points to its lowest-ever, fourth-quarter operating ratio of 56.2% and growing EBITDA 6% to CAD 79 million. Canadian Pacific generated higher operating cash flow and reduced its capital spending by 38%, producing free cash flow of CAD 488 million, up from CAD 168 million last year. The firm paid CAD 73 million in dividends, repurchased a negligible amount of shares, and repaid CAD 374 million of commercial paper. The firm ended the quarter with CAD 164 million in cash and total debt of CAD 8.7 billion, resulting in rent-adjusted leverage falling a modest 0.1 turns to 2.8 times.

We compare Canadian Pacific (rating: BBB+, stable outlook) with rails Norfolk Southern (rating: BBB+, negative outlook), CSX (rating: BBB+, stable outlook), and Kansas City Southern (rating: BBB, stable outlook). Canadian Pacific's rent-adjusted leverage of 2.8 times is higher than CSX's 2.6 times and Kansas City Southern's 2.6 times but consistent with Norfolk Southern's at 2.8 times. However, Canadian Pacific's operating ratio is at least 10 percentage points better than its aforementioned peers.

Market Data

The following bond prices are provided by Advantage data

The Canadian Pacific 3.70% notes due 2026 are indicated at +93 basis points.

The CSX 2.60% notes due 2026 have recently traded at +90 basis points.

The Norfolk Southern 2.90% notes due 2026 are indicated at +101 basis points.

Kansas City Southern's 3.125% notes due 2026 are indicated at +139 basis points.

Goldman's Solid 4Q Results Supported by Strong Fixed-Income Trading and Expense Control

MCR Credit Risk Assessment

Goldman Sachs Group (rating: BBB+, stable outlook) reported solid fourth-quarter results, with net income available to common shareholders of \$2.2 billion, which was 2.5% higher than the prior quarter but 275% higher than the year-earlier quarter, which was negatively affected by \$1.95 billion of litigation

expense. Goldman's profit for the quarter translated into an annualized return on average equity of 11.4%, up from 11.1% in the prior quarter and just 3.1% in the year-earlier quarter. Goldman's quarterly ROE was its highest in eight quarters and compared favorably to all the U.S. global banks to report fourth-quarter results thus far. For the full year, Goldman reported a ROE of 9.4%, which exceeded that of Morgan Stanley (rating: BBB, stable outlook), Bank of America (rating: BBB, stable outlook), and Citigroup (rating: A-, stable outlook), but trailed JPMorgan Chase (rating: A-, stable outlook), which reported 10.0%, and Wells Fargo (rating: A, negative outlook), which reported 10.9%. Results for the quarter were characterized by higher revenue--which increased 12.3% year over year--and by lower expenses, which decreased 23.0% due mainly to materially lower legal costs. Adjusted for legal costs in the year-earlier quarter, operating costs decreased 0.6%. Higher fixed-income trading revenue during the quarter was the primary contributor to the improved revenue picture. Revenue in the fixed-income, currencies and commodities segment increased 78.3% year over year, besting most of its peers. The results reflect higher revenue across most business lines, including credit and interest-rate products. By contrast, equity trading revenue decreased 9.2% year over year, which compared unfavorably to a peer average increase around 8%. Goldman's investing and lending segment and investment management also reported respectable revenue improvements, increasing 14.5% and 3.4%, respectively. However, investment banking revenue decreased 3.9%, led by lower financial advisory revenue, which decreased 19.3%. Debt underwriting revenue provided a partial offset by increasing 28.4% year over year, reflecting higher revenue from leveraged finance and asset-backed activity.

Goldman's credit profile is strengthened by higher capital ratios during the quarter, which compare favorably to peers. Due largely to lower risk-weighted assets, regulatory capital measures increased to 13.1% transitional common equity Tier 1 capital ratio and a 15.1% Tier 1 ratio, which compare favorably to peers other than Morgan Stanley, which recently reported industry-leading capital ratios of 16.8% and 19.0%, respectively. Goldman's tangible common equity/tangible asset ratio increased slightly to 8.3% and compares favorably to a peer average around 8%. Specifically, this ratio is approximately 90 basis points higher than that of JPMorgan and Morgan Stanley.

Market Data

Given its business model as an investment bank, Goldman Sachs can be compared to close peer Morgan Stanley as well as global banks that include significant investment banks in their overall operations. According to pricing service Advantage Data Inc., Goldman Sachs' 3.75% notes due in 2026 recently traded at +140 basis points over the nearest Treasury. By comparison, JPMorgan Chase's 2.95% due in 2026 are indicated at +120 basis points, while Citigroup's 3.20% notes due in 2026 are indicated at +142 basis points. Meanwhile, 10-year notes of Morgan Stanley are indicated at +139 basis points, while those Bank of America (rating: BBB, stable outlook) are indicated at +145 basis points.

Netflix Catches 4Q Subscriber Growth Tailwind, but Guiding to Higher Cash Burn in 2017

MCR Credit Risk Assessment

Netflix Inc. (BB-, stable) reported its fourth-quarter and year-end operating results on Jan. 18, reflecting strong subscriber growth in both U.S. and international markets. Subscriber net additions in the U.S. and internationally were ahead of guidance, helped by the rollout of Netflix to Comcast Corp's (A-, stable) X1 distribution platform in the U.S. during the quarter, as well as investment in original content in overseas

markets. However, management noted that the strong subscriber volume in the fourth quarter may include some pull-forward from the first quarter. Despite its expectation for further improvement in gross margin, management is guiding to average negative free cash flow of \$500 million per quarter in 2017, compared with an average burn rate of \$400 million in 2016. Management indicated that it will continue to look to additional debt to meet its cash needs if borrowing costs remain reasonable.

For the December quarter, Netflix added 7.05 million total subscribers, including 5.8 million paid subscribers. This brings net new paid subscriber net growth for the year to 18.5 million, an increase of 13% over the pace achieved in 2015. Both domestic (1.4 million paid net adds) and international (4.3 million paid net adds) were ahead of expectations for the quarter. For the first quarter 2017, management is guiding to 5.2 million total net adds globally, including 1.5 million in the U.S.

Revenue increased 36% year over year, as a result of subscriber growth as well as an increase in average revenue per subscriber, which grew 11.6% from a year ago as a result of scheduled price increases for certain customers. The company reported its U.S. operating margin up 4 percentage points over a year ago to 38%, while the international operating margin remained negative but improved a percentage point from the third quarter to negative 7.0%. Domestic margin improvement in the quarter was partially attributable to the timing of content deals, which may indicate a contraction in upcoming quarters. Though the company is guiding to an international gross margin of 1.5% in the first quarter, management hinted that the margin will likely remain negative for the full year. Our rating assumes the company will continue to move steadily toward an international gross margin of at least 3% by 2020, while maintaining domestic gross margins around 35%.

Netflix's cash and investments ended 2016 at \$1.7 billion, down \$391 million from the prior quarter and down \$577 million from a year ago. This primarily reflects the company's free cash burn rate of \$1.6 billion over the past 12 months (a higher burn rate compared with previous guidance of negative \$1.5 billion). Contributing to the net cash usage was a 52% growth in content assets from 2015. In 2017, management plans to invest \$6 billion through cost of revenue to produce an additional 1,000 hours of original programming, compared with \$5 billion in 2016.

We calculate year-end net debt/EBITDA (including the cost of stock compensation) at 3.7 times, up three fourths of a turn from last quarter as a result of \$1 billion of new senior debt. For comparison, the company reported a net excess cash balance equivalent to 0.8 times EBITDA at the end of 2015. EBITDA was \$437 million in 2016, an increase of 19% from a year ago.

Market Data

On Oct. 24, 2016, Netflix sold \$1 billion of 4.38% notes due 2026 at par (+263 basis points over Treasuries). According to Advantage Data, Inc., these notes are now indicated at a yield of 4.49% (+207 basis points). T-Mobile US Inc's (BB, stable) 6.50% notes due 2026 are indicated at a yield of 4.71% to the 2024 par call (+301 basis points over Treasuries) despite a rating one notch higher compared with Netflix. The spread of T-Mobile's 2026 notes is only 10 basis points tighter over the past three months. Meanwhile, the BofA Merrill Lynch BB rated high-yield index was reported at a spread of +262 basis points, or 46 basis points tighter from three months ago.

Fresh Off Solid 4Q Earnings, U.S. Bancorp Issues 5-Year Notes

Market News and Data

U.S. Bancorp (rating: A+, stable outlook) is in the market with an offering of benchmark-size tranches of 5-year senior holding company notes as well as a mixture of 3-year fixed- and floating-rate senior bank notes. According to pricing service Advantage Data, bonds with maturities similar to the new issuance for U.S. Bancorp and key comparables are indicated over the nearest Treasury as follows:

U.S. Bancorp 2.35% notes due 2021 at +57 basis points.

Wells Fargo & Co (rating: A, negative outlook) 2.10% notes due 2021 at +92 bps.

PNC Bank NA (rating: A-, stable outlook) 2.15% bank notes due 2021 at +69 bps.

Fifth Third Bancorp (rating: BBB+, stable outlook) 2.875% notes due 2020 at +79 bps.

KeyCorp (rating: BBB+, stable outlook) 2.90% notes due 2020 at +84 bps.

MCR Credit Risk Assessment

U.S. Bancorp's credit rating stands at the top of our bank universe. The regional bank's credit rating reflects the firm's diversified revenue stream, consistent profitability, and wide economic moat as assigned by Morningstar's Equity Research Group. Revenue is well balanced, with fee-based sources representing around half of the total. The company has two highly scalable businesses that generate stable high returns with little capital employed: wealth management and payment processing contributing 10% and 27% of core revenue, respectively. Traditional consumer banking represents 34%, while wholesale banking contributes 14% of core revenue. USB benefits from a low-cost deposit base and a lean operating structure that minimizes costs and contributes to a 54.5% efficiency ratio in 2016, well below a peer average around 60-65%. U.S. Bancorp's low-risk business model has produced top-decile returns relative to a broader peer group, with return on equity averaging over 15% during the past five years and about 13.4% in the trailing 12 months ended December 2016. Reflecting the bank's history of wise underwriting practices, asset quality is also superior to most peers, with charge-offs and nonperforming loans during the most recent year representing under 0.5% of loans. Even at the height of the financial crisis, U.S. Bancorp never incurred a loss resulting from severe credit charge-offs as seen at other institutions. However, capital levels are low and detract from our credit opinion. At year-end, U.S. Bancorp's common equity Tier 1 ratio was 9.4% while its tangible common equity ratio was 7.5%. Both rates compare unfavorably to peer averages around 11% and 9%, respectively.

Union Pacific Finishes 2016 on Solid Footing and Guides to Better 2017

MCR Credit Risk Assessment

Union Pacific (rating: A, stable outlook) finished 2016 on a high note, driven by an improving operating ratio and moderating revenue declines during the fourth quarter. Union Pacific provided positive commentary about 2017, with expectations for low-single-digit volume growth, and it will continue pushing prices above rail inflation. The firm is guiding to capital spending of \$3.1 billion for 2017, down \$400 million from 2016 levels, so free cash flow should increase in 2017, compared with 2016.

For the quarter, revenue decreased 1% compared with the year-ago period, with a 3% decline in volume and a 2% improvement in revenue per car. Similar to quarterly trends throughout 2016, the volume decline was broad-based. Agricultural products, 12% of volume, was the only category to post an

increase. However, management mentioned that intermodal volume, 19% of volume assuming all containers are double-stacked, would have increased 2% instead of the reported flat volume. Profitability also benefited from modest network gains and a 2% reduction in train, engine, and yard employees. The operating ratio improved 120 basis points to 62% and EBITDA grew a modest 2% to \$2.5 billion compared with the same period last year. The firm generated \$2.1 billion in operating cash flow and cut capital spending by \$426 million, causing free cash flow to nearly triple to \$1.2 billion. The firm paid \$497 million in dividends, repurchased \$1 billion in shares, and repaid \$600 million of debt. Union Pacific ended the quarter with \$1.3 billion in cash and total debt of \$15 billion, resulting in rent-adjusted leverage falling a modest 0.1 turns to 2.0 times.

We compare Union Pacific (rating: A, stable outlook) with rails Canadian National (rating: A, stable outlook) and Canadian Pacific (rating: BBB+, stable outlook). Union Pacific operates with slightly higher rent-adjusted leverage than Canadian National (2.0 times versus 1.8 times) and is less profitable (2016 operating ratio of 63.5% for Union Pacific versus 56% for Canadian National). Although Union Pacific operates with lower leverage than its BBB+ rated peer Canadian Pacific (2.0 times versus 2.8 times), its 2016 63.5% operating ratio is higher than Canadian Pacific's 56.5% mark.

Market Data

The following bond prices are provided by Advantage Data:

Union Pacific's (rating: A, stable outlook) 2.75% notes due 2026 are indicated at +67 basis points.
 Canadian National's (rating: A, stable outlook) 2.75% notes due 2026 are indicated at +64 basis points.
 Canadian Pacific's (rating: BBB+, stable outlook) 3.70% notes due 2026 are indicated at +86 basis points.

Mallinckrodt Reduces Litigation Overhang, but Pricing Concerns Remain

MCR Credit Risk Assessment

On Jan. 18, Mallinckrodt PLC (BB-, negative) announced a settlement with the U.S. Federal Trade Commission (FTC) to resolve an investigation into legacy actions taken by the firm's Questcor unit related to its synthetic ACTH product, Synacthen Depot. As part of the agreement, Mallinckrodt will pay \$100 million to settle FTC claims as well as out-license the medicine to Marathon Pharmaceuticals for the development and potential commercialization in two indications, infantile spasms and nephrotic syndrome. We see minimal effect to the firm's credit profile from the cash payment given a cash balance of \$280 million and free cash flow generation that was around \$1 billion during the firm's fiscal year ended in September.

However, the price of Mallinckrodt's best-seller, H. P. Acthar Gel, which directly competes with Synacthen Depot, has risen substantially over the past decade. With heightened scrutiny of drug pricing arising from the new U.S. administration, we envision further price elevation to be muted for the firm's top selling drug that represented over one third of total revenue in fiscal 2016. We are already concerned about weakness in the firm's specialty generics business that will post shrinking revenue into 2017, as increased competition and recently released opioid prescription guidelines to help address addiction should continue to negatively affect pricing and volume in this business. Potential price stagnation of Mallinckrodt's best-seller would negatively influence the growth prospects of the branded

specialty drug segment that has been offsetting headwinds in the generics unit. Currently, the long-term risk of generic and branded competition on H. P. Acthar Gel and its outsize contribution to the bottom line keep Mallinckrodt's moat as assigned by Morningstar's equity group at none. We would also highlight that the company's appetite for further acquisitions remains strong, which informs our negative outlook for the firm's credit rating.

Market Data

We compare Mallinckrodt's bonds with high-yield specialty pharmaceutical peers--Endo International PLC (B, negative) and Valeant Pharmaceuticals International Inc. (B, negative). In the approximate 5-year maturity bucket, Mallinckrodt's bonds recently traded much tighter than its key peers, including a spread about 160 basis points tighter than Endo's bonds and roughly 350 basis points tighter than Valeant's bonds, which can be seen as follows:

Mallinckrodt's 5.75% notes due in 2022 traded at 91.00, yield to maturity of 7.79% and spread to maturity of +572 basis points.

Endo's 5.75% notes due in 2022 traded at 86.00, yield to maturity of 9.33% and spread to maturity of +736 basis points.

Valeant's 7.50% notes due in 2021 traded at 87.75, yield to maturity of 11.04% and spread to maturity of +921 basis points.

Western Union's 4Q Charge a Short-Term Negative, but Ultimately Neutral to Our Rating

Western Union reported that it will be taking a \$570 million charge in the fourth quarter of 2016 tied to the \$586 million agreement it reached with the U.S. Department of Justice and the Federal Trade Commission over concerns of inadequate controls in place for misconduct committed by agents and third parties during 2004-12. While the charge will negatively affect financial results for full-year 2016, we consider this a one-time event that is manageable given Western Union's history of stellar operating performance. Through third-quarter 2016, the company reported net income of \$821 million; assuming run-rate fourth-quarter results are comparable to the year-ago period, Western Union is likely to report a comfortable, if somewhat lower than normal, level of net earnings. Furthermore, the agreement will also settle a separate investigation that was being undertaken by the U.S. Treasury Department's Financial Crimes Enforcement Network, with no further potential payout necessary.

While we do not feel the announcement warrants a revision to Western Union's rating or negative outlook, we will look to the company's year-end 2016 results, expected to be released Feb. 9, 2017, for additional information on the settlement. We could lower our credit rating if Western Union's long-term credit profile were to change materially from our current expectations.

Kansas City Southern Ends 2016 on Mixed Note, While Uncertainty Reverberates Into 2017

MCR Credit Risk Assessment

Kansas City Southern (rating: BBB, stable outlook) ended 2016 with muted results, but 2017 will resonate with political uncertainty given that Kansas City Southern generates approximately 50% of that revenue from Mexico--roughly 30% of this amount is denominated in Mexican pesos. The firm's cross-border revenue, which represents around 40% of its overall revenue, is split with 60% exported to

Mexico and the remaining 40% is imported to the U.S. The firm's biggest cross-border commodity group is grain, specifically Midwest corn into Mexico. Despite the burgeoning risk, management is still optimistic about its key growth opportunities, and noted favorable volume trends pertaining to 65% of its volume heading into the new year. Kansas City Southern is projecting a 4% decline in capital spending to between \$550 million and \$560 million, which should partially mitigate any potential cash flow risks should 2017 prove challenging.

For the quarter, revenue was essentially unchanged at \$599 million, as flat carloads and positive price per car was offset by foreign currency headwinds. Volume increased 19% in automotive (7% of carloads) and 10% in agriculture and minerals (12% of carloads), but was offset by a 10% decline in energy (13% of volume) and a 9% fall in chemical and petroleum (11% of volume). Operating metrics were mixed, with velocity improving 4%, but dwell hours (time a car resides in a terminal) increasing 16% versus last year. Rail inflation was led by compensation and benefits, up 11% from last year, although foreign currency reduced expense growth by five percentage points. Nevertheless, the operating ratio worsened 140 basis points to 64.8%, although EBITDA was roughly unchanged at \$289 million. The firm generated \$71 million in free cash down \$2 million from last year. It paid \$36 million in dividends, repurchased \$86 million in shares, and repaid \$73 million of debt, causing cash to decline \$123 million sequentially to \$171 million. The firm ended the quarter with \$2.5 billion debt, causing rent-adjusted leverage to fall 0.1 turns to 2.5 times.

We compare Kansas City Southern (rating: BBB, stable outlook) to rails Canadian Pacific (rating: BBB+, stable outlook), Norfolk Southern (rating: BBB+, negative outlook), and CSX (rating: BBB+, stable outlook). Kansas City Southern's rent-adjusted leverage of 2.5 times compares favorably with Canadian Pacific's 2.8 times, CSX's 2.6 times, and Norfolk Southern's at 2.8 times. Moreover, Kansas City Southern's 64.9% operating ratio bests CSX's (71%) and Norfolk Southern's (70.2%), but is surpassed by Canadian Pacific's (56.5%). Kansas City Southern also faces a greater risk than its peers given its large aforementioned Mexican exposure.

Market Data

The following bond prices are provided by Advantage Data:

Kansas City Southern's (rating: BBB, stable outlook) 3.125% notes due 2026 are indicated at +134 basis points.

The CSX (rating: BBB+, stable outlook) 2.60% notes due 2026 have recently traded at +95 basis points.

The Canadian Pacific (rating: BBB+, stable outlook) 3.70% notes due 2026 are indicated at +88 basis points.

The Norfolk Southern (rating: BBB+, negative outlook) 2.90% notes due 2026 are indicated at +94 basis points.

IBM's Growth Constrained in 4Q; Guidance Points to Similar Performance in 2017*MCR Credit Risk Assessment*

International Business Machines (rating: A+, negative) released fourth-quarter and year-end 2016 operating results Jan. 19. IBM reported \$21.8 billion of revenue for the fourth quarter, down 1.0% year over year.

Strategic initiatives grew 12% year over year and now account for 41% of revenue. Growth in this segment was once again led by cloud revenue, which grew 33% year over year. Analytics revenue grew 9%, while mobile and security also maintained solid growth, though the last two segments remain minor contributors to the strategic segment. We estimate IBM's legacy segment revenue declined around 10% from a year ago. Performance in this segment was driven by a 12% decline in systems revenue, reflecting weaker sales in power and storage, partially offset by an uptick in z Systems mainframe sales. IBM's non-GAAP operating margin in the quarter was 24.8%, roughly flat compared with the year-ago quarter, but up from the third quarter.

Management said it is in the process of restructuring its global finance unit as a separate funding subsidiary, which will be called IBM Credit LLC. As part of the change, management is targeting an increase in leverage from 7 times equity to 9 times; it expects the new subsidiary to be able to access the debt market directly later in 2017.

IBM's cash and investments ended the December quarter at \$8.5 billion, \$1.4 billion lower than the previous quarter, though up \$333 million from year-end 2015 on net new debt issuance during 2016. We calculate that consolidated net debt was 2.2 times EBITDA compared with 1.7 times at the end of 2015. Total debt increased \$2.3 billion during the year, while trailing four-quarter EBITDA declined 15%. Total debt included \$28 billion of financial services debt, up \$663 million from year-end 2015, supported by \$26.7 billion of finance receivables. Non-investment-grade exposure in these receivables ticked lower during the quarter to 48% of the total, following some write-downs in the portfolio.

Trailing four-quarter free cash flow declined 3.3% to \$12.8 billion year over year. Acquisitions totaled \$6.0 billion, though no significant transactions were completed during the December quarter. Total payouts declined to 67% of free cash flow compared with 72% over the previous four consecutive quarters. Net share repurchases totaled \$3.3 billion over the past four quarters compared with \$4.6 billion in 2015, while dividends, at \$5.3 billion, are running 7.3% higher than last year.

Market Data

According to Advantage Data and Finra Trace, IBM's 3.45% senior notes due in 2026 are indicated at a spread of +79 basis points over the nearest Treasury, tighter by about 5 basis points since mid-October. Among comparable issuers, Applied Materials' (rating: A+) 3.90% notes due in 2025 are indicated at +92 basis points, also around 5 basis points tighter from mid-October. Oracle's (rating: AA-) 2.65% notes due in 2026 are indicated at +89 basis points, unchanged from mid-October. Over the same period, the Morningstar Industrial Corporate A+ index tightened about 4 basis points and is now quoted at +95 basis points.

Schlumberger Posts Decent 4Q Results; Cameron Integration Remains Ahead of Plan*MCR Credit Risk Assessment*

Leading oil services company Schlumberger (rating: A+, stable outlook) reported fourth-quarter 2016 revenue of \$27.8 billion, \$7.7 billion (22%) lower than \$35.5 billion revenue in fourth-quarter 2015. Commensurate with this decline, operating cash flow for fourth-quarter 2016 was \$2.0 billion, \$165 million (8%) lower than approximately \$2.2 billion for the year-ago quarter (before impairments and other charges, net of tax, of \$583 million and \$1.8 billion, respectively). The fourth-quarter 2016 numbers include Cameron, purchased by Schlumberger on April 1, 2016.

On a sequential basis, overall demand for Schlumberger's oilfield products and services appears to have stabilized in the fourth quarter. Improving North American land-based and strong Middle Eastern activities were largely offset by continued weakness in Latin America (specifically, Mexico and Argentina), U.S. offshore, the Far East, and seasonal activity declines in Europe, CIS, and Africa. On the earnings conference call, management indicated that for Schlumberger to reactivate its Venezuelan operations, the company would require more conviction about being paid there. Despite continued pressure on pricing, tremendous internal cost and efficiency improvements have allowed Schlumberger to maintain pretax operating margins above 10% and to continue to generate free cash flow, more than covering capital expenditures and dividends. For fourth-quarter 2016, Schlumberger reported \$1.1 billion in free cash flow (before \$696 million paid in dividends). The integration of Cameron into Schlumberger remains ahead of schedule, with cost- and revenue-related synergies expected to exceed \$600 million in the second year, better than originally expected.

Although Schlumberger did not give explicit 2017 guidance, on the conference call management stated that Cameron segment revenue and margins will likely bottom in the first quarter and that, after first-quarter seasonal slowness, most end-markets should improve in 2017, but the pace and timing is uncertain. With a leaned out cost and support structure, we think Schlumberger is well-poised to benefit from a broader upturn in demand for oilfield services, assuming the oil price continues to rise. In particular, management continues to like company prospects in North America and the Middle East. Further, management said on the call that a restructuring charge planned for the first quarter will be the company's last.

As of December, Schlumberger's liquidity remains excellent, with \$9.5 billion in cash and equivalents and an estimated \$4.0 billion available on its \$6.8 billion combined credit facility and commercial paper program. Management guidance for 2017 capital expenditures is \$2.2 billion, slightly higher than \$2.1 billion in 2016, but still below \$2.4 billion spent in 2015. Upcoming maturities of fixed-rate public notes include \$499 million due in 2017 and \$1.6 billion in 2018.

At the end of December, total debt was \$19.6 billion and net debt \$10.1 billion. We estimate the ratio of total debt/trailing 12-month EBITDA to be 3.0 times and net leverage 1.5 times, higher than 1.9 times and 0.6 times at year-end 2015, respectively.

Market Data

Schlumberger can be compared with Halliburton (rating: BBB+, negative outlook), a large, diversified oilfield-services peer. According to pricing service Advantage Data, the 4.0% notes due on Dec. 21, 2025, from Schlumberger Holdings, the principal U.S. subsidiary of Schlumberger, recently traded at +103 basis points over the nearest Treasury. By comparison, Halliburton's 3.80% notes due in 2025 recently traded at +125 basis points. Elsewhere within the energy industry, the 3.326% notes due on Nov. 17, 2025, from Chevron (rating: AA-) recently traded at +71 basis points over and Occidental Petroleum's (rating: AA-) 3.40% notes due in 2026 have been trading at +100 basis points over the nearest Treasury.

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