Morningstar Corporate Credit Research Highlights

Corporate credit spreads widen in response to rising geopolitical tensions.

Morningstar Credit Research, LLC
14 August 2017

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Cardinal Health **CAH**	A-	A/UR-

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Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Walt Disney **DIS**	A+	A+

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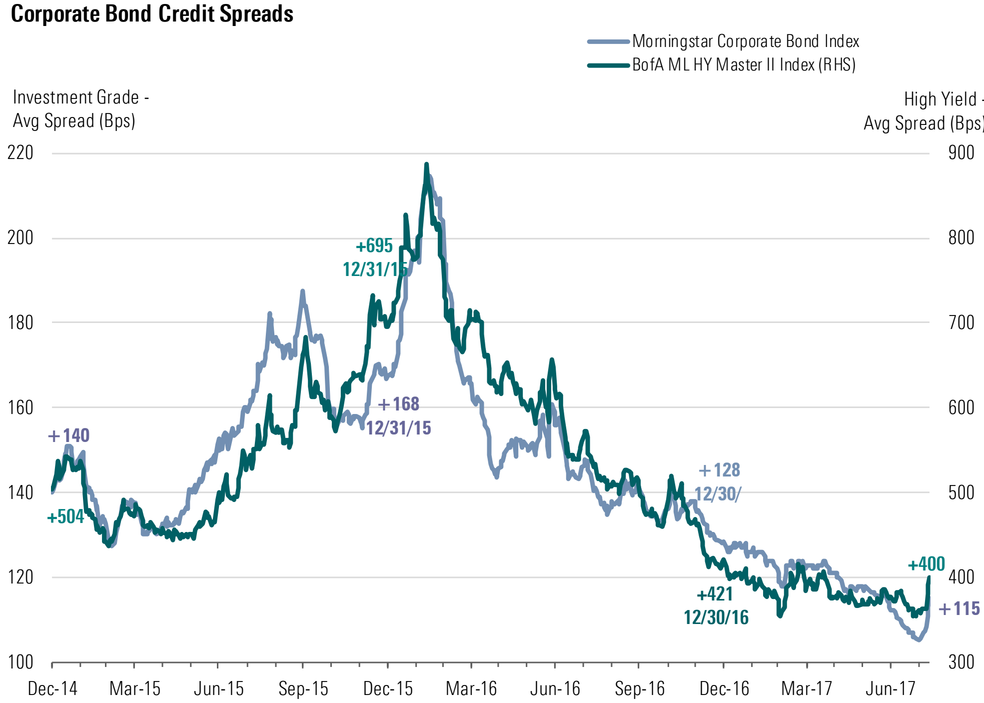
Credit Market Insights

Corporate Credit Spreads Widen in Response to Rising Geopolitical Tensions

Corporate credit spreads widened from their recent lows as geopolitical tensions escalated last week. After bottoming out at +105 at the end of July, the average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) widened 10 basis points to +115, with the preponderance of the widening occurring last week. Similarly, since hitting its recent lows at the end of July, the average credit spread of the BofA Merrill Lynch High Yield Master Index has widened 45 basis points to +400. The equity market experienced a rare pullback as the S&P 500 declined 1.43%.

Corporate Bond Credit Spreads



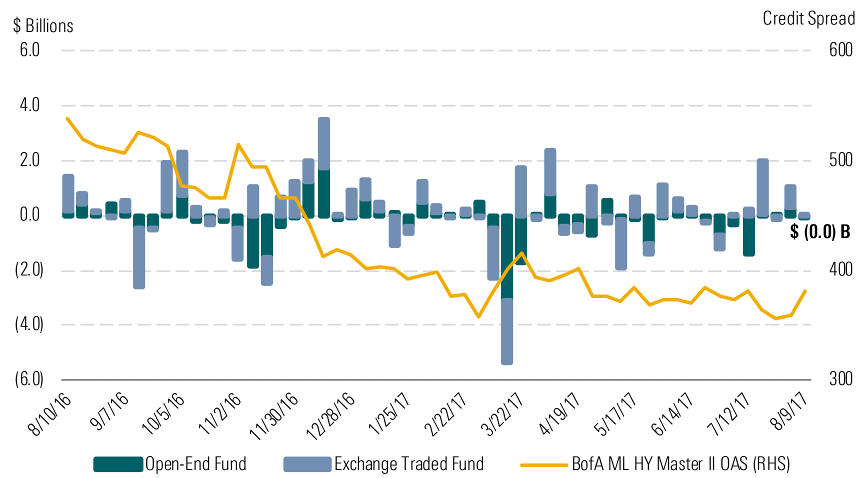
Source: Morningstar,Inc., BofA Merrill Lynch Global Indexes. Data as of 08/11/2017.

As investors looked to derisk portfolio allocations, the flight to the safety of U.S. Treasury bonds pushed interest rates lower. Interest rates peaked in mid-July and have been declining over the past month, with a substantial amount of the decline occurring last week. For example, since July 7, the yield on the 10-year Treasury bond has declined 20 basis points to 2.19%, with almost half of that decline occurring just last week. This action was not limited to the United States, as the yield on Germany's 10-year bond has declined 22 basis points since mid-July to 0.38%. In Switzerland, after briefly emerging above zero, the interest rate on long-term Swiss bonds slid back into negative territory as the yield on the 10-year Swiss bond declined to a negative 0.16%.

Though market sentiment has turned sour, there remains a strong underlying demand for U.S. dollar-denominated corporate bonds. As evidence, even though issuers typically shy away from the new issue market during August, which historically is the slowest month of the year as a significant number of institutional investors schedule vacations, British American Tobacco (rating: BBB, stable) decided to issue $17.25 billion of bonds to fund its acquisition of Reynolds Tobacco. This transaction is the second-largest corporate bond deal issued this year, surpassed only by AT&T's (rating: BBB/UR-) $22.5 billion transaction, which itself was the third-largest corporate bond deal in history. In addition, McCormick (rating: A+/UR-) issued $2.5 billion of new bonds to finance its acquisition of Reckitt Benckiser's food division. Acquisition financing is likely to remain the dominant theme over the near term as there remain several large strategic buyouts that will be debt-funded. For example, Amazon.com (rating: A, stable) is reportedly holding investor calls in preparation for the financing it intends to complete in order to buy While Foods.

With volatility rising from its historical lows, investors mostly stuck to the sidelines as fund flows in the high-yield market came to a near standstill last week. The minor amount of redemptions occurring among the open-end funds was exactly offset by inflows into high-yield exchange-traded funds.

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 Aug. 11, 2017

(000,000s $ unless otherwise noted)

British American Tobacco	BATS	BBB	$2,250	2.30%	Senior Unsecured	2020	+80
British American Tobacco	BATS	BBB	$1,000	L+59	Senior Unsecured	2020	NA
British American Tobacco	BATS	BBB	$2,250	2.76%	Senior Unsecured	2022	+95
British American Tobacco	BATS	BBB	$750	L+88	Senior Unsecured	2022	NA
British American Tobacco	BATS	BBB	$2,500	3.22%	Senior Unsecured	2024	+115
British American Tobacco	BATS	BBB	GBP 450	2.13%	Senior Unsecured	2025	+143(1)
British American Tobacco	BATS	BBB	$3,500	3.56%	Senior Unsecured	2027	+130
British American Tobacco	BATS	BBB	$2,500	4.39%	Senior Unsecured	2037	+155
British American Tobacco	BATS	BBB	$2,500	4.54%	Senior Unsecured	2047	+170
Ecolab	ECL	BBB+	$500	2.38%	Senior Unsecured	2022	+57
Intercontinental Exchange Inc	ICE	A	$500	2.35%	Senior Unsecured	2022	+62
Intercontinental Exchange Inc	ICE	A	$500	3.10%	Senior Unsecured	2027	+92
Kraft Heinz	KHC	BBB-	$350	L+42	Senior Unsecured	2019	NA
Kraft Heinz	KHC	BBB-	$650	L+57	Senior Unsecured	2021	NA
Kraft Heinz	KHC	BBB-	$500	L+82	Senior Unsecured	2022	NA
McCormick	MKC	A+/UR-	$750	2.70%	Senior Unsecured	2022	+90
McCormick	MKC	A+/UR-	$700	3.15%	Senior Unsecured	2024	+110
McCormick	MKC	A+/UR-	$750	3.40%	Senior Unsecured	2027	+120
McCormick	MKC	A+/UR-	$300	4.20%	Senior Unsecured	2047	+140
O'Reilly Automotive	ORLY	BBB+	$750	3.60%	Senior Unsecured	2027	+140
Priceline Group	PCLN	A-	$500	2.75%	Senior Unsecured	2023	+100
Priceline Group	PCLN	A-	$500	3.55%	Senior Unsecured	2028	+135
Procter & Gamble	PG	AA	$750	2.15%	Senior Unsecured	2022	+38
Procter & Gamble	PG	AA	$1,250	2.85%	Senior Unsecured	2027	+63
Thermo Fisher Scientific	TMO	BBB	$750	3.20%	Senior Unsecured	2027	+108
Thermo Fisher Scientific	TMO	BBB	$750	4.10%	Senior Unsecured	2047	+138

Source: Bloomberg, company Securities and Exchange Commission filings

(1) Spread over U.K. Treasuries.

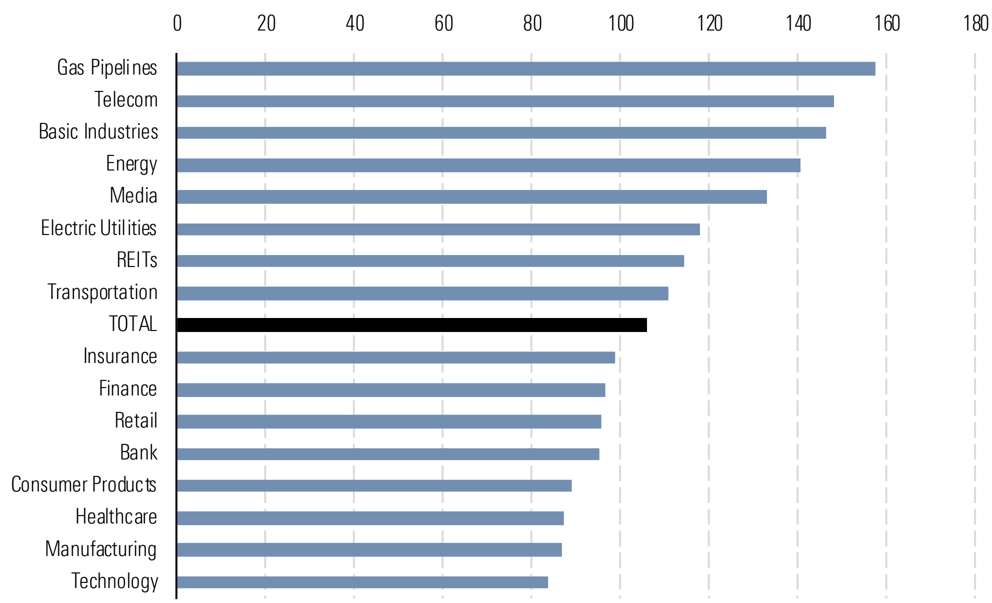
Exhibit 2 Morningstar, Inc. Corporate Bond Index Sector Summary

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-**	**4,794**	**6.9**	**115**	**10**	**(14)**	**0.04**	**4.70**
FINANCIAL	**A-**	**1,466**	**5.5**	**102**	**7**	**(20)**	**0.17**	**4.36**
Bank	A-	891	5.1	101	7	(21)	0.12	4.16
Finance	A	276	5.6	104	8	(17)	0.10	4.16
Insurance	A	214	7.9	103	5	(19)	0.49	5.74
REITs	BBB+	76	5.9	114	1	(21)	0.62	5.15
INDUSTRIAL	**A-**	**2,758**	**7.6**	**120**	**12**	**(10)**	**(0.09)**	**4.78**
Basic Industries	BBB+	220	7.7	154	9	(27)	0.08	7.21
Consumer Products	A-	312	7.7	99	10	(9)	0.08	4.42
Energy	A-	408	7.3	150	11	(5)	0.03	4.99
Healthcare	A-	399	7.8	103	16	(12)	(0.41)	5.17
Manufacturing	A-	412	6.3	95	8	(14)	0.09	3.89
Media	BBB+	192	8.4	152	18	(6)	(0.49)	5.15
Retail	A-	161	8.2	107	12	(1)	0.02	4.10
Technology	A+	317	7.2	95	11	(10)	(0.15)	4.30
Telecom	BBB+	151	8.6	161	12	3	(0.16)	3.99
Transportation	BBB+	140	9.1	118	7	(16)	0.25	5.69
UTILITY	**BBB+**	**531**	**8.6**	**138**	**7**	**(14)**	**0.42**	**5.94**
Electric Utilities	A-	312	9.1	118	4	(18)	0.72	6.30
Gas Pipelines	BBB	209	7.7	168	12	(9)	(0.03)	5.42
Rating Bucket								
AAA Bucket		112	8.2	63	7	(3)	0.09	4.06
AA Bucket		484	6.0	72	6	(12)	0.19	3.56
A Bucket		1,854	6.9	91	7	(15)	0.18	4.40
BBB Bucket		2,344	7.1	148	13	(16)	(0.11)	5.30
Term Bucket								
1-4	A-	1,520	2.4	70	6	(24)	0.12	2.27
4-7	A-	1,160	4.7	97	8	(18)	0.17	4.24
7-10	A-	895	7.1	129	12	(8)	0.08	5.17
10PLUS	A-	1,219	13.8	170	14	(4)	(0.18)	7.60

Data as of 08/11/2017

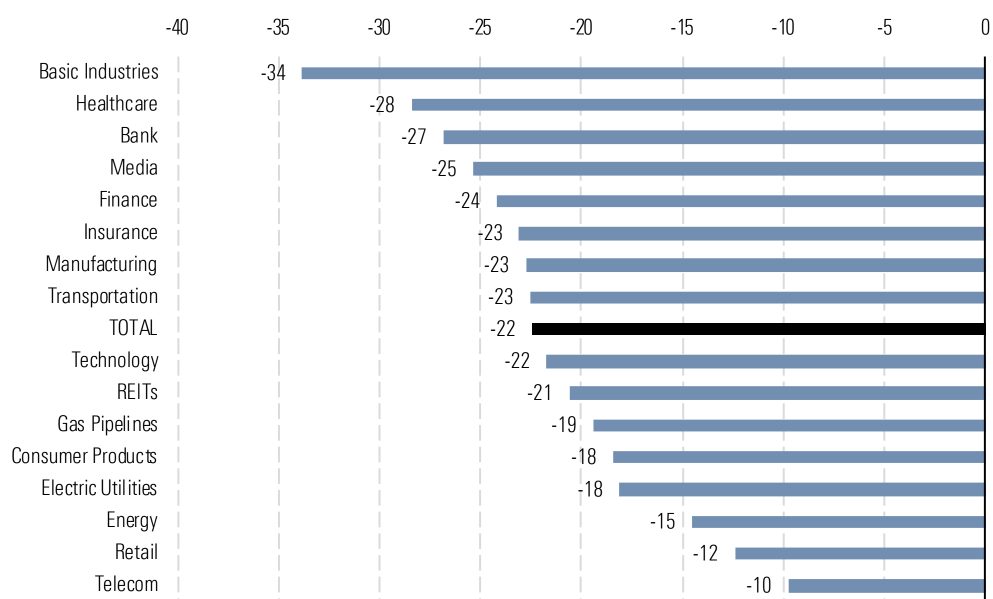
Source: Morningstar, Inc.

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



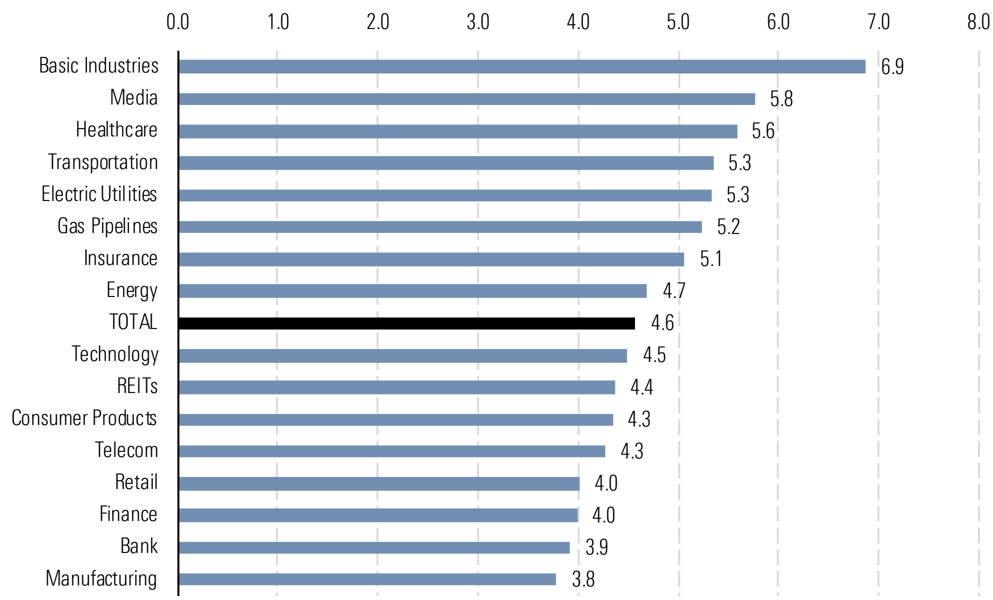
Source: Morningstar, Inc.

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 changes

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
British American Tobacco **BATS**	BBB	BBB+/UR-
Cardinal Health **CAH**	A-	A/UR-

► Rating affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Walt Disney **DIS**	A+	A+

British American Tobacco's Rating Downgraded on Reynolds American Acquisition

Morningstar Credit Ratings, LLC is downgrading British American Tobacco PLC's corporate credit rating to BBB from BBB+, removing it from under review negative, and assigning a stable outlook. These actions follow the company's acquisition of the remaining 57.8% of Reynolds American Inc. for approximately $54 billion and the assumption of $13 billion of Reynolds American Inc.'s debt, which is unconditionally guaranteed by British American. Funding for the transaction was provided by $25 billion of bank debt consisting of two bridge facilities; $15 billion and $5 billion maturing in 2018 and 2019 respectively, two $2.5 billion term loans maturing in 2020 and 2022, respectively, and $30 billion of new equity. Proceeds from British American's recent notes issuances aggregating approximately $21 billion are expected to be used to repay the bridge facility.

The acquisition creates a global tobacco company, broadens British American's ownership in the Americas, one of the most profitable tobacco regions in the world, and strengthens the company's position in the next generation of tobacco products. Initially cost synergies will be partially offset by the cost to achieve them, but they are expected to grow to $400 million annually by the end of 2020. However, the significant increase in debt and debt maturities during MCR's five-year forecast period pressures the company's Cash Flow Cushion and Solvency Score. Debt/adjusted EBITDA is estimated at approximately the mid-4 times, on a pro forma basis, which is high for the rating category. Though, it is expected to decline in line with the company's net debt/adjusted EBITDA target of around 3 times by the end of 2019. Forecast free cash flow (cash flow from operations less capital expenditures and dividends), generation is expected to exceed GBP 2 billion annually in the near-to-intermediate term, and will likely be used for debt reduction. Proposed regulations in the U.S. to reduce nicotine levels, if enacted, could increase the rate of long-term consumption declines, but we believe that most cigarette consumers will migrate to the next generation of tobacco products and that British American will maintain its competitive position.

In addition to its expanded U.S. position, we expect the company to continue to benefit from its strong presence throughout Western Europe, Latin America, the Middle East, and Asia. British American's global footprint positions the company well to benefit from emerging markets with a growing population of young adults and less regulation. MCR's stable rating outlook on British American reflects the company's commitment to deleverage, its ability to offset volume declines through pricing, and generate strong and stable operating earnings and cash flows, which supports a solid Business Risk Score.

Over the long term, we forecast that cigarette volume will decline at a mid-single-digit rate annually in developed markets, which we expect will be more than offset by price increases. In the near to intermediate term, we project that British American will increase its revenue at a low-single-digit rate and that post-acquisition operating margins will improve modestly. Our credit rating incorporates the legal and regulatory risks inherent to the tobacco sector as litigation remains unpredictable in the U.S., but currently manageable. Increased regulation is also a risk, and we expect regulatory bodies to implement further marketing regulations in both the long and the short term. Industry volume could also be adversely affected by rising excise taxes, as governments struggle to raise revenue.

We would consider a positive rating action if British American further extends its debt maturities and deleverages, resulting in an improvement in the company's Cash Flow Cushion and Solvency Score. British American achieving its net debt/adjusted EBITDA target of about 3 times by 2019, increasing revenue growth through new products and maintaining profitability margins, may also results in a positive rating action. Loss of pricing ability in developed markets to offset consumption declines that negatively impacts operating margins, and weakens either the company's Cash Flow Cushion or its Solvency Score could result in a negative rating action. A negative rating action may also occur due to an increase in tobacco regulation, which in turn could cause deterioration in the company's intangible asset value and have an adverse impact on revenue, earnings, and cash flow.

Cardinal Health's Rating Downgraded to A- With Stable Outlook on Medtronic Product Acquisition

Morningstar Credit Ratings, LLC is downgrading the corporate credit rating of Cardinal Health Inc one notch to A- following the firm's acquisition of Medtronic's patient care, deep vein thrombosis, and nutritional insufficiency businesses for $6.1 billion. This acquisition has increased Cardinal's leverage initially and looks likely to keep leverage above the previous target for several years. This increased leverage has cut into the firm's leverage-sensitive pillars, which has contributed to its downgrade. We currently view the firm's credit trajectory as stable.

From a Business Risk perspective, our view of Cardinal has not changed significantly because of this combination, and Cardinal still earns an above-average score in this pillar because of its competitive advantages primarily in drug distribution combined with its significant scale 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, CVS Health accounts for about 25% of Cardinal's revenue. While we think this relationship remains healthy, dependence on limited sources of business can lead to somewhat volatile earnings, especially if customers switch to other distribution providers.

With these concentration risks in mind, Cardinal is attempting to diversify into medical products and distribution, and its latest acquisition in this area will increase leverage for the next few years. At the end of June, Cardinal owed $10.4 billion in debt, or pro forma leverage in the mid-2s by our estimates, compared with $5.5 billion at the end of March, or 1.6 times adjusted EBITDA and in the middle of its previous target range of 1.50-1.75 times. Management expects to repay about $1.5 billion of debt within the next three years, but it estimates gross leverage will only reach about 2.0 times by the middle of calendar 2020, still above its previous target leverage, which influences our new rating.

Although we view Cardinal as weakly positioned in its rating category, our stable outlook is influenced by its plans to deleverage. If the firm significantly delays its deleveraging efforts to pursue more debt-funded acquisitions or shareholder returns, our new credit rating could prove too optimistic. Positively, if the company deleverages into its previous target range, we would consider an upgrade, but we do not see that scenario as likely in the next few years.

Disney's A+ Rating Affirmed, Moving Outlook to Stable

Morningstar Credit Ratings, LLC is affirming the A+ corporate credit rating on Walt Disney Co. and moving the outlook to stable from positive. Our rating reflects Disney's moderate Business Risk, a solid Cash Flow Cushion, and a strong Solvency Score pillar, driven by high returns on investment.

Our outlook is based on our expectation of stable growth and profitability, supported by Disney's core parks and resorts, film library, and branded consumer products. Morningstar's Equity Research Group assigns a wide economic moat, supported by deep investment in creative and branded content that would be exceedingly difficult for a competitor to replicate, particularly the opportunities for cross-marketing its brands across the portfolio. Disney's core television network assets still attract large numbers of viewers and enjoy negotiating leverage with cable operators, though we expect distribution fees to moderate over time to reflect shifting viewer preferences. Longer term, we expect the rise of video streaming (OTT) to increase competitive pressure on ESPN and other network properties, though Disney networks remain a popular choice among current OTT platforms. We believe Disney's majority ownership in video streaming technology joint venture BAMTech should provide a strong underpinning for the development of its own direct-to-consumer streaming efforts over the next few years.

Disney continues to pursue a reasonably conservative capital allocation policy, though its shareholder payout ratio remained above 100% in the last 12 months and leverage metrics have crept modestly higher over the period. At the end of the June quarter, Disney reported total debt of 1.3 times trailing four-quarter EBITDA and net debt at 1.1 times, both slightly higher than a year ago, but comfortably within the historical range over the past decade of 1-1.5 times. We are assuming the $1.6 billion acquisition of an additional stake in BAMTech to be funded primarily through cash on hand, which will likely move net leverage a bit higher to 1.2 times EBITDA by year-end. Our credit view is based on our expectation that management will continue to maintain leverage metrics within historical tolerances.

Our rating assumes revenue growth will average around 4% over the next five years with operating margin stable in the mid-20% area. We may consider an upgrade of our credit rating if the company continues to expand operating margins and returns on invested capital while maintaining a strong balance sheet with low leverage. We may consider a downgrade in the event of a material change in the company's financial policy that results in a prolonged increase in debt or erosion of cash flow.

Recent Notes Published by Credit Analysts

Fresenius Plans to Boost Leverage From Recent Lows to Acquire NxStage Medical

MCR Credit Risk Assessment

On Aug. 7, top-tier dialysis service provider Fresenius Medical Care AG & Co. KGaA (rating: BBB-, stable) announced plans to acquire NxStage Medical (not rated) for about $2.0 billion in enterprise value, which is scheduled for 2018. Since Fresenius plans to use debt financing to make the transaction, we are adding the company to our Potential New Issue Supply list, and we expect leverage to rise a bit if this transaction closes as expected. However, this plan to increase leverage appears manageable and does not change our view of the company's BBB- rating and stable outlook.

Strategically, the planned acquisition of NxStage makes sense for Fresenius, which is the top provider of dialysis equipment in the world, and we expect pro forma leverage to remain at manageable levels. This acquisition should expand Fresenius' reach in home hemodialysis equipment in particular, which is a growing piece of the dialysis market as patients seek more options in this time-consuming therapy. NxStage generated revenue of $366 million in 2016 and is just free cash flow positive, so this transaction looks somewhat expensive on traditional valuation metrics. Also, from a credit perspective, leverage looks set to rise since Fresenius plans to finance the acquisition with new debt borrowings. As of June, net debt/EBITDA was lower than we've been expecting in the long run at 2.2 times, and management expects pro forma net leverage to rise 60-70 basis points. However, net leverage should still remain within the company's 2.5-3.0 times target range if this transaction closes as expected.

Market Data

In the healthcare services sector, we compare bonds from Fresenius with bonds from DaVita Inc. (rating: BB+, negative), and HCA Holdings Inc. (rating: BB, stable). However, given its investment-grade status, Fresenius' bonds trade well tight of these firms, and we include Walgreens Boots Alliance Inc. (rating: BBB-, stable) as a similar-rated healthcare firm, albeit from a different sector. All of the following bond data was sourced from Interactive Data:

Fresenius' 4.75% notes due 2024 at +143 basis points.
Walgreens' 3.45% notes due 2026 at +121 basis points.
DaVita's 5.00% notes due 2025 at +277 basis points.
HCA's 5.38% notes due 2025 at +231 basis points.

For comparison with the roughly 10-year maturities, the Morningstar Corporate Bond Index was recently at +166 basis points at BBB- and BofA Merrill Lynch's BB Index was recently at +221 basis points.

Endo Lowers EBITDA Guidance; Elevated Net Leverage Expected Through 2017

MCR Credit Risk Assessment

On Aug. 8, Endo International PLC's (rating: B, negative) announced a declining top line by 5% in the second quarter, as each operating segment experienced a decline or flat growth. The firm's U.S. Generic Pharmaceuticals saw a base business decline of 34% that was more or less offset by strong increases in sterile injectables and new launches. The benefit of two first-to-file copycat medicines—generic

Seroquel XR and Zetia—that launched in late 2016 will not be present in the second half of the year. In addition, the U.S. Branded Pharmaceuticals segment, which fell 15% in the second quarter, will be pressured by the voluntary market withdrawal of the pain treatment Opana ER on Sept. 1. While the International Pharmaceuticals business held steady in the second quarter, the divestment of Litha (South America operations) in July and planned sales of Somar (Mexico) in the fourth quarter will dampen second-half growth prospects. As such, Endo moderated sales guidance for 2017 to $3.38 billion-$3.53 billion for 2017 from $3.45 billion-$3.60 billion, and it adjusted EBITDA to $1.48 billion-$1.56 billion for 2017 from $1.50 billion-$1.58 billion. Endo has made substantial progress under its strategic plan laid out by its new CEO last year to transform into a leaner, growth-oriented drug manufacturer. Though, we see a rocky path ahead for Endo due to continued pricing and volume pressures on its generic drug segment and a thin research program to drive growth of the branded pharmaceuticals business, mainly focused on increasing utility of Xiaflex for the reduction of cellulite.

We see instability of Endo's credit profile due to greater-than-historical generic drug price erosion, significant corporate portfolio restructuring, and ongoing product liability litigation. The combination of these factors along with inflated leverage informs our negative outlook for the firm. However, we gain some comfort that debt leverage may ease over the next few years as the firm reiterated at its quarterly conference call that its top commitment is reducing its debt load. For the trailing 12 months at the end of the second quarter, net debt leverage was 4.7 times (total debt of $8.3 billion less unrestricted cash of $617 million), which remains above its target of 3-4 times. Endo did not offer a time frame for the measure to fall into its range but did state that net leverage would be in the high 4 times at the end of 2017. Clarity around its mesh liability caseload, resulting from a new settlement agreement, helps stabilize Endo' credit profile, but constrained cash flow from these mesh settlements and stressed operations may prevent Endo from reaching its net leverage goal for several years, in our estimation. However, the firm has plenty of liquidity with its cash balance ($981 million as of June 30 including restricted cash) and its $1 billion secured revolving credit facility. At the end of the second quarter, Endo has ample cushion under the lone financial covenant in its secured credit facilities with secured leverage around 2.0 times for the latest 12 months at the end of the second quarter compared with a maximum secured leverage ratio covenant at 3.50 times.

Market Data

We compare Endo's bonds to a key peer that is also rated in the broad B category in the specialty pharmaceutical industry, Valeant Pharmaceuticals International Inc (rating: B-, negative). In the approximate 10-year maturity bucket, Endo's bonds are roughly 40 basis points wider than Valeant's bonds. All bond data is sourced from Interactive Data, which can be seen as follows:

Endo's 6.00% notes due in 2025 at 91.00, yield to maturity of 9.46%, and spread to maturity of +735 basis points;
Valeant's 6.13% notes due in 2025 at 84.00, yield to maturity of 9.06%, and spread to maturity of +694 basis points.

Tenet Trims 2017 Outlook While Leverage Remains Elevated

MCR Credit Risk Assessment

On Aug. 7, Tenet Healthcare Corp (rating: B-, stable) reported weaker-than-expected second-quarter results and cut its guidance for the rest of 2017. From a credit perspective, Tenet operates with elevated leverage, and we do not expect that to change in the near term, given the company's continued purchase of ambulatory service assets. Our B- rating and stable outlook remain unchanged.

During the quarter, Tenet produced weaker-than-anticipated results, which caused the company to cut its guidance for the full year. In the second quarter, Tenet generated $4.8 billion in net revenue, below consensus of $4.9 billion and below management's previous forecast range of $4.85 billion-$5.05 billion. Tenet reported adjusted EBITDA of $570 million, including a $23 million gain on the sale of its home health and hospice assets; this was weak considering its previous outlook range of $550 million-$600 million. With these weak results relative to previous expectations, management cut its outlook for the full year. The company now expects net revenue of $19.1 billion-$19.4 billion (down from $19.7 billion-$20.1 billion previously), adjusted EBITDA, including the gain on the sale of its home health and hospice assets, down to $2.45 billion-$2.55 billion (from $2.53 billion-$2.63 billion previously), and adjusted free cash flow of $525 million-$725 million (down from $600 million-$800 million previously). Management highlighted that its reduced outlook is related to the recently completed divestitures ($30 million of the $75 million EBITDA outlook range reduction), lower volumes and higher uncompensated care expenses in its hospital operations ($35 million of the $75 million EBITDA outlook range reduction), and Conifer weakness ($15 million of the $75 million EBITDA outlook range reduction), which may be offset modestly by $5 million in higher-than-expected ambulatory care EBITDA.

From a credit perspective, we do not expect much improvement in the near term either, as Tenet is pursuing an accelerated purchase of its USPI joint venture that should keep its leverage elevated for the foreseeable future. Tenet now owns 80% of the joint venture as of July 2017, up from 56% in June, and plans to increase that ownership interest to 95% by July 2019. Outflows related to these investments are expected to total $711 million in 2017 and roughly $275 million-$325 million in both 2018 and 2019. The company is financing these outflows with divestiture proceeds (roughly $750 million completed on Aug. 1), existing cash, and additional borrowings on its credit agreement. Because of these activities, we expect net leverage, currently around 6 times, to remain elevated during the next couple of years. Management has previously stated that it aims to reduce leverage to below 5 times by 2019.

Market Data

In our coverage universe, Tenet is rated much lower than its key hospital peer HCA Healthcare Inc (rating: BB, stable). Therefore, we also include other healthcare companies in the broad B category as key credit comparables, specifically Endo International PLC (rating: B, negative) and Valeant Pharmaceuticals International Inc (rating: B-, negative). Recent bond data from all of these firms is sourced from Interactive Data, which can be seen as follows:

Tenet's 5.13% notes due in 2025 at 100.38, yield to worst of 5.03%, and spread to worst of +325 basis points.

HCA's 5.88% notes due 2026 at 108.75, yield to worst of 4.56%, and spread to worst of +241 basis points.
Endo's 6.00% notes due in 2025 at 81.75, yield to worst of 9.46%, and spread to worst of +735 basis points.
Valeant's 6.13% notes due in 2025 at 84.00, yield to worst of 9.06%, and spread to worst of +693 basis points.

Fund Performance, Foreign Exchange Gains Lead to Respectable AUM Growth at Janus Henderson
MCR Credit Risk Assessment
In its first quarter reporting results as a newly combined entity, Janus Henderson (rating: A-, stable) had a decent quarter, with the company earning $41.7 million, a 35% increase over the first quarter of 2017 but only a 7% increase over the prior-year quarter. However, performance only included one month of operating results from the former Janus Capital Group as the merger closed at the end of May. On an adjusted pro forma basis dating back to Jan. 1, 2016, the combined companies would have reported a more impressive 37% quarter-over-quarter increase in earnings to $139.8 million and a 41% increase over the prior-year quarter.

Janus Henderson reported growth in AUM at 4%, slightly higher than our five-year forecast 3% annual growth, resulting in the firm ending the period with $345 billion of AUM. The increase was driven by market/fund performance and foreign exchange gains—particularly on GBP-denominated assets—due to the weakening of the dollar during the quarter. All of Janus Henderson's investment strategies by capability reported higher levels of AUM over the prior quarter, with equities leading the charge with an $11.1 billion increase. Of particular note, equities and alternative strategies benefited from positive net flows, with equities gaining $1.2 billion from net sales inflows and alternatives $0.8 billion. The firm's percentage of assets outperforming benchmarks are 69%, 71%, and 89% on a 1, 3, and 5-year basis, respectively, though quantitative equity performance is extremely poor on a 1-year basis at only 6% outperformance and multi-asset capabilities are struggling at 21% outperformance on a 3-year basis.

Positively, Janus Henderson stated that it plans to follow a conservative capital policy that would result in continued low financial leverage. The company will not seek to pre-spend cash flows, bolstering our view that the firm will attempt to grow and expand through free cash flow generation as opposed to debt financing. Reported trailing 12-month (TTM) gross debt/EBITDA is slightly elevated at 1.6 times due to mismatches between income statement and balance sheet items arising from the end-of-May combination, and we estimate that run-rate financial leverage will shake out around 0.7 times. Additionally, the firm has realized pretax net cost synergies of $57 million resulting from the merger as of June 30, 2017, and is projecting 12-month cost savings of at least $85 million. Overall, Janus Henderson continues to target $110 million of recurring annual cost synergies within the next three years.

Rated peers we compare against Janus Henderson include Eaton Vance (rating: A-, stable) and Affiliated Managers Group (rating: BBB+, stable). Eaton Vance's rating reflects the company's diverse asset mix and niche focus in areas such as tax-advantaged strategies and specialty products while also taking into account its propensity to aggressively return capital to shareholders. AMG's rating reflects the company's solid operating performance, strong cash flow generation and disciplined capital policy.

Market Data

The following spreads over the nearest Treasury are provided by Interactive Data:

The Janus Henderson (A-, stable) 4.875% notes due in 2025 are indicated at +147 basis points.
The Eaton Vance (A-, stable) 3.50% notes due in 2027 are indicated at +101 basis points.
The AMG (BBB+, stable) 3.50% notes due in 2025 are indicated at +122 basis points.

CVS' Leverage Remains Elevated in Mid-2017, as Retail Operations Face Headwinds

MCR Credit Risk Assessment

On Aug. 8, CVS Health Corp (rating: BBB+, stable) reported decent second-quarter results and raised the low end of its earnings guidance range for 2017. However, repurchases have been a key lever to keep earnings per share roughly flat in 2017, as adjusted EBITDA continues to decline year over year on weakness in the retail pharmacy operations. Outflows to shareholders have kept CVS from deleveraging in 2017, too, and we do not expect much improvement on that front in the near term.

In the second quarter, net revenue grew 5% to $45.7 billion (above consensus of $45.4 billion) and adjusted earnings per share grew 1% to $1.33 (above consensus of $1.31), primarily on strength in the pharmacy benefit management operations (revenue up nearly 10% year over year) and recent share-repurchase activity. Revenue from the pharmacy business declined 2% year over year in the second quarter. With the lower-margin PBM business growing faster than the pharmacy segment and the retail pharmacy business suffering from new PBM network trends, CVS' adjusted EBITDA declined 5%, as margins were squeezed.

For 2017, the company's guidance has not changed much since the beginning of the year, and leverage appears likely to remain pretty stagnant, as we expected. In 2017, management expects net revenue growth of 3.0%-4.0% (from 2.50%-4.25% at the beginning of 2017) and increased its adjusted EPS outlook this quarter to $5.83-$5.93 (from $5.77-$5.93), or roughly flat with the $5.84 generated in 2016. The company has not changed its free cash flow outlook for 2017 and still expects $6.0 billion-$6.4 billion (roughly $1.5 billion more than the $4.6 billion of free cash flow produced so far in first half of the year). Given that weak free cash flow outlook and the company's plan to push out another $2.0 billion to shareholders through its repurchase and dividend program through the rest of the year (out of a total plan of $7.0 billion for 2017), we do not expect significant deleveraging in the near term. As of June, gross debt/EBITDA stood at 2.2 times and lease-adjusted leverage stood at 3.2 times by our estimates, or about half a turn above its 2.7 times lease-adjusted target.

Market Data

We compare CVS' bonds with those key pharmaceutical supply chain peers Express Scripts and Walgreens. In this peer group, CVS' bonds generally traded tighter than its peers while Express Scripts traded slightly wider. All of the following bond data is sourced from Interactive Data.

In the approximate 5-year maturity bucket, recent trades over the nearest Treasury were as follows:

CVS Health Corp's (rating: BBB+, stable) 2.13% notes due 2021 at +60 basis points.
Express Scripts Holding Co's (rating: A-, negative) 3.30% notes due 2021 at +78 basis points.
Walgreens Boots Alliance Inc's (rating: BBB-, stable) 3.30% notes due 2021 at +70 basis points.

In the approximate 10-year maturity bucket, CVS recently traded at the tightest spread, close to the A- bucket of the Morningstar Corporate Bond Index, while Express Scrips is a wide outlier roughly in line with the BBB bucket of the Morningstar Corporate Bond Index. Spreads over the nearest Treasury from recent trades can be seen as follows:

CVS' 2.88% notes due 2026 at +99 basis points.
Express Scripts' 3.40% notes due 2027 at +144 basis points.
Walgreen's 3.45% notes due 2026 at +121 basis points.

For comparison, the Morningstar Corporate Bond Index is at +96 basis points at A-, +128 basis points at BBB+, +139 basis points at BBB, and +166 basis points at BBB-.

In the approximate 30-year maturity bucket, recent trades over the nearest Treasury were as follows:

CVS' 5.13% notes due 2045 at +145 basis points.
Express Scripts' 4.80% notes due 2046 at +178 basis points.
Walgreen's 4.65% due 2046 at +153 basis points.

Valeant Holds EBITDA Guidance but Drops Sales Outlook; Debt Falls by Nearly $1.4 Billion in 2017

MCR Credit Risk Assessment

On Aug. 8, Valeant (rating: B-, negative) posted an 8% drop in total sales on a reported basis in the second quarter, comprising a 3% decrease in revenue generated by the Bausch & Lomb/international segment, a 3% decline in sales from the branded Rx division, and a 27% free fall in the U.S. diversified products business. Incorporating lower-than-expected results from the dermatology business and recent divestitures (Dendreon and skin-care brands CerAve, AcneFree, and Ambi), the company lowered its outlook for sales for 2017 to $8.7 billion-$8.9 billion from $8.9 billion-$9.1 billion. Despite the top-line pressure, Valeant maintained its expectation for adjusted EBITDA of $3.60 billion-$3.75 billion. However, this guidance does not include the pending divestment of iNova and Obagi Medical Products expected by year-end. We still think Valeant can achieve revenue growth in the low single digits compounded annually through 2021, given that its corporate portfolio includes attractive businesses in ophthalmology, dermatology, and gastrointestinal medicines. With an eye on bulking up its internal research program and supporting product introductions including the newly approved Siliq (psoriasis) and potentially IDP-118 (psoriasis) in 2018, we see these added operating costs holding EBITDA generation relatively flat over the next five years.

While we positively view Valeant's commitment to reducing highly elevated debt leverage (a remnant from its prior rollup strategy from 2010 to 2015) over the next few years, we see the company's goal to decrease the debt load by more than $5 billion by February 2018 as aggressive, which informs our negative outlook. So far in 2017, the firm has paid down nearly $1.4 billion of outstanding debt using cash flow generation and asset sales proceeds to drop the total balance to $28.5 billion on June 30, or gross debt leverage (total debt/adjusted EBITDA) of 7.1 times for the trailing 12 months. Considering cash and investments balance of $1.2 billion, net debt leverage was slightly lower at 6.8 times. Valeant does have some breathing room to direct all free cash flow, which we expect to approach an estimated average of $1.3 billion over the next five years, toward its debt-reduction goal, as it has satisfied all of its mandatory term loan amortization and has no significant debt maturities through 2019. In addition, Valeant used $811 million in proceeds from the sales of Dendreon to prepay its term loan and will redeem its 6.75% senior notes due in 2018 ($500 million) in August. In the first quarter, the firm alleviated one of our main concerns that a maximum secured leverage covenant might be tripped in its credit facilities, with an amendment in March that removed this requirement from its term loan agreement and relaxed it to 3.00 times (from 2.50 times) in its revolving credit facility. Secured leverage stood at 2.7 times for the latest 12 months at the end of the second quarter, by our estimation. The company also has leeway under a newly amended minimum interest coverage covenant of 1.50 times (was 2.0 times) under its revolver, given that the measure stood at 2.2 times for the trailing 12 months ended June 30.

Market Data
We compare Valeant's bonds with key peers that are also rated in the general B category in the healthcare industry, which includes specialty pharmaceutical firm Endo International PLC (rating: B, negative) and healthcare provider Tenet Healthcare Corp (rating: B-, stable). In the approximate 10-year maturity bucket, Valeant's bonds are recently trading tighter than Endo's bonds by around 40 basis points and wider than those at Tenet by roughly 370 basis points. All bond data is sourced from Interactive Data, which can be seen as follows:

Valeant's 6.13% notes due in 2025 at 84.00, yield to maturity of 9.06%, and spread to maturity of +694 basis points.
Endo's 6.00% notes due in 2025 at 91.00, yield to maturity of 9.46%, and spread to maturity of +735 basis points.
Tenet's 5.13% notes due in 2025 at 100.38, yield to worst of 5.03%, and spread to worst of +325 basis points.

Mallinckrodt's Revenue Falls in 2Q From Generic Pricing Pressure; Total Debt Burden Eases
MCR Credit Risk Assessment
On Aug. 8, Mallinckrodt PLC (rating: BB-, stable) reported a decline of 4.9% in revenue as modest growth (0.9% reported) of its specialty brands segment did not outweigh continued pricing pressure in the U.S. on its specialty generic portfolio that fell by 18%. The firm's best-selling specialty medicines, Acthar Gel (19 different disease states), Inomax (respiratory failure), and Ofirmev (acute pain), grew 7.1%, 3.6%, and 7.1%, respectively, and together accounted for 63% of total sales in the quarter. Mallinckrodt is actively

building research expertise in core therapeutic areas, including establishing evidence of clinical efficacy via post-marketing studies to bolster growth prospects for its bestseller Acthar Gel, representing 39% of total sales alone. But, the firm's late-stage research pipeline at this point is composed of primarily line extensions for marketed drugs that usually have only modest market potential, which leads us to think that revenue may modestly decline over the next five years. Given these limited internal opportunities, the firm may engage in debt-funded acquisitions to expand its specialty drug business, like the recent announcement of the pending purchase of InfaCare, and to offset a potential Ofirmev patent loss in 2020. The firm has some leeway to advance its late-stage research pipeline given a refinancing of term loans in the first quarter.

As Mallinckrodt executes upon its business strategy of building strength as an internal drug developer, we keep a cautious eye on the firm's debt leverage. Typically, Mallinckrodt spreads its capital priorities across business development to add commercial assets or late-stage projects, share repurchases, and debt repayment. However, we anticipate more cash may be directed to shareholders or aggressive acquisition activity than to debt reduction. On June 30, the firm owed $5.9 billion in debt, which decreased by nearly $300 million since the start of 2017 or 4.2 times EBITDA for the trailing 12 months. With $330 million of cash on hand, net debt leverage stood at 3.9 times. Given Mallinckrodt's successful extension in late February 2017 of a debt maturity wall ($1.9 billion) into 2024, we see the firm having little trouble managing a well-laddered long-term debt maturity schedule over the next five years consisting of $200 million (receivables securitization) due in fiscal 2017, $300 million in notes due in fiscal 2018, and $700 million of notes due in fiscal 2020. This view is supported by steady free cash flow generation that we expect to average around $900 million annually over the next five years. Further liquidity arises from a recently upsized $900 million five-year revolving credit agreement maturing in February 2022. But the firm graciously rewards shareholders via active share repurchasing. So far in 2017, the firm repurchased roughly $293 million in shares, which more than consumed free cash flow of $121 million (operating cash flow of $223 million less capital spending of $102 million) generated in the first half of the year. The firm's board of directors authorized a $1 billion share repurchase program in March 2017 after a prior $350 million authorization from March 2016 was exhausted within one year. Accordingly, we think that any improvement to leverage will likely stem from operational strength rather than a lower debt load.

Market Data

We compare Mallinckrodt's bonds with high-yield specialty pharmaceutical peers Endo International PLC (rating: B, negative) and Valeant Pharmaceuticals International Inc. (rating: B-, negative). In the approximate 5-year maturity bucket, Mallinckrodt's bonds recently traded much tighter than its key peers, including a spread at around 260 basis points tighter than Endo's bonds and 180 basis points tighter than Valeant's bonds. All bond data is sourced from Interactive Data, which can be seen as follows:

Mallinckrodt's 5.25% notes due in 2025 traded at 92.00, yield to maturity of 6.86%, and spread to maturity of +474 basis points.

Endo's 6.00% notes due in 2025 traded at 91.00, yield to maturity of 9.46%, and spread to maturity of +735 basis points.
Valeant's 6.13% notes due in 2025 traded at 84.00, yield to maturity of 9.06%, and spread to maturity of +694 basis points.

Strong Retrans Fee Growth Spurs Solid CBS' 2Q Revenue Growth, but Margins Lower on Higher Costs

MCR Credit Risk Assessment

CBS Corp. (rating: BBB, stable) reported its second-quarter operating results Aug. 7. For the quarter, revenue grew 9%, driven by 12% growth in content licensing fees. Affiliate fees also grew 16%, including a 25% jump in retransmission and reverse comp fees. Meanwhile, overall advertising revenue was up 4%, with network ad revenue up 7%, supported by ad spending in April for the NCAA Final Four. Despite solid revenue performance, operating income grew only 3% from a year ago, held back by 14% growth in operating expenses. As a result, operating margin declined to 21% in the quarter, down 100 basis points from a year ago.

CBS provided an update on its growth goals for its streaming video platforms CBS All-Access and Showtime. By year-end 2017, management expects total streaming subscribers to grow to 4 million. Longer-term, its goal is 8 million subscribers globally by 2020. The company plans to roll out a 24/7 live sports streaming package by year-end and will also stream some late-season NFL games through All-Access this fall. On Aug. 6, CBS also announced it reached agreement with AT&T Inc. (rating: BBB, UR-) to join DirecTV Now's slate of networks.

Net debt edged higher to 2.9 times EBITDA at the end of the quarter, its second consecutive sequential increase and four tenths of a turn higher from a year ago as CBS maintains a shareholder payout ratio well above 100%. Free cash flow totaled $1.2 billion over the past 12 months, insufficient to support the $3 billion of net repurchases and dividend payments over the period. To fund the $2 billion funding gap, CBS issued $2.1 billion of debt, net of repayments. This included $900 million of senior notes issued in June as well as $1.3 billion of net debt issuance on behalf of CBS Radio, which it will be spinning out as part of its sale to buyer Entercom (not rated) in the fourth quarter. Excluding CBS Radio, CBS' total debt has increased $650 million from a year ago to $9.1 billion, while cash and investments has remained flat at $176 million. Longer term, we believe management remains committed to maintaining a conservative leverage ratio with an upper bound around 2.8 times. Management guided to $1 billion of additional repurchases in the second half of 2017 against the $3.3 billion of remaining authorization at June 30.

Our BBB rating reflects CBS' solid operating profile, including an improving Solvency Score, solid Cash Flow Cushion, and moderate Business Risk. CBS also maintains solid profitability and cash flow despite revenue growth challenges. Although advertising revenue has been declining as a proportion of revenue, it remains the largest single contributor, keeping CBS more cyclical than peers. We consider uncertainty to be elevated given growing interest in merger transactions between media content and distribution companies. Morningstar's Equity Research Group assigns CBS a narrow economic moat, supported by its network broadcast licenses and owned TV stations, which serve as valuable outlets to leverage CBS' investment in programming content. Our rating assumes CBS will continue to manage net debt within a range of 2.5 and 3.0 times EBITDA.

Market Data

According to pricing supplied by Interactive Data as of Aug. 8, CBS' 2.90% notes due 2027 were indicated at +135 basis points over the nearest Treasury, 8 basis points tighter from original issue pricing on June 26. Over the same period, Omnicom Group Inc.'s (rating: BBB+, stable) 3.60% notes due 2026 were indicated 4 basis points tighter at +122 basis points while Comcast Corp's (rating: A-, stable) 3.30% notes due 2027, indicated at +90 basis points, are 3 basis points wider. Meanwhile, Morningstar Inc's Corporate Bond BBB Index, currently quoted at +131 basis points, is 10 basis points tighter since the end of June.

Zoetis Corrals Solid Performance in 2Q, Raises Sales Outlook for 2017

MCR Credit Risk Assessment

Zoetis Inc.'s (rating: BBB+, stable) solid operational performance continued into the second quarter, as its lean operating structure drove a 10% jump in net income from a 5% increase in revenue, on a reported basis, compared with a 17% jump in net income from a 6% increase in revenue in the first quarter. The second-quarter sales increase was supported by positive contributions from both operating segments, with U.S. sales rising 5% and international revenue increasing 5% as announced on the firm's Aug. 8 conference call. Durable demand for its companion animal drug portfolio, specifically canine atopic dermatitis medicines Apoquel and Cytopoint, and flea and tick treatment Simparica, may help sustain the attractive revenue trend at least through this year. With strong results in the first half of the year, Zoetis narrowed and raised its sales expectation for 2017 to \$5.15 billion-\$5.25 billion from \$5.10 billion-\$5.225 billion. Despite added expenses from the recently acquired Nexvet Biopharma business, the firm held its expectation for adjusted operating margin of 34%-35% in 2017. We see operating leverage coupled with revenue pacing industry growth in the midsingle digits yielding EBITDA growth in the low double digits through 2021 compounded annually.

We anticipate that Zoetis' debt load at the end of the second quarter remained consistent with the first quarter level of \$4.5 billion since there is no debt maturing in 2017. As such, we estimate gross leverage stood at 2.7 times EBITDA for the trailing 12 months, which comfortably fell into its 2.5-3.0 times target range. We are mindful of the firm's capital deployment strategy that can push leverage to levels no longer commensurate with the current rating, especially as viable acquisitions appear or shareholder rewards step up. But Zoetis stated that cash flow was used to fund its \$85 million purchase of Nexvet in July, keeping its debt load constant. Strengthening operations may create a steady stream of free cash flow over the next five years that we anticipate will average more than \$1 billion annually. This financial flexibility is plenty to satisfy modest debt maturities of around \$1.3 billion through 2021. However, shareholder-friendly actions have accelerated, as Zoetis raised its dividend by nearly 11% in 2017 and presently pays an annual dividend about \$200 million. The company also recently stepped up pacing of share repurchases to around \$125 million per quarter using its new \$1.5 billion share-repurchase authorization from December 2016. These shareholder returns already consume nearly all free cash flow and, if increased substantially, could push leverage higher.

Market Data

For best comparisons to the Zoetis' notes, we look to similar-rated Merck KGaA (rating: BBB+, stable) and AbbVie Inc. (rating: BBB+, negative). Within this group and adjusted for bond maturities, Zoetis' 10-year bonds recently traded tighter than those of AbbVie and in line with those of Merck KGaA. Zoetis' 10-year bonds also traded much tighter than the level of Morningstar Inc.'s BBB+ Corporate Bond Index. All of the following bond data is sourced from Interactive Data.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Zoetis' 3.25% notes due 2023 at +75 basis points.
AbbVie's 2.9% notes due 2022 at +76 basis points.
Merck KGaA's 2.95% notes due 2022 at +69 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Zoetis' 4.5% notes due 2025 at +86 basis points.
AbbVie's 3.2% notes due 2026 at +108 basis points.
Merck KGaA's 3.25% notes due 2025 at +86 basis points.

For comparison to the approximate 10-year maturities, Morningstar Inc.'s Corporate Bond Index is at +128 basis points in the BBB+ category.

McCormick Offering New 5-Year, 7-Year, 10-Year, and 30-Year Notes

MCR Credit Risk Assessment

McCormick's pro forma debt/EBITDA will approach 5 times for the acquisition; this represents a substantial increase from its leverage profile, which has remained near 2.0 times over the past several years. While McCormick will reduce leverage over the next several years, its debt profile will remain elevated for its current rating even after 2020, as the company is expected to manage its capital structure more aggressively. McCormick anticipates deleveraging to approximately 3 times by 2020 year-end or still 1 turn above historical leverage guidance. We view a multiple notch downgrade as likely. We view the acquisition favorably as Reckitt Benckiser's food division vaults McCormick into a leading position in the U.S. condiment market. RB Foods' 2017 revenue and adjusted EBITDA are estimated at $581 million and $215 million, respectively.

For comparison purposes, lower-rated General Mills' leverage was 3.2 times; this company is significantly larger than McCormick with over $16 billion of revenue versus McCormick's pro forma $5.0 billion. General Mills has competitive market positions in multiple food categories and a more diverse product portfolio. However, McCormick is growing faster and has near domination of the spice and seasoning category in the United States. Both companies have good Business Risk scores reflective of the packaged food industry. McCormick has a weaker Cash Flow Cushion because of the high level of maturities in the five-year forecast period. Kellogg's leverage is higher than General Mills', approaching 4.0 times, and its product mix is more narrowly focused, with a disproportion exposure to the breakfast consumption period.

Market Data

McCormick & Company (rating: A+/UR-) is in the market with a multitranche issue of 5-year, 7-year, 10-year, and 30-year notes. Proceeds from the notes offering and the company's $500 million common stock offering are expected to be used to fund the $4.2 billion acquisition of Reckitt Benckiser's food division. Excess proceeds will probably be used for general corporate purposes including repayment of the company's $250 million 5.750% notes due Dec. 15.

For market comparables, we reference General Mills (rating: BBB+, stable) and Kellogg Company (rating: BBB, stable). The following market pricing data is from Interactive Data as of Aug. 9.

In the 10-year area, comparable issues recently traded as follows:

McCormick's 3.25% notes due 2025 at +114 basis points over the nearest Treasury.
General Mills Inc's. 3.20% notes due 2027 at +95 basis points.
Kellogg Corporation's 3.25% notes due 2026 at +108 basis points.

As additional points of reference, the BBB+ tranche of the Morningstar Corporate Bond Index is at a spread of +129 basis points and the BBB tranche is at a spread of +132 basis points.

Mylan Lowers EBITDA Expectation for 2017 and Resets Net Leverage Goal

MCR Credit Risk Assessment

On Aug. 9, Mylan NV (rating: BBB-, stable) cited pricing pressure in the U.S. generic market and dampened sales of its best-seller EpiPen as key factors for less-than-expected operating performance. While total revenue increased 15.7% in the second quarter, the gain stemmed from last year's acquisitions of Meda and the topical business (Renaissance Acquisition Holdings), which added over $630 million of revenue and reversed a 9.8% organic decline. By segment, Mylan's Europe division jumped 59% (but dropped 4% organically) and Rest of World segment rose 29% (increased 9.5% organically) due to Meda contributions while the North America business also dropped 9% (negative 19% organically) due to a fall in EpiPen sales and generic drug pricing pressure in the U.S. With an expectation that the U.S. pricing dynamic will worsen in the second half of the year and the deferral of all major launches in the U.S. (including generics to Teva Pharmaceutical Industries Ltd's (rating: BBB-, stable) Copaxone and GlaxoSmithKline's (rating: A, stable) Advair) into 2018, Mylan lowered its sales and earnings guidance for this year. The firm now hopes to grow total sales in 2017 to $11.5 billion-$12.5 billion (from $12.25 billion-$13.75 billion originally), and increase adjusted EBITDA to $3.75 billion-$3.95 billion (from $4.35 billion-$4.74 billion previously). Management also lowered its earnings guidance for 2017 into the range of $4.30-$4.70 from $5.15-$5.55, in addition to dropping its 2018 plan for adjusted EPS to $5.40 from $6.00.

From a credit perspective, the downward adjustment in management's EBITDA expectations gives us pause as we consider the firm's progress in reaching its long-term average net debt leverage target of 3 times. The firm rejiggered its outlook for debt leverage for 2017 to approximately 3.7 times (from 3.0 times previously) given the operational pressures. At the end of the second quarter, Mylan owed $15.1 billion in debt and had around $613 million of cash yielding pro forma gross leverage and net leverage of 4.0 times and 3.8 times, respectively, for the trailing 12 months, weakly positioning the firm in the BBB- rating category. We already thought that the goal for 2017 was aggressive after Mylan executed new term loans in November 2016 that effectively extended the maturities of $2.4 billion in term loans originally due in 2017, which if repaid could have accelerated leverage improvement. Now, Mylan has debt maturities over the next few years of $220 million in 2017, $1.7 billion due in 2018, and $3.2 billion due in 2019 that can be managed with free cash flow averaging more than $2 billion annually through 2021, in our estimation. This level of free cash flow together with its second-quarter ending cash balance provides enough flexibility to reduce leverage to its new goal, if the firm refrains from aggressive capital-allocation activities. However, the firm takes an aggressive approach to business development seeking complementary assets to its branded, generic, and over-the-counter drug portfolios, which can occasionally boost gross debt/adjusted EBITDA to more than 4 times on a pro forma basis.

Market Data

For closest comparisons to Mylan's notes, we look to similarly rated companies, Teva Pharmaceutical Industries Ltd's (rating: BBB-, stable), Perrigo PLC (rating: BBB-, negative), and Shire PLC (rating: BBB-, stable). Within this comparable group and adjusted for bond maturities, Mylan's 10-year bonds trade in line with those at Perrigo, tighter than those at Teva, and wider than those at Shire. Mylan's bonds also traded wider than Morningstar Inc.'s BBB- Corporate Bond Index. All of the following bond data is sourced from Interactive Data.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Mylan's 4.20% notes due 2023 at +139 basis points.
Teva's 2.95% notes due in 2022 at +194 basis points.
Perrigo's 4.00% notes due 2023 at +97 basis points.
Shire's 2.88% notes due 2023 at +103 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Mylan's 3.95% notes due 2026 at +181 basis points.
Teva's 3.15% notes due in 2026 at +216 basis points.
Perrigo's 4.38% notes due 2026 at +176 basis points.
Shire's 3.20% notes due 2026 at +129 basis points.

For comparison to the approximate 10-year maturities, Morningstar Inc.'s Corporate Bond Index is at +140 basis points in the BBB category and at +167 basis points in the BBB- category.

In the approximate 30-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Mylan's 5.25% notes due 2046 at +214 basis points.
Teva's 4.10% notes due in 2046 at +235 basis points.
Perrigo's 4.90% notes due 2044 at +226 basis points.
Shire's (Baxalta) 5.25% notes due 2045 at +149 basis points.

Thermo Fisher Issuing Debt to Fund Leverage-Increasing Patheon Deal
MCR Credit Risk Assessment
Our BBB credit rating for Thermo Fisher (rating: BBB, stable) reflects the firm's advantages in life sciences and relatively high debt leverage. The firm scores moderately on our Business Risk pillar. In this pillar, the positive factors of its narrow moat assessment from Morningstar's Equity Research Group, large size, and relatively diverse operations are offset by its aggressive capital-allocation strategy, which creates event risk for creditors, in our opinion. As Thermo Fisher is the largest supplier of research instruments and consumables, we view its business as attractive based primarily on scale advantages. The firm provides a wide breadth of life science products, including scientific instruments, lab equipment, software, and services through large manufacturing, sales, and distribution operations. Thermo has assembled its advantages and broad product set through many mergers and acquisitions. While the firm's acquisitive strategy has contributed to its market-leading position in life sciences, it has also elevated debt leverage that contributes to a relatively weak Cash Flow Cushion pillar and constrained Solvency Score and Distance to Default pillars.

In May, Thermo Fisher revealed plans to pursue another acquisition that will boost its leverage. Strategically, the Patheon acquisition will allow Thermo to expand in the contract development and manufacturing field, which should help its biopharmaceutical clients introduce new therapies to the marketplace through a variety of services. Financially, we anticipate this transaction will increase leverage to roughly 4 times initially, which is within the range we have come to expect from the life sciences leader. For perspective, in early July Thermo's gross debt/adjusted EBITDA stood around 3.4 times by our estimates or roughly half a turn above its 3.0 times target. However, we view this target as more of a floor than a sustainable operating goal, and management has said in the past that it would be willing to boost gross leverage to 4.5 times for the right acquisition, as it continues on its crusade to consolidate the highly fragmented life sciences industry. So this plan to acquire Patheon merely illuminates Thermo's ongoing appetite for acquisitions, in our opinion. Positively, management still remains committed to maintaining its investment-grade status, and the company will forgo share repurchases to enable quick deleveraging in the year or so after the acquisition is completed.

Market Data

According to regulatory filings, life sciences leader Thermo Fisher Scientific Inc (rating: BBB, stable) is in the market issuing new bonds on Aug. 10, although we have yet to see the maturity lengths within this offering. Proceeds from the new issuance will be used to finance part of the $7.2 billion acquisition of Patheon NV (not rated), which is expected to close in late 2017. Thermo recently issued $3.0 billion of bonds in Europe and is in the process of issuing roughly $1.5 billion of shares to finance part of this transaction. The company expects to finance the rest of the total consideration (about $2.7 billion) with new borrowings, including this issuance.

Thermo's closest credit comparable that we cover is Boston Scientific Corp (rating: BBB, positive), and for comparison within life sciences, we include higher-rated Agilent Technologies Inc (rating: A-, stable) as another key comparable. All of the following bond data is sourced from Interactive Data.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Thermo Fisher's 3.30% notes due 2022 at +64 basis points.
Agilent's 3.20% notes due 2022 at +98 basis points.
Boston Scientific's 3.38% notes due 2022 at +81 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Thermo Fisher's 2.95% notes due 2026 at +104 basis points.
Agilent's 3.05% notes due 2026 at +124 basis points.
Boston Scientific's 3.85% notes due 2025 at +105 basis points.

For comparison with the approximate 10-year maturities, Morningstar Inc's Corporate Bond Index is at +99 for the A- category, +132 basis points in the BBB+ category, and +143 basis points in the BBB category.

Perrigo Raises Depressed Sales Expectation for 2017; Debt Leverage Concern Alleviated

MCR Credit Risk Assessment

On Aug. 10, Perrigo (rating: BBB-, negative) posted better operating results than expected for the second quarter, leading the company to increase its sales and earnings outlook for the full year. While total revenue remains under pressure from the divestment of the Tysabri (multiple sclerosis) royalty-bearing stream in March, the firm saw higher-than-expected sales performance in its consumer healthcare international and prescription pharmaceuticals businesses to increase its sales outlook to $4.70 billion-$4.85 billion (from $4.6 billion-$4.8 billion). In the second quarter, total revenue fell 8% on a reported basis, including a 4% decrease in sales from the consumer healthcare America segment, a 9% fall in sales generated by consumer healthcare international business, and a 13% drop in sales from prescription pharmaceuticals. While sales are down this year, management anticipated that 2017 would be an inflection point as the firm works through the sales of the Tysabri asset, product portfolio pruning, and geographic alignment. Given growing confidence from this performance trough, Perrigo also materially raised its adjusted diluted earnings per share guidance to $4.45-$4.70 from $4.15-$4.50. Our BBB- rating and negative outlook consider that Perrigo's strategy to repair struggling segments may potentially create variability in earnings and cash flows over the length of its efforts. As such, we think operational results are likely to stay volatile as the company carries out its strategic initiatives to reinvigorate flagging performance through increased internal investment and corporate pruning.

Our top immediate concern had been the pressure on debt leverage following the divestiture of the Tysabri asset, which contributed nearly one third of Perrigo's earnings. Our initial expectation for debt repayment of more than $2 billion following completion of the transaction to maintain gross leverage near its current level has already been exceeded, as the firm reduced its debt load by around $2.1 billion in the first half of 2017. As such, Perrigo owed debt of $3.7 billion and had a cash balance of $761 million at the end of the second quarter, or gross debt leverage and net debt leverage around 2.9 times and 2.3 times, respectively, by our estimates. Despite the loss of Tysabri earnings, these credit measures compare with gross debt leverage and net debt leverage around 3.6 times and 3.2 times, respectively, at the end of 2016. Furthermore, Perrigo plans to pay down $370 million in maturing debt by the end of the year. These activities have eased downward pressure on the current rating, in our mind. However, we will remain cautious on Perrigo's capital deployment since the firm see its newfound financial flexibility as reason for returning to share repurchases and potentially targeting bolt-on acquisitions.

Market Data

For closest comparisons with Perrigo's notes, we look to similar-rated Mylan (rating: BBB-, stable), Teva Pharmaceutical Industries Ltd (rating: BBB-, stable), and Shire PLC (rating: BBB-, positive). Within this comparable group and adjusted for bond maturities, Perrigo's 10-year bonds trade close to those of Mylan, tighter to those of Teva, and wider than those of Shire. Perrigo's 10-year bonds also trade in line with the BBB- Morningstar Corporate Bond Index. All of the following bond data is sourced from Interactive Data.

In the approximate 5-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Perrigo's 4.00% notes due 2023 at +93 basis points.
Mylan's 4.20% notes due 2023 at +136 basis points.
Teva's 2.95% notes due in 2022 at +190 basis points.
Shire's 2.88% notes due 2023 at +99 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Perrigo's 4.375% notes due 2026 at +173 basis points.
Mylan's 3.95% notes due 2026 at +177 basis points.

Teva's 3.15% notes due in 2026 at +212 basis points.
Shire's 3.2% notes due 2026 at +125 basis points.

For comparison to the approximate 10-year maturities, the Morningstar Corporate Bond Index is at +143 basis points in the BBB category and +171 basis points in the BBB- category.

In the approximate 30-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:

Perrigo's 4.9% notes due 2044 at +222 basis points.
Mylan's 5.25% notes due 2046 at +211 basis points.
Teva's 4.10% notes due in 2046 at +231 basis points.
Shire's (Baxalta) 5.25% notes due 2045 at +145 basis points.

Credit Contacts

Basic Materials
Sean Sexton, CFA
sean.sexton@morningstar.com
+1 312 348-3077

Consumer
Dave Sekera, CFA
david.sekera@morningstar.com
+1 312 696-6293

Consumer Defensive
Wesley Moultrie, CPA, CGMA
wesley.moultrie@morningstar.com
+1 312 384-5405

Consumer Cyclical
Wayne Stefurak, CFA
wayne.stefurak@morningstar.com
+1 312 696-6114

Energy
Andrew O'Conor
andrew.oconor@morningstar.com
+1 312 348-3021

Financials – Banks
Chris Baker, CFA
christopher.baker@morningstar.com
+1 312 244-7533

Financials – European Banks
Erin Davis
erin.davis@morningstar.com
+1 312 384-4810

Financials – Insurance, Nonbank Financials
Jeremy Graczyk, CFA
jeremy.graczyk@morningstar.com
+1 312 244-7491

Healthcare
Julie Utterback, CFA
julie.utterback@morningstar.com
+ 1 312 696-6278

Healthcare
Michael Zbinovec
michael.zbinovec@morningstar.com
+ 1 312 348-3136

Industrials
Rick Tauber, CFA, CPA
rick.tauber@morningstar.com
+1 312 384-5431

Industrials
Basili Alukos, CFA, CPA
basili.alukos@morningstar.com
+1 312 384-4984

REITs
Chris Wimmer, CFA
chris.wimmer@morningstar.com
+1 646 560 4585

REITs
Mike Magerman, CFA
mike.magerman@morningstar.com
+1 267 960 6022

Technology, Media, and Telecom
Michael Dimler, CFA
michael.dimler@morningstar.com
+1 312 696-6339

For More Information
Gregg Novek
+1 646 560-4529
gregg.novek@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA