Morningstar Corporate Credit Research Highlights

Corporate bond market holds steady.

Morningstar Credit Ratings, LLC
24 April 2017

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Alphabet GOOGL	AA	AA
Apple AAPL	AA-	AA-
Cardinal Health CAH	A/UR-	A

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Credit Market Insights

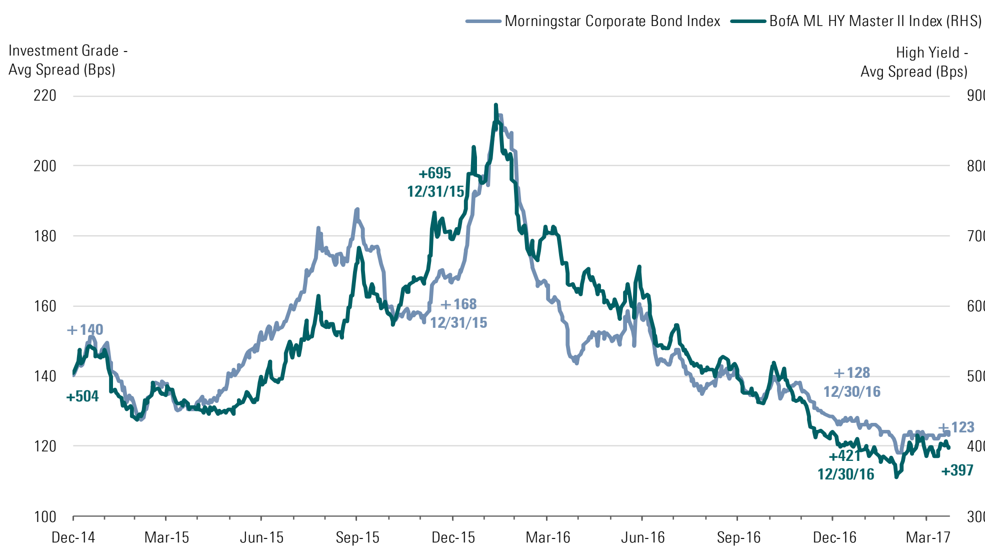
Corporate Bond Market Holds Steady

Irrespective of heightened global tensions, upcoming elections in Europe, and the lack of demonstrable political progress in effecting positive change in U.S. policies, volatility remained muted in the corporate bond market. The investment-grade market has been mostly in a holding pattern in which corporate credit spreads have been essentially flat over the past month; in the high-yield market, investor demand for yield has helped credit spreads grind slightly tighter.

The average corporate credit spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) was unchanged over the course of last week at +123. Over the past four weeks, the trading range of the average credit spread in the investment-grade index has fluctuated by only 2 basis points and since the end of last year has traded in a 10-basis-point range.

In the high-yield market, the Bank of America Merrill Lynch High Yield Master Index tightened slightly as credit spreads declined 6 basis points to end the week at +397. Over the past four weeks, there has been a little more volatility in the high-yield market as the index has traded in a 27-basis-point range and since the end of last year has traded in a 66-basis-point range. Much of the downside volatility occurred in mid-March when oil prices briefly dipped below $50 per barrel; however, high-yield corporate credit spreads quickly recovered when oil prices bounced higher. Since then, the markets' sensitivity to oil prices has subsided as oil has once again dipped below $50 per barrel. Rising production led to a 3.5% decline in oil prices last week to $49.61 per barrel, but the average spread in the energy sector only widened 4 basis points to +443, near the middle of its trading range since the end of last year.

Corporate Bond Credit Spreads



Source: Morningstar,Inc., BofA Merrill Lynch Global Indexes. Data as of 04/21/2017.

In addition to the apparent discounting of potential international risks, the domestic economic situation has failed to spur volatility. According to the GDPNow forecast released by Federal Reserve Bank of Atlanta, first-quarter GDP growth appears to have mostly stagnated. First-quarter economic growth is projected to be only 0.5%. This represents a significant reduction from the 2.5% pace the Atlanta Fed had expected as recently as Feb. 27. In our Second-Quarter 2017 Corporate Credit Market Insights published March 28, we noted that Robert Johnson, Morningstar, Inc.'s director of economic analysis, was expecting that GDP growth in the first quarter would only be about 1.0%. His estimate was well below the average consensus expectations of Wall Street economists.

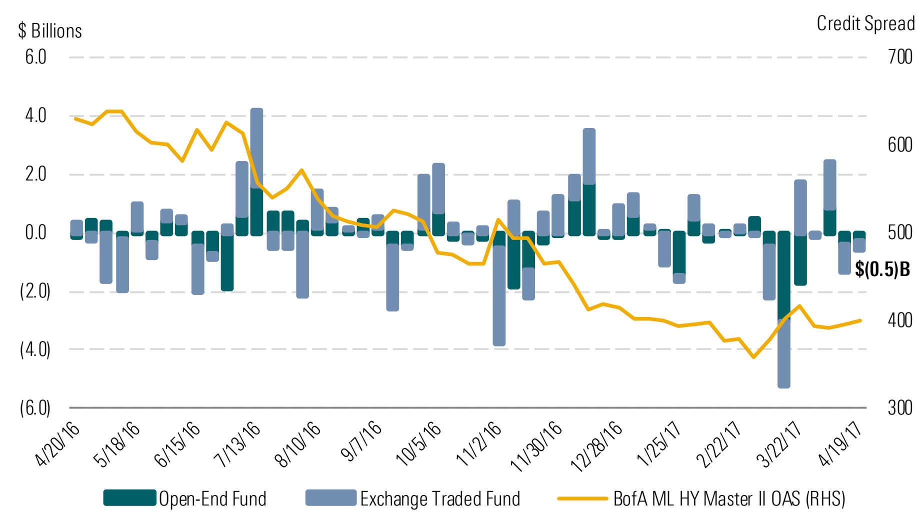
Although the first quarter appears dour, Johnson expects economic growth will rebound toward a more normalized level in the second quarter. He forecasts GDP growth to increase to 2.1% for the second quarter and range between 1.75% and 2.0% for the full year. He expects that at the end of this year, the yield on the 10-year U.S. Treasury will be 3.00%-3.50% and the run rate of inflation will be 2.00% on a fourth-quarter over fourth-quarter basis.

New Issue Market Beginning to Awaken; Moderate Weekly Outflows in High Yield

New issue volume in the corporate bond market remained low last week as earnings season continues, but it has been picking up as companies that report early during earnings season have tapped the public capital markets. For example, several of the large global banks that we rate were active in the markets. As other companies announce quarterly earnings, we expect the pace of new issues will pick up steam as companies look to either refinance near-term maturing debt or take advantage of low yields and relatively tight corporate credit spreads.

While there was a moderate amount of outflows in the high-yield sector over past two weeks, investors in fixed income generally stayed their course. Among the high-yield mutual funds and exchange-traded funds, $0.5 billion of assets were withdrawn last week and $1.3 billion were redeemed the prior week.

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



Source: Morningstar , Inc. and BofA Merrill Lynch Global Indexes.

Exhibit 1 Morningstar Credit New Issue Monitor
Week ended April 21, 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	L+100	Senior Unsecured	2023	NA
Bank of America	BAC	BBB	$1,250	2.88%	Senior Unsecured	2023	+115
Bank of America	BAC	BBB	$2,000	3.71%	Senior Unsecured	2028	+150
Bank of America	BAC	BBB	$2,000	4.24%	Senior Unsecured	2038	+137
Citigroup	C	A-	$2,250	2.75%	Senior Unsecured	2022	+107
Citigroup	C	A-	$1,250	L+96	Senior Unsecured	2022	NA
Darden Restaurants	DRI	BBB-	$500	3.85%	Senior Unsecured	2027	+150
General Motors Financial	GM	BBB-(1)	$1,000	2.65%	Senior Unsecured	2020	+120
General Motors Financial	GM	BBB-(1)	$750	L+93	Senior Unsecured	2020	NA
General Motors Financial	GM	BBB-(1)	$1,250	3.95%	Senior Unsecured	2024	+180
JPMorgan Chase	JPM	A-	$1,250	L+90	Senior Unsecured	2023	NA
JPMorgan Chase	JPM	A-	$1,500	2.78%	Senior Unsecured	2023	+107
JPMorgan Chase	JPM	A-	$2,500	3.54%	Senior Unsecured	2028	+137
Lennar	LEA	BBB-	$650	4.50%	Senior Unsecured	2024	+248
Lowe's Companies	LOW	A	$1,500	3.10%	Senior Unsecured	2027	+90
Lowe's Companies	LOW	A	$1,500	4.05%	Senior Unsecured	2047	+120
Morgan Stanley	MS	BBB	$1,750	L+122	Senior Unsecured	2024	NA
Phillips 66	PSX	BBB+	$300	L+65	Senior Unsecured	2019	NA
Phillips 66	PSX	BBB+	$300	L+75	Senior Unsecured	2020	NA
Wells Fargo	WFC	A	$1,000	2.09%	Senior Unsecured	2022	+112

Source: Advantage Data, company SEC filings
(1) Morningstar's issuer credit rating is assigned at the holding company level.

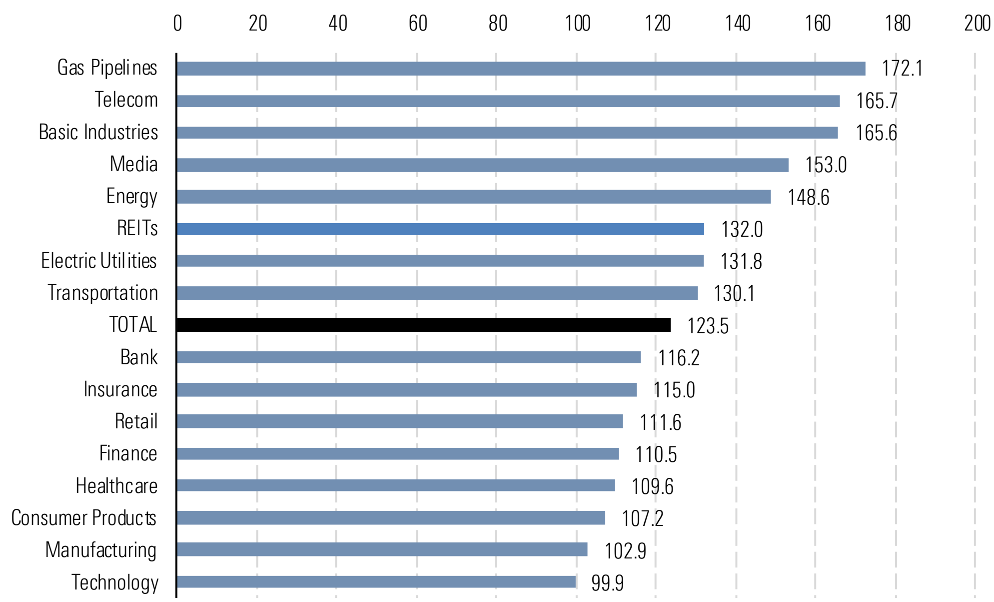
Exhibit 2 Morningstar, Inc. Corporate Bond Index Sector Summary

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-**	**4,718**	**6.8**	**123**	**1**	**(5)**	**1.12**	**2.52**
FINANCIAL	**A-**	**1,454**	**5.5**	**116**	**1**	**(7)**	**0.92**	**2.26**
Bank	A-	896	5.1	116	2	(6)	0.82	2.07
Finance	A	265	5.7	111	1	(10)	0.94	2.50
Insurance	A	213	7.6	115	(1)	(7)	1.44	3.05
REITs	BBB+	72	5.9	132	0	(3)	1.08	2.46
INDUSTRIAL	**A-**	**2,695**	**7.5**	**126**	**1**	**(4)**	**1.21**	**2.63**
Basic Industries	BBB+	227	7.6	166	4	(15)	1.08	4.22
Consumer Products	A-	296	7.5	107	0	(0)	1.26	2.23
Energy	A-	404	7.1	149	1	(7)	1.06	3.08
Healthcare	A-	397	7.7	110	(1)	(6)	1.30	2.67
Manufacturing	A-	391	6.2	103	1	(6)	0.96	2.12
Media	BBB+	191	8.3	153	(1)	(5)	1.46	2.89
Retail	A-	163	8.1	112	1	4	1.32	2.11
Technology	A+	291	7.2	100	0	(5)	1.26	2.51
Telecom	BBB+	158	8.6	166	1	8	1.24	1.82
Transportation	BBB+	134	9.0	130	(1)	(3)	1.49	2.88
UTILITY	**BBB+**	**523**	**8.4**	**149**	**0**	**(3)**	**1.44**	**2.97**
Electric Utilities	A-	304	8.8	132	1	(4)	1.41	2.91
Gas Pipelines	BBB+	211	7.7	172	(2)	(5)	1.47	3.10
Rating Bucket								
AAA Bucket		114	7.9	66	(1)	0	1.30	2.09
AA Bucket		557	5.9	78	1	(5)	0.97	2.05
A Bucket		1,760	6.8	102	1	(3)	1.11	2.25
BBB Bucket		2,287	7.0	157	1	(7)	1.16	2.89
Term Bucket								
1-4	A	1,487	2.3	81	(0)	(13)	0.40	1.30
4-7	A-	1,150	4.6	107	0	(9)	1.00	2.44
7-10	A-	886	7.1	137	3	0	1.29	2.93
10PLUS	A-	1,195	13.7	177	0	2	1.93	3.70

Data as of 04/21/2017

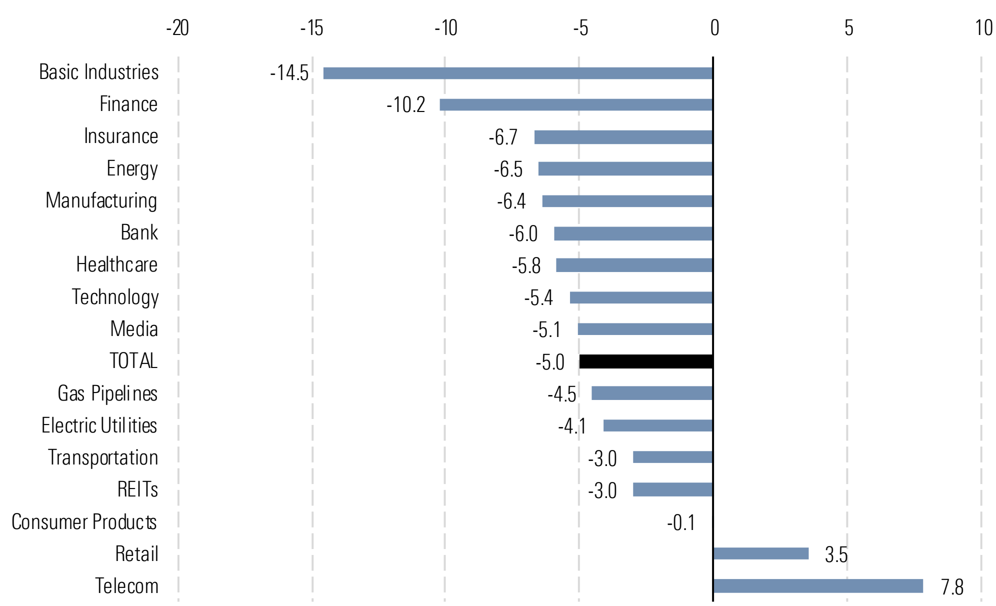
Source: Morningstar, Inc.

Exhibit 3 Morningstar, Inc. Corporate Bond Index Spread by Sector



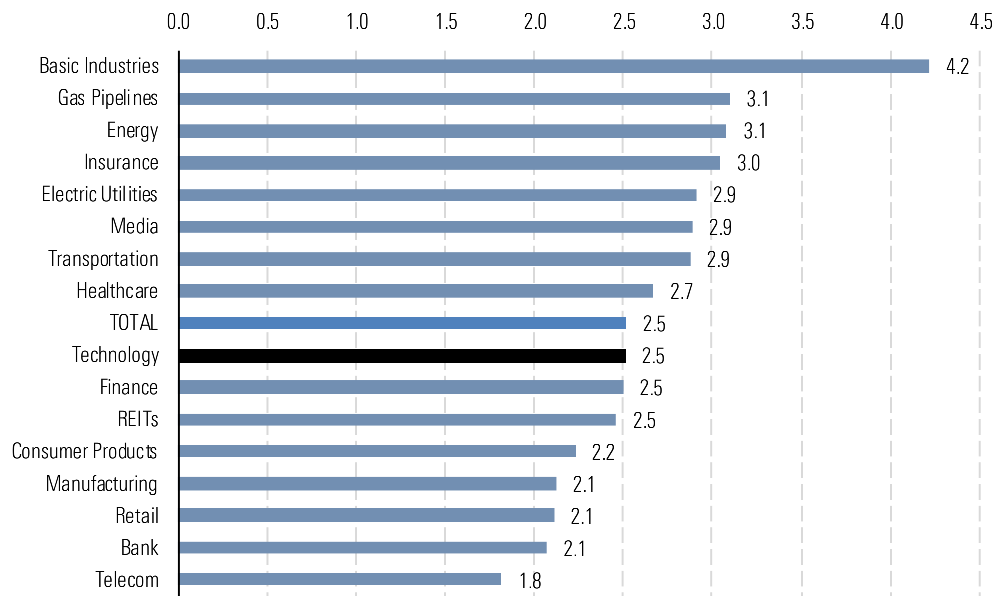
Source: Morningstar, Inc.

Exhibit 4 Morningstar, Inc. Corporate Bond Index YTD Spread Change



Source: Morningstar, Inc.

Exhibit 5 Morningstar, Inc. Corporate Bond Index YTD Return



Source: Morningstar, Inc.

Credit Rating Actions

► Rating affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Alphabet GOOGL	AA	AA
Apple AAPL	AA-	AA-
Cardinal Health CAH	A/UR-	A

Alphabet's Rating Affirmed at AA, Outlook Stable, on Projected Expansion of Digital Ad Market

April 18

Morningstar Credit Ratings, LLC is affirming its AA corporate credit rating on Alphabet, Inc. and maintaining a stable outlook. Our rating reflects the benefits of Alphabet's robust growth, high returns on invested capital, and conservative balance sheet management. These factors support strong Business Risk and Solvency Score pillars. Also, Morningstar's Equity Research Group assigns Alphabet a wide economic moat, driven by its dominant market share in digital advertising. However, these attributes are offset in our Business Risk assessment by Alphabet's heavy revenue dependence on Internet search and advertising-related products, which contribute about 90% of revenue.

The company has ramped up capital spending to fund its other bets segment. This represents about half of Alphabet's capital spending, which is now at 12.5% of sales. We note significant uncertainty associated with these growth projects and we view the potential for these to positively and materially contribute to Alphabet's long-term sustainable competitive advantage as far from assured. However, despite the higher capital spending, the company's ability to generate cash remains strong. For 2016, free cash flow totaled 29% of revenue and contributed to further growth in cash reserves.

Backed by solid growth and profitability, Alphabet maintains a strong and highly flexible balance sheet. The company reported global cash and cash equivalents of $86.3 billion and total debt of $5.2 billion as of the end of 2016. About 40% of the company's cash and cash equivalents are held domestically, in contrast to much lower percentages among similar-rated peers. Short-term liquidity is also supported by a $4.0 billion revolving credit facility, which backs a $5 billion commercial paper program.

We continue to expect Alphabet's performance to remain supported by expansion in the market for digital advertising, which eMarketer predicts will grow at a rate of around 12% between 2016 and 2020. We project Alphabet's revenue growth to moderate from around 20% to the midteens by 2021, with operating margins remaining stable in the mid-20s.

Our rating assumes that management will maintain its conservative capital-allocation stance as the company matures. We may consider an upgrade of the rating if the company is able to develop material and sustainable new sources of revenue growth through its other bets segment without sacrificing financial safety. However, if the digital ad market suddenly weakens or if management were to shift to a more aggressive capital policy and dramatically increase its debt, we may consider a downgrade of the rating.

Apple's Rating Affirmed at AA-, Outlook Negative on Slower Revenue Growth and Rising Leverage
April 18
Morningstar Credit Ratings, LLC is affirming its AA- rating on Apple and maintaining a negative outlook. Our credit rating reflects Apple's moderate Business Risk and its strong Solvency and Cash Flow Cushion rankings, which are supported by high returns on invested capital and over $200 billion of overseas cash and investments.

Morningstar's Equity Research Group continues to assign Apple a narrow moat, driven by moderate but sustainable customer switching costs. However, despite Apple's popularity with consumers, we remain concerned that Apple's dominance in consumer electronics may decline if the company is not able to introduce new products to offset maturing product lines. Apple's flagship iPhone brand is nearly 10 years old and represented 62% of Apple's 2016 revenue. When combined with the iPad and Macintosh products, the three consumer brands represent 82% of revenue.

Furthermore, while operating performance has moderated, Apple has been dramatically increasing its debt balances and maintaining its focus on large share repurchases. At the end of the December quarter, the company reported $246 billion of global cash and investments, up 14% from a year earlier. However, domestic cash reserves represented just 6.5% of the global total, up only 2% year over year. Since 2011, Apple has taken on nearly $90 billion of debt, pushing total debt to 1.3 times trailing EBITDA to help fund share repurchases. Meanwhile, operating performance has weakened in the past year as the smartphone market has matured.

We believe that management will manage its shareholder payouts to maintain a consistent base of domestic cash while keeping total debt between 1.0 and 1.5 times EBITDA, which is consistent with many of its similar-rated peers. We are also assuming revenue growth of 6% to 7% over the next two years, buoyed by iPhone 8 sales. Longer term, we expect growth to moderate toward 3% or 4%, with operating margin settling in the 20%-25% area by 2021. Our negative outlook takes into consideration a recent slowdown in revenue growth and the growing concentration of revenue.

We may consider an upgrade to the rating if the company shows progress toward significant new sources of revenue growth without materially diluting existing margins. Conversely, we may consider lowering the rating if total debt is allowed to rise materially from its current level, particularly in combination with a material reduction in domestically held cash or a prolonged decline in operating revenue or profitability.

Cardinal Health's Rating Under Review Negative on Medtronic Acquisition
April 18
Morningstar Credit Ratings, LLC is placing its A credit rating on Cardinal Health Inc under review negative on the company's plan to acquire Medtronic's patient care, deep vein thrombosis, and nutritional insufficiency businesses for $6 billion. This acquisition looks set to increase Cardinal's leverage initially and keep leverage above the previous target for several years. Therefore, we think a

downgrade is likely if this pending acquisition is completed, and we plan to update our rating accordingly in the near future.

From a Business Risk perspective, our view of Cardinal will not change significantly as a result of this acquisition. Cardinal will still earn an above-average Business Risk score because of its competitive advantages primarily in drug distribution combined with its large size and low cyclicality. Morningstar's Equity Research Group gives all three major pharmaceutical distributors in the United States—AmerisourceBergen, Cardinal, and McKesson—wide economic moat assessments. These three cumulatively control nearly all of this essential part of the drug supply chain, resulting in scale advantages. However, we also recognize customer concentration risks in our Business Risk pillar. For example, in fiscal 2016, CVS Health accounted for 25% of Cardinal's revenue. While we think this relationship remains healthy, this dependence on limited sources can lead to somewhat volatile earnings if Cardinal's customers switch to other distribution providers.

With these concentration risks in mind, Cardinal is attempting to diversify in medical products and distribution, and its latest acquisition in this area will increase leverage in the near future. At the end of December, the company owed $5.5 billion in gross debt, or 1.6 times adjusted EBITDA by our estimates and in the middle of its previous target range of 1.50-1.75 times. The $6.1 billion acquisition of Medtronic is a large one for Cardinal, and the firm plans to finance $4.5 billion with a new offering of senior notes and the balance with existing cash. Cardinal held $1.9 billion of cash on its balance sheet, which resulted in net leverage of around 1.0 times at the end of December. Planned financing activities look set to initially push gross leverage up to the mid-2s, by our estimates, after the acquisition is completed in the calendar third quarter of 2017. Management expects to repay about $1.5 billion of debt in the three years after the acquisition, but it estimates gross leverage will remain slightly above 2.0 times through June 2020.

We would consider a downgrade of Cardinal if capital-allocation activities cause the firm to operate above its previous target leverage range for several years. This debt-funded acquisition looks like a negative credit catalyst that could result in a downgrade of Cardinal, as this sustained increase in leverage cuts into our Solvency Score. We also believe the Distance to Default pillar may weaken as leverage rises on this acquisition and the stock's recent volatility is considered.

Recent Notes Published by Credit Analysts

Despite Mediocre Profits, Citigroup Reports Solid 1Q for Bondholders

MCR Credit Risk Assessment

On April 13, Citigroup (rating: A-, stable) reported solid results from a bondholder perspective. While its profits continue to trail those of peers JPMorgan Chase (rating: A-, stable) and Wells Fargo (rating: A, negative) with an annualized return on common equity for the period of 7.2% compared with 10.4% and 11.5%, respectively, results benefited from higher capital ratios and improved asset quality. Citigroup's net income available to common shareholders of $3.8 billion was 15.6% higher than a year ago and 16.5% higher sequentially. However, contrary to peers, its results were hurt by lower net interest income. Meager loan growth and higher interest costs contributed to net interest income that was 3.3% below year-earlier levels. Higher fee-based revenue from principal transactions contributed to total revenue that was 3.2% higher than year-earlier levels. Citi's results benefited from cost control. Operating costs were unchanged year over year and contributed positively to the company's strong efficiency ratio of 58%, which compares favorably with peers. A $166 million reserve release in the corporate loan portfolio overcame higher reserves in the consumer portfolio and contributed to credit costs that were 18.7% below year-earlier levels. At the segment level, solid results in the institutional clients services group compared favorably with weak results in the consumer bank, trends that were also observed at peers reporting thus far. Investment banking revenue increased 39.1% compared with a weak year-earlier quarter. Trading revenue increased 17.8% year over year, led by fixed income, which increased 18.7%, and equities, which increased 10.3%.

Citigroup's balance sheet improved during the quarter. Due in part to lower risk-weighted assets, regulatory capital increased during the quarter. Fully phased common equity Tier 1 capital finished the quarter at 12.8%, 20 basis points higher than the prior quarter and 45 bps higher than a year ago. Tangible common equity, an important aspect of our Solvency Score measure, remained unchanged from the prior quarter, representing 10.1% of tangible assets, a level considerably above global peers. By comparison, JPMorgan reported a 12.4% CET1 ratio and a TCE ratio of just 7.3% while Wells Fargo reported an 11.2% ratio CET1 and 7.8% TCE ratio. Citi's nonperforming loans decreased 10.7% year over year to represent 0.84% of loans, 12 bps lower than a year ago. Reserve coverage represented 227% of nonperformers, which compares favorably with a peer average around 150%.

Market News and Data

We compare Citigroup with large global U.S. banks including JPMorgan, Bank of America (rating: BBB, stable outlook), and Wells Fargo. Because of the company's presence in investment banking and investment management, we also consider Goldman Sachs (rating: BBB+, stable) and Morgan Stanley (rating: BBB, stable outlook). Citigroup's 3.20% senior notes due 2026 are indicated by pricing service Advantage Data at +142 basis points over the nearest Treasury while 10-year notes of JPMorgan are indicated at +124 bps. Similar-maturity notes of Wells Fargo are indicated at +123 bps. Among lower-rated companies, Goldman Sachs' 3.85% notes due 2027 are indicated at +145 bps while Morgan Stanley's 3.625% notes due 2027 are indicated at +142 bps. By comparison, Bank of America's 3.248% notes due 2027 are indicated at +143 bps.

JPMorgan Reports Another Solid Quarter in 1Q

MCR Credit Risk Assessment

On April 13, JPMorgan Chase (rating: A-, stable) reported solid first-quarter results that included higher revenue and net income, improved asset quality, and higher capital levels. The company reported net income available to common shareholders of $6.0 billion, 18.3% higher than the relatively weak year-earlier quarter but 4.5% below the prior quarter. By our calculations, annualized return on common equity for the period was 10.4%, comparing favorably with global peer Citigroup (rating: A-, stable), which reported a ROE of 7.2%, but trailing Wells Fargo (rating: A, negative), which reported a solid 11.5%. Results were supported by revenue that was 6.2% higher than a year earlier. Solid loan growth, which increased 5.7% year over year, and higher interest rates contributed to net interest income that was 6.0% higher than a year ago. Higher investment banking fees and principal transactions, partially offset by lower mortgage and credit card income, led to fee-based revenue that was 6.3% higher than a year ago. Higher operating costs, which increased 8.5% year over year and contributed to a weaker efficiency ratio of 60.3% versus 58.7% a year ago, were partially offset by credit costs that decreased 27.9% as improvements in the oil and gas portfolio outweighed deterioration in the consumer loan portfolio. At the segment level, results in the consumer and community bank decreased 20.2% year over year as a write-down on the student loan portfolio and higher credit card charge-offs detracted from profits. Despite record assets under management and higher revenue in the asset management segment, results were hurt by higher legal expenses, which contributed to profits that were 34.4% below a year earlier. However, strong results in the commercial bank and the corporate and investment bank, which increased 61.1% and 63.8%, respectively, drove the company's solid quarterly results. In the investment bank, higher debt underwriting fees contributed to banking revenue that was 25.0% higher than a year ago. In the markets division, fixed-income trading again contributed strongly to results, with revenue increasing 17.2% to $4.2 billion during the quarter. Equity trading was less sanguine, with revenue just 1.9% above year-earlier levels.

JPMorgan's balance sheet also improved during the quarter. As a result of lower risk-weighted assets and higher equity, regulatory capital increased handsomely during the quarter. Fully phased common equity Tier 1 capital finished the quarter at 12.4%, which was 20 basis points higher than the prior quarter and 70 bps higher than a year ago. Nonperforming loans decreased 16.2% year over year to represent 0.70% of loans, 18 bps lower than a year ago. Reserve coverage represented 215.3% of nonperformers, comparing favorably with a peer average around 150%.

Market News and Data

We compare JPMorgan with large global U.S. banks including Citigroup, Bank of America (rating: BBB, stable outlook), and Wells Fargo. Because of the company's presence in investment banking and investment management, we also consider Goldman Sachs (rating: BBB+, stable) and Morgan Stanley (rating: BBB, stable). JPMorgan's 2.95% senior notes due 2026 are indicated by pricing service Advantage Data at +124 basis points over the nearest Treasury while 10-year notes of Citigroup are indicated at +142 bps. Similar-maturity notes of Wells Fargo are indicated at +123 bps. Among lower-rated companies, Goldman Sachs' 3.75% notes due 2026 are indicated at +145 bps while Morgan

Stanley's 3.625% notes due 2026 are indicated at +142 bps. By comparison, Bank of America's 3.248% notes due 2027 are indicated at +143 bps.

Abbott Amends Alere Merger Agreement; Expects Closing in 3Q

MCR Credit Risk Assessment

On April 14, Abbott Laboratories (rating: BBB+, stable) announced that it had amended its merger agreement with Alere Inc (not rated). Instead of paying $5.8 billion for the point-of-care diagnostic firm as initially planned, Abbott has agreed to pay $5.3 billion in equity value for Alere, or $51 per share. Importantly, the two firms also agreed to dismiss their respective lawsuits regarding the combination, and Abbott expects the transaction to close by the end of the third quarter. Uncertainty has surrounded the Alere transaction, and Abbott management's enthusiasm for that deal has been constrained by the target's financial reporting delays, product recalls, and government investigations. However, with a discount to the initial acquisition agreement, Abbott currently appears committed to following through on the transaction.

As we have stated previously, our rating for Abbott is BBB+ with or without the Alere transaction. By our estimates, net leverage stood around 4 times in early January after the St. Jude transaction, and the Alere transaction will probably keep net leverage around that level in 2017 and generally cause a setback in its deleveraging by about a year. However, that delay is not significant enough to change our view of Abbott's long-term credit profile. Abbott's management team has stated that after these acquisition activities, its primary capital allocation goal will be rapid deleveraging. With some debt repayment and growing profits, we estimate net leverage could decline to the mid-2s within the next few years.

Market Data

We use Becton, Dickinson and Co (rating: BBB+, stable) and Zimmer Biomet Holdings Inc (rating: BBB+, negative) as key comparables for Abbott's bonds. All of following bond data is sourced from Advantage Data and Finra Trace.

In the approximate 5-year maturity bucket, these issuers have recently traded as follows over the nearest Treasury:
Abbott's (rating: BBB+, stable) 2.90% notes due in 2021 at +90 basis points.
Becton's (rating: BBB+, stable) 3.13% notes due in 2021 at +74 basis points.
Zimmer's (rating: BBB+, negative) 3.15% notes due in 2022 at +107 basis points.

In the roughly 10-year maturity bucket, bonds from these issuers have recently traded as follows:
Abbott's 3.75% notes due in 2026 at +139 basis points.
Becton's 3.73% notes due in 2024 at +104 basis points.
Zimmer's 3.55% notes due in 2025 at +145 basis points.

For comparison, Morningstar Inc's Corporate Bond Index is at +114 basis points at A-, +145 basis points in the BBB+ category, and +157 basis points in the BBB category.

In the roughly 30-year maturity bucket, bonds from these issuers have recently traded as follows over the nearest Treasury:
Abbott's 4.90% notes due in 2046 at +170 basis points.
Becton's 4.69% notes due in 2044 at +138 basis points.
Zimmer's 4.45% notes due in 2045 at +166 basis points.

T-Mobile Announces Purchase of $8 Billion of Wireless Spectrum

MCR Credit Risk Assessment

On April 13, the U.S. Federal Communications Commission released bidding results for its auction of 600-megahertz broadcast spectrum, which closed on March 30. In its release, the FCC reported that T-Mobile US Inc. (rating: BB, stable) was awarded $8 billion of spectrum, including 1,525 licenses across 414 market areas. This amount is consistent with our expectations and should result in moderately higher debt levels.

At the end of its December quarter, the carrier reported $25 billion of total debt, including $2.6 billion of tower financing obligations, supported by $5.5 billion of cash. Net debt was equivalent to 2.1 times trailing 12-month EBITDA. To support its bidding activities, T-Mobile amassed about $9 billion of funding resources, including cash on hand and $4 billion of contingent commitments with its majority shareholder Deutsche Telekom (not rated). Pro forma for the spectrum purchase, which is scheduled to close in the second quarter, we estimate that net debt may increase close to 2.6 times by year-end, based on the low end of management's 2017 EBITDA guidance of $10.4 billion.

Though T-Mobile's Business Risk pillar is well supported by its spectrum assets and its solid record of customer attraction and retention, its competitive position may be constrained over the long term by the lack of a sustainable cost advantage against much larger rivals. As a result, we believe its credit position may be hindered by the long-term need to invest in network expansion, including wireless spectrum investment or other improvement activities to compete with more deep-pocketed rivals. We continue to view merger and acquisition risk as a key source of uncertainty for the credit, as well, but this would likely by mitigated by change-of-control provisions in T-Mobile's senior notes indenture.

Market Data

According to Advantage Data and Finra Trace, T-Mobile's 6.5% notes due in 2026 traded on April 17 at $109.50, which represents a yield to the 2024 par call of 4.60% (+305 basis points over the nearest Treasury). For comparison, the bonds traded at $109.63 on April 10. Meanwhile, Dish Network Corp. (rating: BB-, negative) was also awarded $6.2 billion of spectrum in the auction. Its 5.88% notes due in 2024 traded on April 17 at a price of $115.20, which corresponds to a yield to maturity of 5.61% (+344 basis points), with the price lower by about a point from April 10. Finally, Netflix Inc.'s (rating: BB-, stable) 4.38% notes due in 2026 traded on April 13 at a yield to maturity of 4.52% (+232 basis points).

Dish Surprises With $6.2 Billion Spectrum Purchase
MCR Credit Risk Assessment

On April 13, the U.S. Federal Communications Commission released bidding results for its auction of 600-megahertz broadcast spectrum, which closed on March 30. In its release, the FCC reported that an affiliate of Dish Network Corp (rating: BB-, negative) was awarded $6.2 billion of spectrum representing 486 licenses across 416 market areas. While we expected Dish to bid in the auction, its final award is much larger than we anticipated. In our view, it will result in reduced liquidity and higher debt levels and exacerbate Dish's existing credit challenges.

We believe that Dish will fund most of its purchase with proceeds from the $4 billion of convertible notes it has issued since August 2016, including its most recent issue of $1 billion of these notes in March. We also expect the remaining $1.6 billion (assuming 10% already paid for deposits) of spectrum purchase to be funded through cash on hand. At the end of December, Dish had $2.4 billion of excess cash on its balance sheet, excluding $3 billion of proceeds from the August convertible notes. The convertible notes are senior obligations of Dish Network and are structurally subordinated to senior notes issued by Dish's pay-TV subsidiary, Dish DBS.

On a pro forma basis, we estimate that total consolidated debt for Dish Network is now $17.5 billion, including $14.2 billion issued by Dish DBS. We calculate that cash on hand will likely decline below $1 billion late in the second quarter when the auction purchase commitments are settled. As a result, we estimate consolidated net debt will increase to around 5.1 times EBITDA compared with 3.4 times at the end of December.

Dish's primary debt issuer, Dish DBS, reported net debt equivalent to 4.4 times DBS' trailing EBITDA in its December quarter. This may increase to as high as 4.6 times if the current $781 million of cash held at DBS is paid up to Network as a dividend to help fund the spectrum purchase. Debt at Dish DBS currently averages just over $1,000 per subscriber compared with the $1,500 per subscriber debt limit imposed by its senior indenture. Covenants also require that net leverage remain at or below 8.0 times EBITDA, or no additional debt can be incurred.

Our current rating incorporates our view the asset-light corporate structure of pay-TV subsidiary Dish DBS is a key source of risk and uncertainty for bondholders, particularly the fact that the wireless spectrum acquired using debt issued by Dish DBS is domiciled beyond the legal reach of DBS' bondholders. Furthermore, Dish DBS also does not own most of the core operating assets that support its business, including satellites. Bondholders also face the probability that Dish management will continue to tap the retained cash flow at DBS to support the build-out of its wireless business or to fund other investments outside of bondholder control.

Under the terms of its current spectrum licenses, Dish has until 2020 to make its spectrum available to 70% of its covered population, which points to a steep spending curve and significant uncertainty that the technology will work as expected. With limited internal cash flow to direct toward this effort, we believe the company may continue to pursue debt financing to the extent allowable under its current indentures. Moreover, in the event the spectrum gets sold or monetized, bondholders have no assurance that any material amount of proceeds will be applied to reduce debt, given the current asset structure.

Market Data
According to data provided by Advantage Data and Finra Trace, BB- rated Dish Network's 7.75% notes due in 2026 recently traded at a yield to maturity of 5.61% (+344 basis points), or about 20 basis points wider from a week ago. For comparison, CenturyLink Inc's (rating: BB, UR-) 5.63% notes due in 2025 recently traded at a yield to maturity of 6.27% (+417 basis points over the nearest Treasury).

JPMorgan Offering 6-Year and 11-Year Callable Notes
Market News and Data
JPMorgan Chase (rating: A-, stable) is in the market with an offering of benchmark sized 6-year and 11-year fixed rate senior unsecured holding company notes, with each tranche 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 similar maturities issued by JPMorgan and key comparables are indicated over the nearest Treasury as follows:

6-year area:
JPMorgan Chase & Co 2.972% notes due 2023 at +91 bps.
Wells Fargo & Co (rating: A, negative) 2.10% notes due 2021 at +75 bps.
Citigroup Inc (rating: A-, stable) 2.35% notes due 2021 at +91 bps.
Goldman Sachs (rating: BBB+, stable) 2.35% notes due 2021 at +96 bps.
Bank of America Corporation (rating: BBB, stable) 2.503% notes due 2022 at +93 bps.
Morgan Stanley (rating: BBB, stable) 2.625% notes due 2021 at +95 bps.

11-year area:
JPMorgan Chase & Co 3.782% notes due 2028 at +132 bps.
Wells Fargo & Co 3.00% notes due 2026 at +122 bps.
Citigroup Inc 3.887% notes due 2028 at +148 bps.
Goldman Sachs 3.85% notes due 2027 at +148 bps.
Bank of America Corporation 3.824% notes due 2028 at +146 bps.
Morgan Stanley (rating: BBB, stable) 3.625% notes due 2027 at +139 bps.

MCR Credit Risk Assessment
Our rating for JPMorgan benefits from the firm's diverse revenue sources, solid profits, and adequate asset quality and reserve balances. JPMorgan is the largest U.S. bank with over $2.4 trillion in assets. The bank generated around half of 2016 core net income from relatively low-risk activities, including about 38% from its retail bank and around 9% from asset management. Higher-risk activities such as commercial and investment banking comprise the remaining 53% of earnings. Although higher

regulatory requirements and low interest rates have had a negative impact on results during recent years, JPMorgan's 2016 return on average assets of 0.93% and a 10.1% return on common equity topped those of large U.S. peers. Peers' 2016 results range from Citigroup's 6.7% return on equity to Goldman's 9.4%. During the quarter ending March, JPMorgan continued this trend, reporting an annualized return on common equity of 10.4% which compared favorably to Citigroup's 7.2% but trailed Wells Fargo's 11.5%. We expect higher interest rates to increase profits during our forecast period. Asset quality is consistent with peers with nonperforming loans representing around 0.7% of gross loans as of March. Loan-loss coverage is solid representing around 215% of nonperformers. Although tangible capital is light, representing 7.3% of tangible assets which trails a peer average around 8%, regulatory capital is stronger and modestly higher than global peers with a fully phased common equity Tier 1 ratio of 12.4% and a Tier 1 ratio of 14.3% as of March. Both regulatory capital measures are around 70 bps higher than a year-ago.

Citigroup Offering 5-Year and 31-Year Callable Notes

Market News and Data

Citigroup (rating: A-, stable) is in the market with an offering of benchmark-sized 5-year fixed and floating rate notes senior unsecured holding company notes, as well as 31-year notes which are callable one year before maturity. We understand the latter 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 and net stable funding ratio. According to pricing service Advantage Data, bonds with similar maturities for Citigroup and key comparables are indicated over the nearest Treasury as follows:

5-year area:
Citigroup Inc 2.35% notes due 2021 at +91 bps.
Wells Fargo & Co (rating: A, negative) 2.10% notes due 2021 at +75 bps.
JPMorgan Chase & Co (rating: A-, stable) 2.972% notes due 2023 at +91 bps.
Goldman Sachs (rating: BBB+, stable) 2.35% notes due 2021 at +96 bps.
Bank of America Corporation (rating: BBB, stable) 2.503% notes due 2022 at +93 bps.
Morgan Stanley (rating: BBB, stable) 2.625% notes due 2021 at +95 bps.

31-year area:
Citigroup Inc 4.65% notes due 2045 at +140 bps.
Wells Fargo & Co 3.90% notes due 2045 at +117 bps.
JPMorgan Chase & Co 4.26% notes due 2048 at +129 bps.
Goldman Sachs 4.80% notes due 2044 at +144 bps.
Bank of America Corporation 4.443% notes due 2048 at +142 bps.
Morgan Stanley 4.375% notes due 2047 at +141 bps.

MCR Credit Risk Assessment

Citigroup is the most global of the large U.S. banks. It organizes its operations into a global consumer bank and an institutional client group, which includes transaction services, a scaled-back investment bank, private banking, and commercial lending. Consumer banking generates around 45.5% of 2016 revenue while institutional generated 48%. CitiHoldings, which ceased to be a reporting segment in 2017, generated the remainder of 2016 revenue. Overall, 37% of earnings come from the faster-growing emerging economies. While these international exposures and Citi's spotty history creates event risk, we consider Citigroup's diverse revenue sources a positive factor in our credit assessment. We continue to be impressed with Citigroup's solid capital buffers, which compare favorably to peers, and the firm's improving credit quality. As of March, tangible common equity/tangible assets lead its peer group at 10.1% while fully-phased Basel III common equity Tier 1 finished the quarter at 12.8%. By contrast, JPMorgan's tangible common equity ratio was just 7.3% while its common equity Tier 1 ratio was 12.4%. Similarly, Bank of America's tangible common equity ratio was 8.1% as of December while its common equity Tier 1 ratio was 10.8%. Asset quality has improved to levels comparable to peers, with nonperforming loans representing 0.84% of total loans and the trailing 12-months charge-offs representing around 1.1% of loans, 9 bps below the year-earlier level. Reserves are solid representing around 227% of nonperforming loans. Although Citi's profitability metrics in the 12-month ending March trail global U.S. peers with a return on average assets of 0.86% and a return on average common equity of 7.2%, we believe that Citigroup is well positioned in the A- category because of its strong capital levels and generally improving asset quality.

Netflix Plans 2Q Debt Issuance; Reports Slower Sub Growth and Higher Margins in 1Q
MCR Credit Risk Assessment
Netflix Inc. (BB-, stable) reported its first-quarter operating results April 17, reflecting a slowdown in the pace of subscriber net additions, but stronger operating profits, including a positive gross margin internationally. However, despite higher operating profits, the rate of cash burn remains higher than a year ago. Management also indicated it plans to continue adding debt to its balance sheet as needed to fund content, including an expected issuance within the next two to three months.

During the March quarter, Netflix added 5 million total subscribers, including 5.3 million paid subscribers (implying a net decline in promo subscribers). This brings net new paid subscriber net growth for the trailing four quarters to 17 million. Both domestic (1.5 million paid net adds) and international (3.8 million paid net adds) growth slowed relative to trends last year. For the second quarter, management is guiding to 3.2 million global net adds, with the pace in the U.S. slowing to just under 1 million.

Revenue increased 35% year over year, and the company reported a jump in the portfolio operating margin to 9.7%. However, management is maintaining its operating margin guidance at 7% for the full year. Domestic gross margin jumped 300 basis points from the prior quarter to 41.2%, largely attributable to the decision to defer the release of Season 5 of House of Cards to the second quarter, which reduced costs. The company is expecting domestic gross margin to revert to 36.8% in the second quarter. International gross margin jumped to positive 4.4% in the quarter from negative 7.0% in the fourth quarter. After launching in over 130 countries in 2016, Netflix slowed its new-entry activity during the quarter, which reduced expenses. However, management is guiding international gross margin to fall back to negative 2.5% for the second quarter.

Netflix's cash and investments ended 2016 at $1.3 billion, down $393 million from the prior quarter and down $731 million from a year ago. This primarily reflects the company's free cash burn rate of $1.7 billion over the past 12 months. The firm saw 42% growth in content assets from a year ago, contributing to its net cash usage. 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. Management is guiding to a $2 billion free cash burn rate for the full year.

We calculate year-end net debt/EBITDA at 3.1 times, down a half-turn from the prior quarter as a result of improvement in EBITDA. Trailing 12-month EBITDA was $645 million through the first quarter, an increase of 48% from last quarter. If the company follows through on new debt issuance in the second quarter, we expect net leverage to revert toward the mid-3 times area.

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 4.60% (+239 basis points). For comparison, T-Mobile US Inc's (BB, stable) 6.50% notes due 2026 are indicated at a yield of 4.61% to the 2021 par call (+307 basis points over Treasuries) despite a rating that is one notch higher than that of Netflix. The spread of T-Mobile's 2026 notes is only 5 basis points tighter over the past three months. Meanwhile, the BofA Merrill Lynch BB rated high-yield index is currently at a spread of +260 basis points, just 2 basis points tighter from three months ago.

Johnson & Johnson Sees 1Q Growth Across the Board

MCR Credit Risk Assessment:

On April 18, Johnson & Johnson (rating: AAA, negative) detailed decent sales performance in the first quarter with growth across all of its business segments. Total reported revenue grew 1.6% in the quarter with J&J's consumer segment increasing 1.0%, pharmaceutical division growing 0.8%, and medical device segment rising 3.0%. The firm still saw little impact in the first quarter to its top-selling medicine Remicade (representing 9% of overall sales) from Pfizer Inc's (rating: AA-, stable) U.S. launch of biosimilar Inflectra in November 2016. Given modest inroads from the biosimilar Remicade and no generic competition to Invega Sustenna, Prezista, Procrit, Risperdal Consta, and Zytiga during the year, J&J estimates reported revenue may increase 4.8%-5.8% to $75.4 billion-$76.1 billion in 2017 including the contribution from Actelion Ltd., which is expected to be acquired for $30 billion by the end of the second quarter. We see the benefits of J&J's diverse operations spanning pharmaceuticals, medical devices, and over-the-counter medicines as pharmaceutical growth is expected to slow in 2017 and may be further pressured over the next three years by losses of market exclusivity for multiple blockbuster drugs—Velcade, Invega Sustenna, Zytiga, and Prezista (collectively representing around 10% of total revenue). Despite the potential patent challenges, we estimate sales to increase in the low-single-digits through 2021 compounded annually due to a highly productive drug research program. However, 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 2021 compounded annually, in our estimation, which may be prompting a step up in external investment and shareholder distributions.

Our expectation that financial flexibility may be compromised over the next few years from aggressive capital deployment while J&J battles a period of key drug patent expirations through 2019, informs our negative outlook. J&J maintained a net cash position at the end of the first quarter with $39 billion in cash versus $32 billion in total debt. J&J's tax-effective use of overseas cash to fund the Actelion transaction will have no impact on the debt load or gross debt leverage, which will remain below 1 time in our estimation. With substantial free cash flow averaging nearly $17 billion annually over the next five years, we are confident that J&J can easily manage its well-laddered debt maturities totaling just over $8 billion through 2021. However, capital deployment traditionally balanced between M&A and shareholder returns has skewed with the full satisfaction of a $10 billion repurchase program (initiated in November 2015) by the end of the first quarter of 2017. We recognize that annual dividends approaching $9 billion and share repurchases of $9 billion consumed all free cash flow in 2016, digging into J&J's industry-leading financial flexibility.

Market Data

For closest comparisons to J&J's notes, we look to lower-rated companies, Eli Lilly & Co (rating: AA, stable), Novartis AG (rating: AA, stable), and Merck & Co, Inc (rating: AA, stable). Within this comparable group and adjusted for bond maturities, J&J's 10-year bonds recently traded tighter to those from the AA-rated firms, in general, and tighter than Morningstar Inc.'s Corporate Bond Index at AAA, according to Advantage Data and Finra Trace.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
Johnson & Johnson's 2.45% notes due 2021 at +17 basis points.
Merck's 2.35% notes due 2022 at +38 basis points.
Novartis' 2.4% notes due 2022 at +50 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
J&J's 2.45% notes due 2026 at +63 basis points.
Eli Lilly's 2.75% notes due 2025 at +62 basis points.
Merck's 2.75% notes due 2025 at +72 basis points.
Novartis' 3.1% notes due 2027 at +75 basis points.

For comparison to the approximate 10-year maturities, Morningstar Inc.'s Corporate Bond Index is at +66 basis points in the AAA category and at +78 basis points in the AA category.

In the approximate 30-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
J&J's 3.7% notes due 2046 at +82 basis points.
Eli Lilly's 3.7% notes due 2045 at +92 basis points.
Merck's 3.7% notes due 2045 at +94 basis points.
Novartis' 4.0% notes due 2045 at +96 basis points.

Medtronic Selling Assets; Will Use Proceeds to Deleverage and Repurchase Shares

MCR Credit Risk Assessment

On April 18, Medtronic PLC (rating: A+, stable) announced plans to sell its patient care, deep vein thrombosis, and nutritional insufficiency businesses for $6.1 billion. This sale is scheduled to close by the end of September. The company expects to receive $5.5 billion in aftertax proceeds; it plans to use $1 billion of those proceeds on share repurchases and the rest to pay down debt. These activities should help Medtronic deleverage in line with previous expectations.

Medtronic's leverage is currently elevated from debt issued to fund the 2015 Covidien merger. As of January, Medtronic owed $32 billion in debt, or 3.6 times adjusted EBITDA on a trailing 12-month basis; $11 billion of cash and investments pushed that down to 2.3 times on a net leverage basis. Although it has deleveraged by about a turn since the merger, Medtronic's leverage had remained roughly stagnant in the past few quarters. By using these divestiture proceeds to redeem debt, we estimate Medtronic's gross and net leverage will decline by roughly a quarter to a half turn on a pro forma basis. These activities should also help Medtronic achieve its previously announced plan to reduce debt by another $5 billion-$6 billion by the end fiscal 2018.

Our A+ rating for Medtronic also reflects its strong advantages in the medical device industry, and we do not expect this divestiture to significantly change our view of its business quality. Medtronic will continue to operate one of the most diverse and advantaged medical device businesses in the world even after this divestiture. The wide economic moat assigned by Morningstar's Equity Research Group is rooted in Medtronic's dominant presence in highly engineered medical devices to treat chronic diseases. Medtronic historically has been the market leader in cardiac devices, spinal products, insulin pumps, and neuromodulators for chronic pain. The combination with Covidien added a dominant position in medical instrumentation, a niche that also enjoys high switching costs and an oligopolistic nature. These positive business characteristics will remain intact, despite the planned divestiture.

Market Data

Medtronic's closest credit comparables are Stryker Corp (rating: A+, stable) and C.R. Bard Inc (rating: A+, negative). All of the following bond data is sourced from Advantage Data and Finra Trace.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
Medtronic PLC's 3.13% notes due in 2022 at +66 basis points.
Stryker Corp's 2.63% notes due in 2021 at +70 basis points.
C.R. Bard Inc's 4.40% notes due in 2021 at +73 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
Medtronic PLC's 3.35% notes due in 2027 at +94 basis points.
Stryker Corp's 3.50% notes due in 2026 at +104 basis points.
C.R. Bard Inc's 3.00% notes due in 2026 at +108 basis points.

For comparison with the roughly 10-year maturities, the Morningstar Corporate Bond Index is +92 basis points at A+, +102 basis points at A, and +114 basis points at A-.

In the approximate 30-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
Medtronic PLC's 4.63% notes due in 2045 at +114 basis points.
Stryker Corp's 4.63%% notes due in 2046 at +140 basis points.

Omnicom Reports Solid 1Q Growth and Modestly Lower Leverage
MCR Credit Risk Assessment
Omnicom Group Inc. (rating: BBB+, stable) reported revenue growth of 2.5% in the first quarter, supported by 4.4% organic growth, offset by foreign exchange headwinds and the impact from divestitures. By our calculation, EBITDA margin for the quarter was 13.5%, a 13-basis-point improvement from the year-ago period.

Organic performance was led by 6.4% growth in the advertising segment, while public relations was the slowest-growing segment at 1.8%. Despite stronger-than-expected growth in the first quarter, management remains cautious on growth given uncertainty around geopolitical and macro events, including Brexit as well as unrest in East Asia and the Middle East. For the full year, management is forecasting organic growth of 3%-3.5%, while loss of revenue from dispositions is likely to exceed acquisition impact for the year. We note the organic growth guidance range skews lower than average organic growth over the past five quarters of 3.7%. Management is also guiding to further moderate improvement in EBITDA margin for the balance of the year, which appears manageable in the context of recent performance.

Omnicom reported total debt of $4.9 billion at the end of March. It also reported cash of $2.5 billion, of which we believe more than two thirds is held in the United States, based on Omnicom's most recent foreign cash disclosure in December. Net debt ended the quarter equivalent to 1.1 times EBITDA while we estimate that lease-adjusted net leverage was 2.1 times EBITDAR. For comparison, these metrics were 1.3 times and 2.4 times, respectively, a year ago. Over the past year, debt has increased $300 million, offset by cash growth of $736 million and EBITDA growth of 4.2%.

Free cash flow for the most recent 12 months was $1.5 billion, a decline of 13% from a year ago. Over the same period, the company paid out 81% of free cash flow in the form of repurchases and dividends, compared with 73% last year. However, despite the increase, Omnicom's payout remains consistent with its average of 82% over the past 10 years.

Our BBB+ rating is supported by Omnicom's scale, strong cash flow, and generally low financial risk, offset by cyclicality and dependence on acquisitions for growth. We view the firm as having moderately low Business Risk, though lease-adjusted net debt at 2.1 times EBITDAR continues to keep moderate pressure on the Cash Flow Cushion and Solvency Score pillars. However, Omnicom's lease-adjusted net debt now compares favorably with that of Comcast (rating: A-, stable) at 2.4 times and CBS Corp. (rating: BBB, stable) at 2.9 times EBITDA.

Market Data

According to data provided by Advantage Data and Finra Trace, BBB+ rated Omnicom's 3.6% senior notes due 2026 traded earlier this month at +128 basis points over the nearest Treasury, 3 basis points tighter from its last earnings release Feb. 7. The Morningstar Corporate BBB+ Index is now quoted at +145 basis points, unchanged over the same period. For comparison, A- rated Comcast's 2.35% notes due 2027 traded on April 17 at +95 basis points while BBB rated CBS' 4.00% notes due 2026 are indicated at +139 basis points.

Lowe's Offering New 10-Year and 30-Year Notes to Refinance Existing Issues

Market News and Data

Lowe's Companies, Inc. (rating: A, stable) is reportedly in the market April 19 with a 10-year and 30-year senior-unsecured note offering. The firm is expected to use proceeds to fund a tender offer of existing notes, to retire its $250 million 6.10% Notes due September 15, 2017, and for other general corporate purposes. Today Lowe's announced the commencement of a cash tender offer for up to $1.6 billion of outstanding notes, including (in order of priority), its 7.11% notes due 2037, 6.65% notes due 2037, 5.80% notes due 2036, 5.50% notes due 2035, 5.80% notes due 2040, 5.13% notes due 2041, 5.00% notes due 2043, 6.88% notes due 2028, 6.50% notes due 2029, and 4.63% notes due 2020. Lowe's filed a preliminary prospectus supplement to the prospectus dated August 24, 2015.

MCR compares Lowe's with its peer, Home Depot (rating: A+, stable) and with similar rated big box retailers TJX Companies (rating: A, stable) and Target Corp. (rating A, negative). MCR utilizes data from pricing service Advantage Data and Finra Trace.

In the 10-year maturity area, recent trades over the nearest Treasury were as follows:
Lowe's $1.35 billion 2.5% notes due 2026 at +79 basis points.
Home Depot $1.0 billion 2.13% notes due 2026 at +63 basis points.
TJX $1.0 billion 2.25% notes due 2026 at +91 basis points.
Target $1.0 billion 2.50% notes due 2026 at +98 basis points.

The Morningstar Industrials single-A Corporate Bond Index is at a spread of +93 basis points.

In the 30-year maturity area, recent trades over the nearest Treasury were as follows:
Lowe's $1.35 billion 3.7% notes due 2046 at +109 basis points.
Home Depot $1.6 billion 4.25% notes due 2046 at +100 basis points.
Target $1.0 billion 3.625% notes due 2046 at +121 basis points.

MCR Credit Risk Assessment

Lowe's and Home Depot's strong Business Risk score reflects leading competitive positions in the home improvement retail sector. Each company has a wide economic moat as identified by Morningstar's

Equity Research Group. Both TJX and Target possess somewhat weaker competitive positions in the off-price retail and the discounting sector, respectively. In addition, Target's rating outlook is negative. Lowe's carries the highest leverage among these peer comparisons, at 2.3 times.

Lowe's rating is based on its strong competitive position in home-improvement retailing, consistent free cash flow generation, and the maintenance of a moderately leveraged balance sheet. Lowe's is the second-largest global home improvement retailer, which positions the company well to benefit from an improving U.S housing market. Lowe's has secured competitive advantages, using its scale to negotiate advantageously with vendors, while its low-cost position is in part based on an automated distribution network that integrates its vendors, distribution centers, and stores. MCR believes Lowe's brand is a strong intangible asset, as evidenced by a loyal customer base that relies on the expertise and knowledge of Lowe's store-based employees. We expect these competitive advantages will continue to allow for continued market share gains.

Organic revenue growth has been consistent with Lowe's 5% annual target and MCR forecasts the company could reach its 11% operating margin goal over the next several years. Within one year of closing on its acquisition Rona, one of Canada's leading home-improvement retailers, Lowe's leverage is close to its long-term target of 2.25 times lease-adjusted debt to EBITDAR.

Lowe's Companies credit rating is assigned a stable outlook, reflecting our expectation of solid operating performance within an improving U.S. housing market. Lowe's rating could be raised if its Business Risk rank improves as a result of additional geographic and end-market customer diversification, or if its Solvency Score improves due to higher-than-expected returns and increased interest coverage. Lowe's credit rating could be lowered if weaker profitability and higher leverage impair the Solvency Score.

IBM's Balance Sheet Held Steady in 1Q Despite Uneven Operating Performance

MCR Credit Risk Assessment

International Business Machines Corp. (rating: A+, negative) released first-quarter operating results April 18. Operating results remained mixed, highlighted by ongoing top-line weakness and a decline in gross margin. However, its balance sheet and credit metrics were little-changed relative to a year ago.

IBM reported $18.2 billion of revenue for the quarter, down 2.8% year over year. Adjusted for currency headwinds, revenue declined 2.0% compared with 1% decline in 2016. Revenue performance remains stubbornly bifurcated, with the high growth from its strategic investments still weighed down by a secular decline in its legacy equipment segments. Strategic revenue grew 13% year over year and now accounts for 43% of revenue. Growth in this segment was once again led by cloud revenue, which grew 35% year over year, while as-a-service revenue jumped 61%. Analytics revenue once again grew at 7%, while mobile and security also maintained steady growth, though these segments remain minor contributors to the overall segment. Meanwhile, we estimate IBM's legacy segment revenue declined around 12% from a year ago. Performance in this segment was dominated by an 18% decline in systems revenue, where a 7% growth in storage systems was overwhelmed by a 40% drop in mainframe sales and a 27% drop in power systems, both relative to a year ago. Results also revealed weakness in gross margin, which was down 254 basis points on an adjusted basis, offset by a 17% decline in sales and administrative expenses. As a result, non-GAAP operating margin improved 133 basis points.

Meanwhile, free cash flow declined 17% to $11.7 billion for the trailing four-quarter free cash flow ending March. Acquisitions totaled $3.7 billion during that period, though no significant transactions were completed during the March quarter. Due to the decline in cash flow, total payout to shareholders increased to 90% of free cash flow compared with 62% over the comparable year-ago period. Net share repurchases totaled $3.7 billion over the past four quarters compared with $4.3 billion, while dividends, at $5.3 billion, are running 5% higher than last year. For the full year, based on its full-year EPS guidance of $11.95 per share, we estimate IBM is targeting free cash flow in the $12 billion to $13 billion range.

IBM's cash and investments ended the March quarter at $10.7 billion, up $2.2 billion from the previous quarter but down $4.1 billion from a year ago. Total debt declined $2.4 billion during the year, offsetting a nearly 6% decline in trailing four-quarter EBITDA. We calculate that consolidated net debt ended the first quarter at 1.8 times EBITDA, lower than 2.1 times at the end of 2016 but in line with its level at the end of first-quarter 2016. Adjusted to exclude financing debt, IBM's corporate net debt was 0.2 times EBITDA, also flat compared with the year-ago period. Financial services debt was down $1.3 billion from a year ago, ending March at $25.5 billion. This debt was supported by $27.6 billion of finance receivables, which also declined $1.3 billion. Non-investment-grade exposure in these receivables remained at 48% of the total.

Market Data

According to Advantage Data and Finra Trace, IBM's 3.45% senior notes due in 2026 are indicated at a spread of +83 basis points over the nearest Treasury, unchanged from their level on Jan. 20, the date of IBM's fourth-quarter earnings release. Among comparable issuers, Applied Materials Inc's (rating: A+, stable) 3.30% notes due in 2027 are indicated at +85 basis points, 5 basis points tighter from their issuance in March. Meanwhile, Oracle Corp's (rating: AA-, stable) 2.65% notes due in 2026 are indicated at +89 basis points, also unchanged from Jan. 20. Over the same period, the Morningstar Industrial Corporate A+ index tightened 3 basis points and is now quoted at +92 basis points.

Canadian Pacific Reports Decent 1Q Results and Proffers Optimism for 2017

MCR Credit Risk Assessment

Canadian Pacific Railway Ltd (rating: BBB+, stable) reported mixed first-quarter 2017 results, with a worsening operating ratio partially offset by better free cash flow generation. However, management noted that business started to pick up during March and has persisted thereafter, with revenue ton miles up 6% so far in April compared with the same time last year.

Revenue increased a modest 1% versus the year-ago period, but the growth was masked by 200 basis points of foreign-currency headwinds. Carloads increased 2% versus the year-ago period, as gains in grain (17% of carloads), potash (5%), and meals, minerals, and consumer products (10%) more than offset declines in the remaining five product categories. Meanwhile, the intermodal segment (37% of carloads) posted flat volume. Freight revenue per revenue ton mile was up 1%, foreign currency was a 2-percentage-point headwind, while fuel, and price mix added 3 percentage points of growth.

Canadian Pacific cited weather as partly to blame for weaker profitability during the quarter. Expenses excluding foreign currency and a one-time compensation benefit increased 7% versus the year-ago period. This was driven by a 39% increase in fuel prices. As such, the adjusted operating ratio worsened 240 basis points to 61.3%. Management noted that a lag in fuel prices recovery was responsible for 200 basis points of the decline. The company generated 40% higher operating cash flow and reduced capital spending by 17%, resulting in quarterly free cash flow of CAD 81 million, compared with negative CAD 60 million last year. Canadian Pacific paid CAD 73 million in dividends, repurchased no shares, and reduced a modest amount of debt. As a result, cash increased approximately CAD 40 million sequentially to CAD 201 million while debt to CAD 8.6 billion. Rent-adjusted leverage remained unchanged at 2.9 times.

We compare Canadian Pacific (rating: BBB+, stable) with rails Norfolk Southern Corp (rating: BBB+, negative), CSX Corp (rating: BBB+, stable), and Kansas City Southern (rating: BBB, stable). Canadian Pacific's rent-adjusted leverage of 2.9 times is higher than CSX's 2.5 times, Kansas City Southern's 2.5 times, and Norfolk Southern's 2.7 times. However, Canadian Pacific's operating ratio is at least 5 percentage points better than these peers.

Market Data
The following bond levels are provided by Advantage Data:
The Canadian Pacific 3.70% notes due 2026 are indicated at +106 basis points.
The CSX 2.60% notes due 2026 have recently traded around +100 basis points.
The Norfolk Southern 2.90% notes due 2026 recently traded at +93 basis points.
Kansas City Southern's 3.125% notes due 2026 are indicated at +158 basis points.

Dover Reports Solid 1Q Earnings and Raises 2017 Outlook
MCR Credit Risk Assessment
Dover Corp (rating: A-, negative) reported strong first-quarter earnings led by 15% organic growth in its energy segment (18% of revenue). Moreover, business improvements were broad-based, with organic revenue and bookings up 4% and 12%, respectively, versus the year-ago period. The increased confidence enabled Dover to lift its 2017 revenue and diluted EPS guidance, boosting its organic revenue growth by 1 percentage point to 5% at the midpoint and EPS by 18% to $4.13 per diluted share at the midpoint.

For the quarter, revenue grew 12% compared with the same period last year. Organic growth improved 4% and acquisitions added 12%, while dispositions and foreign currency caused a 4-percentage-point headwind. In the previously beleaguered energy segment, the 1.02 book/bill ratio from the fourth quarter resulted in 15% organic growth, and a 27% increase in bookings. This segment ended the quarter at a book/bill of 1.07. As such, management now expects the energy segment to deliver organic revenue growth of 20% to 23%, up from 13% to 16% from the start of the year. Elsewhere, organic revenue growth was mixed, with engineered systems (34%) was up 2%, fluids (29% of sales) declined 2% while refrigeration and food equipment (19%) posted 5% growth.

Segment profitability improved 500 basis points to 16.7%, with the energy segment posting 12.9% margins, up 890 basis points from last year. However, fluids and refrigeration experienced 150 and 110 basis point declines in margins, respectively. Moreover, corporate expenses grew 22%, presumably related to M&A integration. As such, EBITDA margins expanded a more muted 50 basis points to 15%. Despite the 16% increase in EBITDA, quarterly operating cash flow declined 41% to $78 million. Management mentioned a modest $40 million uptick in prebuild inventory as the culprit, but it seems that accrued expenses and other liabilities had a negative $45 million impact on cash flow. The firm generated $36 million in free cash flow, down from $96 million last year, although it netted $120 million from the sale of businesses. Dover paid $69 million in dividends and repurchased no shares—it is unlikely to repurchase any shares through 2017. The firm repaid $16 million in commercial paper, but currency unfavorable currency movements resulted in a modest increase in debt to $3.6 billion. The firm ended the quarter with $416 million in cash, resulting in pro-forma leverage of 3.0 times.

Although they only compete in some business segments, diversified peers Parker Hannifin Corp (rating: A-, stable) and Illinois Tool Works Inc (rating: A, stable) are reasonable comparables for Dover. Aside from its negative outlook, on a relative basis, Dover's Business Risk suffers from its smaller revenue base—$7 billion versus $12.6 billion for Parker, pro forma for Clarcor, and $13.6 billion for Illinois Tool Works—and a weakened financial position, as indicated by our negative outlook.

Market Data
The following bond spreads are provided by Advantage Data:
The Dover 3.15% notes due 2025 are currently indicated at +82 basis points.
The Parker Hannifin 3.25% notes due in 2027, are indicated at +96 basis points.
The Illinois Tool Works 2.65% notes due in 2026 are indicated at +74 basis points.

Leverage Stagnant as Quest Diagnostics Boosts Earnings Outlook for 2017
MCR Credit Risk Assessment
On April 20, Quest Diagnostics Inc (rating: BBB+, stable) reported solid first-quarter operating results that allowed it to increase earnings guidance for 2017. However, there were no changes to its free cash flow estimates or debt leverage. Overall, these solid credit fundamentals support our stable outlook on Quest's BBB+ credit rating.

During the quarter, Quest's adjusted revenue grew 3.0% on similar (3.2%) volume growth and a slight decline (0.2%) in revenue per requisition. This growth represents a slight acceleration of trends from 2016, and growth acceleration remains one of management's top strategic priorities. Quest pointed to expanding relationships with hospital systems, such as HCA Holdings Inc (rating: BB, stable), through its professional lab services business as a positive catalyst for its growth. Several other relationships, including with AncestryDNA and Safeway, continue to expand the reach of Quest's laboratory services as well. The company's other top strategic priority is its operational excellence efforts to help control costs. On its low-single-digit top-line growth, Quest was able to deliver adjusted operating profit growth of 5.7% during the quarter, as margins rose 50 basis points year over year. With the help of share repurchases and a significant unexpected tax benefit during the quarter related to option exercises, adjusted earnings per share grew 17.7% year over year to $1.33, beating consensus estimates by roughly $0.15.

These positive trends in the first quarter allowed Quest to boost its earnings outlook for 2017, but the firm's free cash flow prospects and balance sheet appear unchanged. In 2017, Quest now expects adjusted EPS of $5.45-$5.60, up from $5.37-$5.52. Notably, this increase in guidance was less than the first-quarter earnings beat, as management really only incorporated the unexpected tax benefit into its full-year guidance, given how early it is in the year. Also, the firm's free cash flow guidance of $800 million-$850 million in 2017 did not change. With no major debt maturities this year, the firm should be able to continue pushing out significant cash to shareholders through repurchases (we estimate $1.3 billion remained on its authorization as of March) and dividends (roughly $250 million annualized run rate). We expect it to continue pursuing tuck-in acquisitions as well. Deleveraging will probably take a backseat to those other capital-allocation priorities, as the firm's debt leverage remains just above its target of 2.5 times at 2.6 times by our estimates as of March. Key peer Laboratory Corp of America Holdings (rating: BBB+, stable) operates with about half a turn more leverage on its balance sheet as of last count and has been rumored to be considering a large, potentially debt-funded acquisition.

In 2018 and beyond, potential reimbursement cuts create uncertainty around the diagnostic lab industry. CMS is now collecting private commercial payer pricing data from applicable labs with the deadline postponed by two months to the end of May. Once that data is collected from the applicable laboratories (accounting for only 69% of Medicare payments on lab tests in 2015), reform to the Medicare payment system for diagnostic testing is possible, which would probably reduce reimbursement rates for clinical laboratories, such as Quest. However, with the timeline for data collection delayed and industry participants questioning why a significant chunk of the market is being excluded from this initiative, a delay in reimbursement changes from CMS' current goal of 2018 is possible. Either way, Quest has said it should be able to manage expected reimbursement cuts through its ongoing cost-control efforts, which should offset the potentially negative revenue impact on the bottom line. Also, uncertainty surrounds the potential volume benefits that could arise if less profitable laboratories exit the business by partnering or selling their businesses to top-tier competitors, such as Quest.

Market Data

Quest's closest comparable from a business and credit perspective is LabCorp, with both firms at BBB+ ratings. All of the following data is sourced from Advantage Data and Finra Trace.

In the approximate 5-year maturity bucket, bonds from these two issuers recently traded over the nearest Treasury as follows:
Quest's 2.50% notes due in 2020 at +70 basis points.
LabCorp's 2.63% notes due in 2020 +100 basis points.

In the approximate 10-year maturity bucket, bonds from these two issuers recently traded over the nearest Treasury as follows:
Quest's 3.45% notes due in 2026 at +130 basis points.
LabCorp's 3.60% notes due in 2025 +148 basis points.

In the approximate 30-year maturity bucket, bonds from these two issuers recently traded over the nearest Treasury as follows:
Quest's 4.70% notes due in 2045 at +161 basis points.
LabCorp's 4.70% notes due in 2045 +179 basis points.

Verizon Delivers Weak 1Q Operating Results While Debt Continues to Climb

MCR Credit Risk Assessment

Verizon Communications Inc (rating: BBB, stable) reported $29.8 billion of operating revenue in the first quarter, a decline of 7.3% year over year, while EBITDA declined by a similar amount. Operating results remain heavily influenced by the migration to deferred revenue wireless plans and recent divestitures in the fixed-line side of the business, which hinder comparability with prior periods. For example, wireline results were positively affected during the quarter by the acquisition of XO Communications in February. Despite weaker operating performance and the uptick in acquisition activity, management reiterated its commitment to reduce net leverage to pre-Vodafone levels (1.5 times EBITDA or lower) by the end of 2019. However, with net debt at 2.7 times at the end of the first quarter, weakening profitability, and a plan to increase network investment over the next few years, we believe management may find its leverage target becoming increasingly difficult to meet.

Verizon's net debt balance increased $7 billion in the first quarter to $112 billion on new debt issuance. In March, the carrier raised $14.3 billion of new debt and securitizations, including $11 billion of new senior notes. The proceeds were applied to retire $3.1 billion of existing long-term senior notes, as well as debt swaps of $9 billion. A portion of the proceeds was also earmarked to fund the $4.5 billion acquisition of Yahoo (not rated), which is expected to close in June.

In wireless, Verizon faced significant headwinds. For the first half of the quarter, the carrier reported it lost 398,000 net phone customers before the launch of its unlimited plan midquarter. Following the launch, Verizon reported that it gained back 109,000 net adds. Segment revenue declined 5% year over year, driven by a 6.1% decline in service revenue. However, after adjusting to reflect the year-over-year-change in installment billings (deferred revenue), we believe service revenue performance was close to flat on the year. Equipment revenue also declined 5%. EBITDA margin for the segment finished down 110 basis points to 45.1%, as a result of revenue weakness compounded by 4% growth in equipment and selling, general, and administrative expense.

In the wireline segment, Verizon reported a 0.6% decline in revenue, though results were skewed by the XO acquisition. On an organic basis, the carrier reported a 3.2% decline in segment revenue, led by a 4.3% decline in enterprise solutions. EBITDA benefited from a 3.5% decline in service expenses and a 9% decline in SG&A.

For the trailing 12 months through March 31, free cash flow was $238 million, which includes the impact of a $3.4 billion pension contribution. However, even adjusted for the pension payment, free cash flow is still less than a third of the level achieved this time last year despite a 4% decline in capital spending over this period. In the years ahead, we expect to see further pressure on free cash flow as the company looks to upgrade and expand its wireless network, including investment in new fiber optic capacity. Earlier this week, Verizon announced a 3-year, $1.1 billion purchase contract with Corning Inc. (rating: A-, negative) to develop 37 million miles of new fiber to improve existing network performance as well as prepare for 5G network upgrades over the next decade.

Market Data
Based on pricing from Advantage Data, BBB rated Verizon's recently issued 4.13% notes due 2027 traded on April 20 at +160 basis points over the nearest Treasury, unchanged from their initial pricing in mid-March. Verizon's 2.63% notes due 2026 are trading at +150 basis points, which is 20 basis points wider from the spread at the last earnings release Jan. 24. Key comparable AT&T Inc's (rating: BBB, UR-) 4.25% notes due 2027, which were issued in early February at +180 basis points, traded on April 20 at +175 basis points. AT&T's rating remains under review pending its merger with Time Warner Inc. (rating: BBB, UR-). Meanwhile, the BBB rating category of Morningstar Corporate Bond Index is now quoted at +152 basis points, or 4 basis points tighter over the past three months.

Improving Global Economic Conditions Aid ABB's 1Q Earnings
MCR Credit Risk Assessment
ABB Ltd (rating: A, stable) reported encouraging first-quarter earnings driven by a second consecutive quarter of revenue growth in constant-currency terms. The firm is proceeding with its Next Level Strategy, which it hopes will shift its portfolio to higher-growth areas while improving overall competitiveness. Already, it sold its high-voltage cables business and acquired B&R to increase its software and solutions capabilities to provide a comprehensive open-architecture automation portfolio. Over time, this shift should help bolster profitability. More immediately, management provided guarded optimism about economic global conditions for the remainder of the 2017.

For the quarter, reported revenue fell 1% versus the year-ago period, but increased 3% on a currency-adjusted basis. On a segment basis, reported revenue increased 3% in robotics and motion (23% of revenue) and was flat in electrification products (28% of revenue). Industrial automation (20% of revenue) and power grids (29% of revenue) reported declines of 7%, and 2%, respectively. The firm noted strength within utilities (35% of business) as customers work to upgrade aging infrastructure and renewable energy, and within industry (40% of revenue) investments in robotics solutions in light industries. As expected, weakness was related to markets that have exposure to oil and gas. Base orders, defined as those with a value of $15 million or less, increased 2% versus the year-ago period in constant dollars, providing support for future revenue growth. ABB again worked to improve profitability, with EBITA margins—its preferred metric—expanding 280 basis points to 10.3%. In total, EBITA margins held flat at 12.1%. Net working capital fell to 13% of sales from 15% last year. Operating cash flow to double to $509 million, while the firm produced free cash flow of $317 million, up from $82 million last year. Including the proceeds from its cable business sale, ABB ended the quarter with $6.8 billion in cash and marketable securities, $6.9 billion in debt, and leverage of 1.6 times EBITDA.

We compare ABB to peers Emerson Electric Co (rating: A+, negative), Honeywell International Inc (rating: A, stable) and Rockwell Automation Inc (rating: A, stable) given that they all compete in the industrial automation market. Although ABB is the number-two player in industrial automation behind Siemens AG (not covered) its profitability compared with these peers is weighed down by its power grids segment.

Market Data
The following bond levels are provided by Advantage Data:
ABB 2.875% notes due 2022 are indicated at +69 basis points.
Emerson 3.15% notes due 2025 recently traded at +56 basis points
Honeywell 2.50% notes due 2026 are indicated at +76 basis points.
Rockwell Automation 2.875% notes due 2025 are indicated at +92 basis points.

EBay's 1Q Results and 2017 Guidance Reflect Progress With Recent Initiatives
MCR Credit Risk Assessment
EBay Inc. (rating: BBB+, stable) reported solid first-quarter results that demonstrate success with recent initiatives. Revenue increased 7% to $2.2 billion (currency neutral). Gross merchandise volume grew 5%, driven by additional active buyers, continued expansion of new user experiences, and brand advertising. StubHub revenue increased 19% to $210 million, aided by strength in international markets and recent acquisitions. Classifieds revenue increased 10% to $199 million, also due to strong international growth. Overall, eBay added 2 million active buyers across its platforms in the first quarter, growing 4% to 169 million users. Non-GAAP operating margin remained under pressure, decreasing 340 basis points to 30.0%, driven by a continued mix shift and ongoing higher investments in its marketplace structured data initiative. Adjusted EBITDA decreased 6.7% year over year to $810 million while margins fell over 400 basis points versus last year to 36.5%.

EBay generated $447 million of free cash flow and paid out $410 million for share repurchases, slightly below its historical run rate of $500 million-$600 million per quarter. Total debt was unchanged from one year ago at $9.0 billion, and total debt/adjusted EBITDA was 2.7 times. EBay continues to maintain a very liquid balance sheet including cash and investments totaling over $11 billion, most of which is held in international accounts. Accordingly, its balance sheet is in a net cash position.

MCR expects eBay will generate full-year revenue growth in the midsingle digits. Adjusted EBITDA margins are expected to decline further during the year, with full-year margins approximating the 36% posted in the first quarter. The rating on eBay contemplates the maintenance of the firm's current liquidity and credit metrics, despite the potential for continued margin pressure, EBITDA declines, and modest acquisition activity.

EBay's rating continues to reflect an average Business Risk score based on its strong competitive position in its e-commerce business, supported by a network effect through a growing base of 169 million active buyers across the globe. Morningstar's Equity Research Group has assigned eBay a narrow economic moat based on these attributes. Nevertheless, while the company's scale provides barriers to entry for new competitors, eBay's Marketplace business is losing share as gross merchandise volume is growing at a low-single-digit pace compared with industry growth in the midteens. EBay's other businesses, including StubHub and classifieds, also possess certain competitive strengths, including an expansive global network, widely recognized brands, and ample advertising resources.

Market Data

MCR compares eBay with other rated online consumer cyclical peers, including Amazon (rating: A, stable), Priceline (rating: A-, positive), and Expedia (rating: BBB-, positive). Using data from pricing service Advantage Data and Finra Trace, we note the following recent trades in existing bond issues:

EBay's $750 million 3.45% notes due 2024 at +119 basis points.
Amazon.com's $1.25 billion 3.8% notes due 2024 at +64 basis points.
Priceline's $1.0 billion 3.60% notes due 2026 at +128 basis points.
Expedia's $750 million 5.0% notes due 2026 at +180 basis points.

Additionally, the Morningstar Industrials BBB+ Corporate Bond Index is at a spread of +146 basis points.

Impressive Cash Flow Generation Highlights Honeywell's 1Q Results

MCR Credit Risk Assessment

Honeywell International Inc (rating: A, stable) started 2017 with solid first-quarter results, led by 2% organic revenue growth. The firm noted strong operational performance across all segments, and the better results enabled Honeywell to lift the bottom end of its 2017 diluted EPS guidance. Honeywell now expects adjusted diluted EPS to increase 7%-10% versus 2016 levels.

Reported revenue was down a smidge, but organic revenue grew 2% versus the year-ago period. Organic revenue was flat in the firm's aerospace segment (37% of revenue), due to weakness in business jets and helicopters. The remaining segments posted organic growth of 3.7%, as the recovery in oil and gas drove a 5% increase in performance materials (22% of sales), while strength in housing helped drive a 3% increase in home and building (27% of revenue). Overall, management was encouraged by the outlook from the manufacturing economy, and noted a double-digit increase in oil and gas orders. Again, productivity measures helped boost overall profitability, with EBITDA margins expanding 120 basis points to 21.7%. The margin gain was most prominent in safety and productivity (14% of sales), expanding margins by 330 basis points to 14.7%. Performance materials posted a 260-basis-point expansion to 22.8%. Honeywell's concerted cash flow conversion efforts paid dividends this quarter, with free cash flow of $772 million, up six times from last year. Honeywell also paid $503 million in dividends and repurchased $310 million in shares. Still, debt was essentially unchanged sequentially at $15.9 billion, while cash and short-term investments increased $232 million sequentially to $9.6

billion. Honeywell ended the quarter with gross leverage of 2.0 times, which is below the firm's targeted level of 2.3-2.5 times.

We compare Honeywell International with peers Emerson Electric Co (rating: A+, negative), Rockwell Automation Inc (rating: A, stable), and United Technologies Corp (rating: A, stable). Honeywell's gross leverage of 2.0 times could increase to the mid-2s and remains substantially higher than the 1.2 times at higher-rated Emerson on a pro forma basis after the latter's recent portfolio changes, and higher than same-rated Rockwell's leverage of 1.6 times. Despite the lower leverage, Rockwell's smaller revenue base affects its Business Risk score. Honeywell's leverage target is only slightly lower than the 2.6 times gross leverage at same-rated United Technologies.

Market Data
The following bond spreads are provided by Advantage Data:
Honeywell 2.50% notes due in 2026 are indicated at +74 basis points.
Emerson Electric (rating: A+, negative) 3.15% notes due in 2025 recently traded at +56 basis points.
United Technologies (rating: A, stable) 2.65% notes due in 2026 are indicated at +74 basis points.
Rockwell Automation (rating: A, stable) 2.875% notes due in 2025 are indicated at +92 basis points.

Kansas City Southern Reports Record 1Q Earnings, but Trade and Competition Issues Resurface
MCR Credit Risk Assessment
Kansas City Southern (rating: BBB, stable) kicked off 2017 with record first-quarter results, as meaningful growth returned for the first time since 2014. The 2017 volume outlook is promising, as has been echoed by other rails and our general view of the industrial economy. For instance, management cited 75% of its business having favorable trends, which should help bolster profitability, while its 5% reduction in capital spending should help it overcome the quarter's weak cash-flow generation.

Revenue increased 8% versus the year-ago period, led by a 6% increase in carloads, and approximately a 3% net increase in revenue per unit. On a commodity basis, carloads grew in almost all categories but notable strength occurred in automotive (up 38%) and energy (up 30%). However, operating metrics deteriorated versus last year. Dwell hours (time a car resides in a terminal) increased 10% versus last year while velocity was down slightly. Offsetting these results was better productivity, as the 6% volume growth was accompanied by flat headcount, excluding mechanical in-sourcing. Operating expenses increased 6%, enabling the operating ratio to improve 120 basis points to 65.4%, with EBITDA growing 11% to $290 million. Despite the operational improvement, Kansas City Southern's cash generation worsened as a result of weaker operating cash flow and greater capital spending. The firm produced negative free cash flow of $31 million, versus $33 million last year. Debt increased slightly to $2.6 billion, but cash declined $78 million sequentially to $123 million. Still, the firm ended the quarter with rent-adjusted leverage of 2.6 times, unchanged from December 2016.

We compare Kansas City Southern to rails Canadian Pacific Railway Ltd (rating: BBB+, stable), Norfolk Southern Corp (rating: BBB+, negative), and CSX Corp (rating: BBB+, stable). Kansas City Southern's rent-adjusted leverage compares favorably with Canadian Pacific's 2.9 times, CSX's 2.4 times, and

Norfolk Southern's 2.7 times. Moreover, Kansas City Southern's 64.7% operating ratio bests CSX's (68.5%) and Norfolk Southern's (68.9%), but is surpassed by Canadian Pacific's (59.2%). However, Kansas City Southern faces a greater risk than its peers given its large Mexican exposure (50% of revenue), which detracts from its Business Risk. Moreover, this issue reared its head again this quarter. In addition to the potential for more costly trade with Mexico, Kansas City Southern's Mexican rail subsidiary rebuffed a 2017 preliminary report from the Mexican's government competition commission claiming a lack of competition in Mexico. Kansas City Southern's response cited evidence to the contrary, but we suspect this issue will continue to vex the railroad.

Market Data
The following bond prices are provided by Advantage Data:
Kansas City Southern's 3.125% notes due 2026 are indicated at +156 basis points.
CSX's 2.60% notes due 2026 are indicated at +105 basis points.
Canadian Pacific's 3.70% notes due 2026 are indicated at +107 basis points.
Norfolk Southern's 2.90% notes due 2026 are indicated at +103 basis points.

North America Rebound Underpins Schlumberger's 1Q Results, Sequentially Higher 2Q Guidance
MCR Credit Risk Assessment
Leading oil services company Schlumberger (rating: A+, stable outlook) reported first-quarter revenue of $6.9 billion, a $374 million (6%) increase relative to $6.5 billion revenue in the year-ago quarter. Despite the increase on the top line, operating cash flow was $656 million, $554 million (46%) lower than approximately $1.2 billion for the year-ago quarter (before merger and integration charges, net of tax, of $68 million and zero, respectively). The first-quarter 2017 numbers include Cameron, purchased by Schlumberger on April 1, 2016. Without Cameron, we estimate first-quarter 2017 revenue and operating cash flow would have been $5.7 billion and $515 million, respectively.

Sequentially and as expected, overall demand for Schlumberger's oilfield products and services modestly declined in the first quarter. The rebound in North America land-based activity and pricing continues, but positive momentum there was more than offset by continued weakness in U.S. offshore, Australia, and Middle East activity declines and greater-than-expected seasonal weakness in China, Russia land, and the North Sea. In Latin America, revenue growth in Brazil was offset by declines in Peru, Colombia, and Ecuador, resulting in flat sequential growth for the region. Africa revenue growth was essentially flat, too. Drawing on a variety of sources, we think international demand for oilfield services remains weak with a meaningful improvement still one to two quarters away.

Despite continued pressure on international 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. For the first quarter, Schlumberger reported $15 million in free cash flow (including $381 million in capital expenditures, but before $696 million paid in dividends). The integration of Cameron into Schlumberger has gone especially well, with cost-related synergies of $400 million in the first year and secured new orders of $600 million resulting from the combination, much better than originally expected.

On the earnings conference call, management said it expects second-quarter earnings to grow 15%-20% sequentially, driven by a continued rebound in North America land and seasonal recovery in China, Russia, and the North Sea. With a leaned-out cost and support structure, Schlumberger appears poised to benefit from a broader upturn in demand for oilfield services, assuming the oil price continues to rise. Management continues to believe that 2017 company prospects are best in North America, with the Middle East and Russia expected to remain resilient. In regards to OneStim, the recently announced joint venture with Weatherford International (rating: B+, negative) to consolidate North American land completion products and services, the transaction is expected to close in the second half of 2017. Formation of the joint venture should help to rationalize surplus North America onshore pressure pumping capacity.

As of March, Schlumberger's liquidity remains excellent, with $7.6 billion in cash and investments and an estimated $4.0 billion available on its $6.6 billion combined credit facility and commercial paper program. Management guidance for 2017 capital expenditures is unchanged at $2.2 billion, slightly higher than $2.1 billion in 2016 but still below $2.4 billion in 2015. Upcoming maturities of long-term borrowings include $2.0 billion in 2018 and $1.3 billion in 2019.

At the end of March, total debt was $19.0 billion and net debt $11.4 billion. We estimate the ratio of total debt/trailing 12-month EBITDA to be 3.0 times and net leverage 1.8 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 Dec. 21, 2025, from Schlumberger Holdings, the principal U.S. subsidiary of Schlumberger, recently traded at +110 basis points over the nearest Treasury. By comparison, Halliburton's 3.80% notes due in 2025 recently traded at +131 basis points. Elsewhere in the energy industry, the 3.326% notes due Nov. 17, 2025, from Chevron (rating: AA-, stable) recently traded at +77 basis points over, and Occidental Petroleum's (rating: A, stable) 3.40% notes due in 2026 have been trading at +113 basis points over the nearest Treasury.

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