

Morningstar Corporate Credit Research Highlights

Activity slows as holidays approach.

Morningstar Credit Ratings, LLC
11 December 2017

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Credit Rating Actions

▶ Rating Changes

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Clorox CLX	A	A-
CVS Health CVS	BBB+/UR-	BBB+

▶ Rating Affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Eaton ETN	BBB+	BBB+
Johnson Controls JCI	BBB+	BBB+
Honeywell HON	A	A
Emerson Electric EMR	A+	A+
Parker Hannifin PH	A-	A-
Amgen AMGN	A	A

Recent Notes Published by Credit Analysts

- ▶ **Valeant** Issues \$1 Billion of Private Unsecured Notes and Tenders for \$1 Billion of Existing Notes
- ▶ **Duke Realty** Issuing New 10-Year Bonds to Repay Revolver and for General Purposes
- ▶ **DaVita** Selling DMG Segment to UnitedHealth's Optum Unit
- ▶ **Martin Marietta Materials** Issuing \$1.4 Billion in Notes to Fund Acquisition
- ▶ **Baker Hughes** Issuing New 144A Notes to Fund Tender and Share Buyback
- ▶ **Federal Realty** Issuing New 10-Year Bonds to Redeem Notes

Credit Market Insights

Market Data and Insights

Three weeks ago, we noted that some investors were locking in profits early for the year and other investors had already begun their year-end window-dressing. Two weeks ago, there was a brief bout of new issue activity as issuers looked to lock in long-term financing before the holiday season. Last week, a few stragglers tapped the markets, but the pace of activity in the new issue market has slowed considerably and trading volume dwindled in the secondary markets. Volatility has also been muted, and corporate credit spreads traded in a narrow range. While there may be a few new issues priced early this week before the Federal Open Market Committee meeting and a few portfolio managers may have some last-minute adjustments to make, trading activity and new issue volume should be light for the remainder of year. The average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) tightened 1 basis point to +100, while the BofA Merrill Lynch High Yield Master Index ended the week unchanged at +363.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., BofA Merrill Lynch Global Indexes. Data as of 12/08/2017.

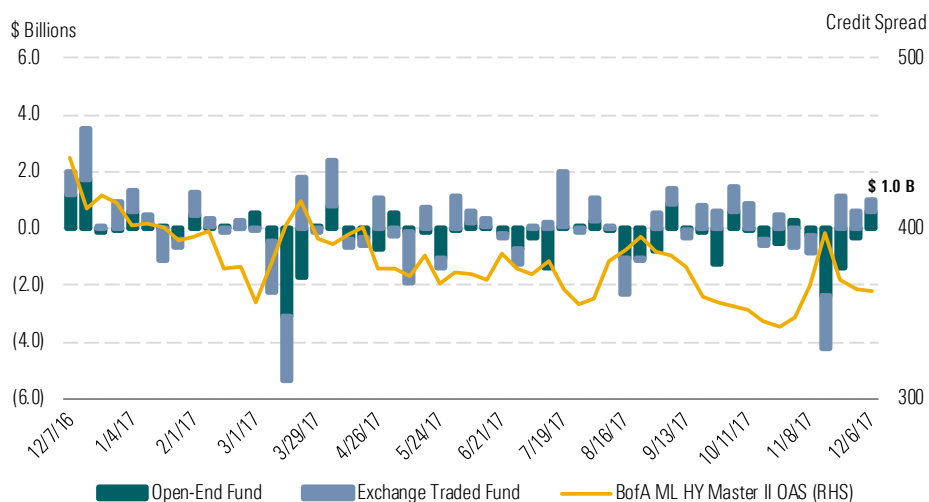
Interest rates widened slightly this past week, but the shape of the yield curve held relatively steady as the spread between the 2-year and 10-year Treasury bonds was unchanged. Although the shape of the curve was unmoved this past week, the yield curve has been on a flattening trend since the Federal Reserve began to raise short-term rates in its pursuit of normalizing monetary policy. Currently, the yield curve is at its flattest level since before the global financial crisis. This flattening trend may continue as it has been influenced by global central bank activities. For example, the Fed has been raising short-term interest rates and is expected to raise the federal funds rate again this week. Short-term rates are expected to rise even further next year. According to CME Group's FedWatch Tool, the market is pricing in a 59% probability that the Fed will raise short-term rates to above 1.75% by the end of 2018.

Although short-term rates have been rising, demand for long-term bonds has kept prices steady. The long end of the curve may be influenced by the ongoing quantitative easing programs of the European Central Bank and Bank of Japan. This demand will continue to be affected by global central bank activity as the ECB will not begin to taper its asset-purchase program until next year. Even then, the ECB will continue to purchase EUR 30 billion per month until September 2018, which will infuse the eurozone with an additional EUR 270 billion of new money.

High-Yield Inflows Retain Momentum

Investors continued to return to the high-yield asset class last week. High-yield open-end funds and exchange-traded funds registered \$1.0 billion of inflows last week, consisting of \$0.6 billion of deposits into open-end funds and \$0.4 billion of net unit creation among ETFs. Year to date, the high-yield asset class has suffered total redemptions of \$10.6 billion, consisting of \$14.8 billion of redemptions in the open-end mutual funds offset by \$4.2 billion of new unit creation in ETFs.

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 Dec. 8, 2017

(000,000s \$ unless otherwise noted)

Issuer			Issue				
Name	Ticker	Morningstar Corporate Rating	Size	Coupon	Description	Maturity	Approx Spread to US Treasuries
American Tower	AMT	BBB	\$700	3.00%	Senior Unsecured	2023	+90
American Tower	AMT	BBB	\$700	3.60%	Senior Unsecured	2028	+130
Baker Hughes, a GE Co	BHGE	BBB+	\$1,250	2.773%	Senior Unsecured	2022	+65
Baker Hughes, a GE Co	BHGE	BBB+	\$1,350	3.337%	Senior Unsecured	2027	+100
Baker Hughes, a GE Co	BHGE	BBB+	\$1,350	4.080%	Senior Unsecured	2047	+135
Charles Schwab	SCHW	A+	\$800	2.65%	Senior Unsecured	2023	+53
Charles Schwab	SCHW	A+	\$700	3.20%	Senior Unsecured	2028	+83
Duke Realty	DRE	BBB+	\$300	3.375%	Senior Unsecured	2027	+103
Federal Realty	FRT	A-	\$475	3.25%	Senior Unsecured	2027	+120
Martin Marietta Materials	MLM	BBB-	\$300	L+50	Senior Unsecured	2019	NA
Martin Marietta Materials	MLM	BBB-	\$500	3.50%	Senior Unsecured	2027	+120
Martin Marietta Materials	MLM	BBB-	\$600	4.25%	Senior Unsecured	2047	+155
Valeant Pharmaceuticals	VRX	B-	\$1,500	9.00%	Senior Unsecured	2025	+691

Source: Bloomberg, company Securities and Exchange Commission filings.

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-	5,006	7.0	100	(1)	(29)	0.44	5.96
FINANCIAL	A-	1,472	5.5	86	(1)	(36)	0.33	5.17
Bank	A-	904	5.0	83	(1)	(39)	0.29	5.01
Finance	A	264	5.8	91	(1)	(30)	0.33	4.65
Insurance	A	214	7.9	90	(0)	(32)	0.55	6.96
REITs	BBB+	81	5.9	107	(5)	(28)	0.32	5.47
INDUSTRIAL	A-	2,934	7.7	105	(1)	(25)	0.49	6.27
Basic Industries	BBB	241	7.9	129	(0)	(51)	0.51	9.93
Consumer Products	A-	336	7.6	87	(1)	(20)	0.47	5.43
Energy	A-	415	7.4	126	(0)	(29)	0.41	7.32
Healthcare	A-	419	7.9	94	(1)	(22)	0.52	6.08
Manufacturing	A-	463	6.2	84	(0)	(25)	0.35	4.90
Media	BBB+	201	8.6	136	(3)	(22)	0.82	6.76
Retail	A-	161	8.1	92	(0)	(16)	0.64	5.45
Technology	A+	347	7.4	83	(1)	(22)	0.42	5.47
Telecom	BBB+	153	9.1	149	(1)	(9)	0.55	6.20
Transportation	BBB+	147	9.1	101	(1)	(32)	0.64	7.42
UTILITY	BBB+	560	8.7	123	(0)	(29)	0.56	7.40
Electric Utilities	A-	333	9.3	107	(0)	(29)	0.64	7.60
Gas Pipelines	BBB	215	7.7	148	(0)	(28)	0.43	7.10

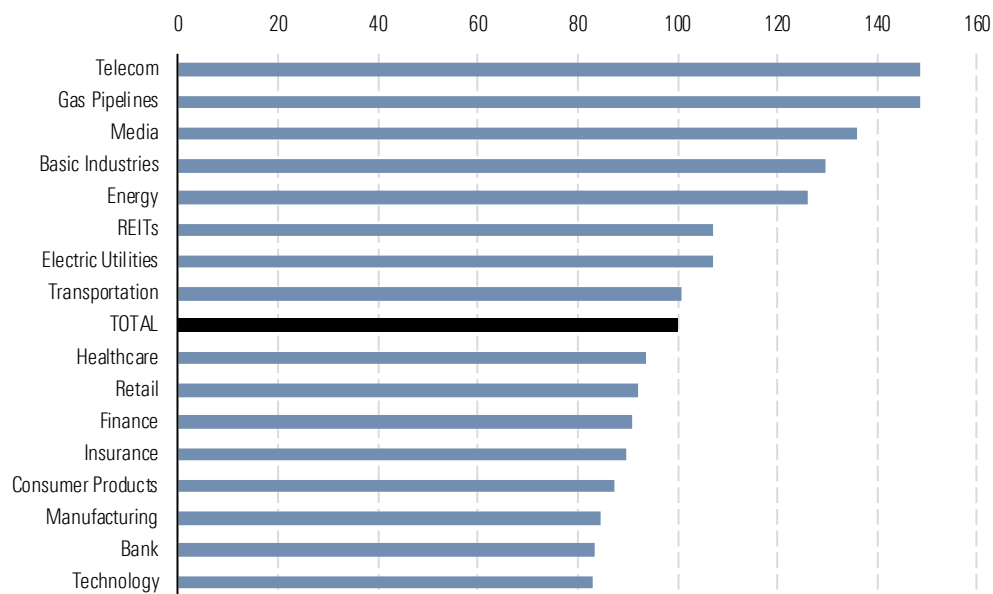
Rating Bucket

AAA Bucket		116	8.3	52	(0)	(14)	0.45	5.50
AA Bucket		497	6.0	61	(1)	(22)	0.34	4.15
A Bucket		1,932	6.9	77	(2)	(29)	0.44	5.41
BBB Bucket		2,461	7.3	131	0	(33)	0.46	6.90

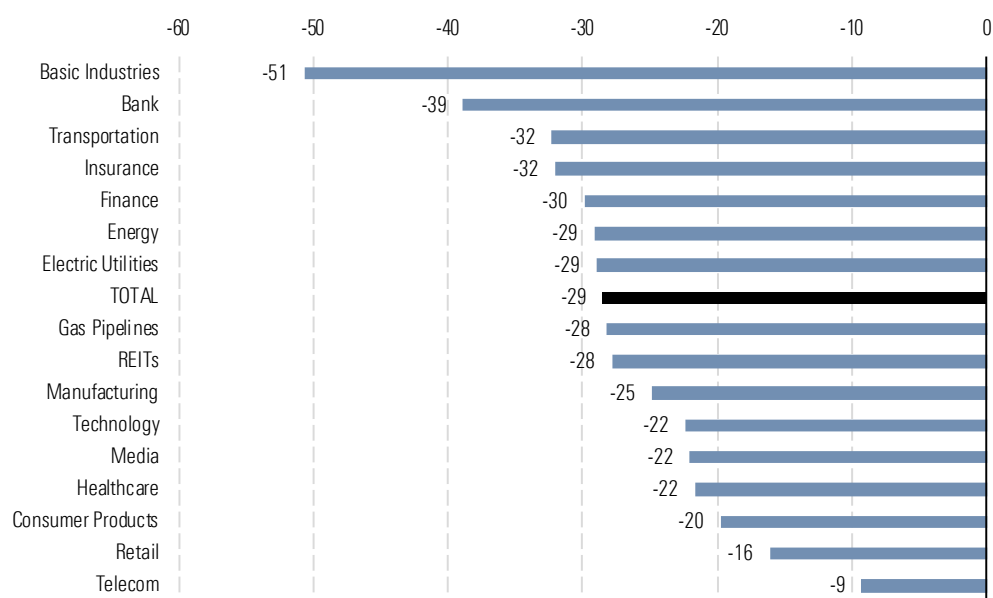
Term Bucket

1-4	A-	1,604	2.3	59	(1)	(34)	0.05	2.29
4-7	A-	1,175	4.7	84	(1)	(32)	0.16	4.39
7-10	A-	928	7.1	111	(1)	(27)	0.39	6.12
10PLUS	A-	1,299	14.0	151	(1)	(24)	1.12	11.48

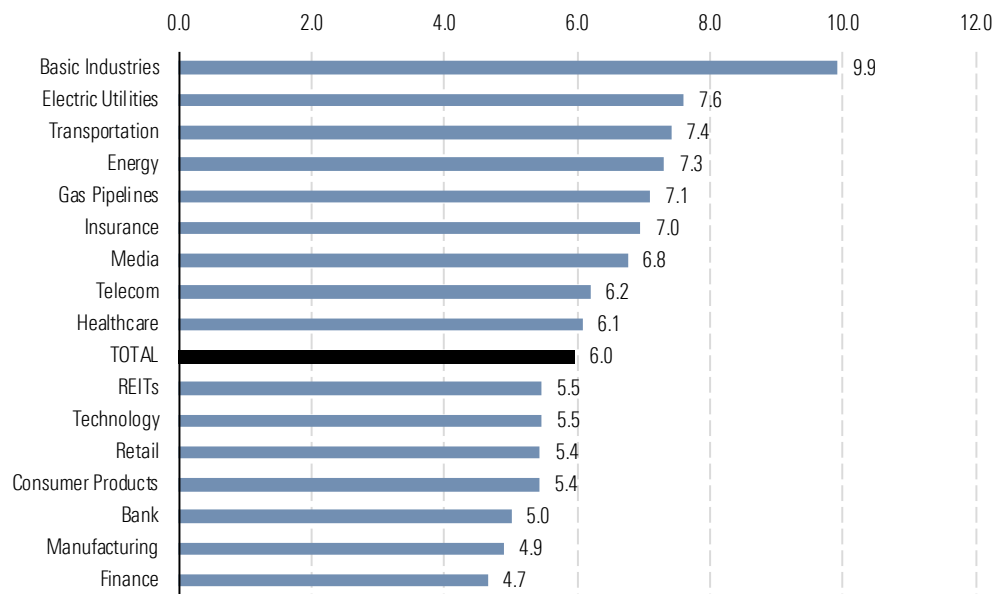
Data as of 12/08/2017

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

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Clorox CLX	A	A-
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Eaton ETN	BBB+	BBB+
Johnson Controls JCI	BBB+	BBB+
Honeywell HON	A	A
Emerson Electric EMR	A+	A+
Parker Hannifin PH	A-	A-
Amgen AMGN	A	A

Clorox's Rating Upgraded to A on Sustained Improvement in Credit Measures; Outlook Stable

Morningstar Credit Ratings, LLC is upgrading the Clorox Company's rating to A and revising the outlook to stable from positive. Clorox's rating and stable outlook is based on continued successful expansion and diversification of its product portfolio, a sustained improvement in its Solvency Score and Cash Flow Cushion, and moderate use of leverage.

Clorox's continued strong recent operating results despite sluggish industry trends exemplify the reasoning behind its wide moat assessment, as assigned by Morningstar's Equity Research Group. The company derives most of its economic profit from brand equity alone, which is supported by its leading market shares, as more than 80% of the firm's portfolio consists of number-one or number-two brands. However, Clorox operates in a highly dynamic and competitive industry. Changing consumer preferences, particularly those shifting to value retailers and online outlets offering lower prices and greater convenience, could threaten Clorox's margins and sales growth. Although Clorox effectively combats private-label encroachment, increasing acceptance of private labels over brands is viewed as both a near-term and long-term headwind to the company's growth.

Clorox maintains a healthy balance sheet with strong liquidity. The company's leverage has been consistently maintained at a little less than 2 times, or below management's targeted leverage range of 2-2.5 times. Our forecast includes low-single-digit top-line growth and stable operating margins in the low 18% area. We expect healthy free cash flow (cash flow from operations less capital expenditures and dividends), which averaged more than \$250 million over the past three years. Our rating also reflects Clorox's recent transformative acquisitions and divestitures. The acquisition of Renew Life in 2016 has gotten off to a strong start, now contributing 2 points to forecast sales growth. The divestiture of Aplicare in 2017 will allow management to focus on core operations and is expected to positively affect the firm's margin in the long run. Our Solvency Score remains strong throughout our forecast and is driven by modest leverage, interest coverage in the teens, and double-digit returns on invested capital. The stable outlook reflects our expectations for steady financial performance and credit metrics, although more aggressive debt-funded acquisitions or share repurchases could affect the rating.

Clorox's debt was \$2.2 billion at Sept. 30, composed of \$413 million of short-term debt (mainly current maturities that were refinanced with commercial paper in October) and long-term debt of \$1.8 billion. Clorox has the following debt maturities: \$298 million in 2021, \$596 million in 2022, and \$906 million thereafter. Clorox maintains strong liquidity, including cash at the end of September of \$468 million, of which we estimate about 40% is held in foreign subsidiaries and could trigger additional taxes if repatriated to the United States. Financial flexibility is afforded by the company's committed \$1.1 billion revolving credit facility, which matures in February 2022. The credit agreement contains a restrictive covenant that requires the company to maintain a minimum interest coverage for a trailing four quarters of at least 4 times. There were no borrowings under the credit agreement at Sept. 30. Clorox's retirement income and retirement health plans are underfunded by \$191 million. However, the pension plan was frozen in 2011, and the company contributed \$31 million to the retirement income plans in fiscal 2017.

Clorox pays out slightly more than 60% of its net income in dividends, higher than the average consumer products firm. Beyond boosting shareholders returns through increased share repurchases and dividends, we believe Clorox will continue to be acquisitive. Management would likely target deals in the \$50 million-\$250 million range that are unlikely to constrain Clorox's balance sheet and hamper the leverage ratio. The company maintains two share-repurchase programs: an open-market purchase program with an authorized aggregate purchase amount of up to \$750 million, which was unused as of Sept. 30, and an evergreen program to offset the anticipated impact of share dilution from stock compensation plans.

Our current rating outlook is stable. A further upgrade in the near-term is not anticipated, however, continued diversification and significant expansion of Clorox's product portfolio, maintenance of its profitability margins and Cash Flow Cushion score, and maintenance of total debt/EBITDA under 2.0 could result in a one-notch upgrade. Conversely, heightened leverage beyond its target range, signaling a change in its capital-allocation policy to a more aggressive stance toward acquisitions and share repurchases, or a weakening of the company's Solvency Score, could result in a rating downgrade of one notch or more.

CVS' BBB+ Rating Under Review Negative on Planned Aetna Merger

Morningstar Credit Ratings, LLC is placing its BBB+ credit rating on CVS Health Corp under review with negative implications based on the company's planned combination with managed-care organization Aetna. This acquisition is expected to close in late 2018 and increase leverage substantially. Assuming the merger closes as expected, rising leverage could cut into the company's Cash Flow Cushion and Distance to Default pillar enough to cause a one-notch downgrade, based on our current understanding of the deal.

From an already elevated level, CVS' leverage looks set to rise further in a merger with Aetna. For example, as of September, lease-adjusted debt/EBITDAR stood at 3.2 times by our estimates, above its previous 2.7 times target. That elevated leverage already pushed CVS to the weak end of BBB+ territory on a stand-alone basis. CVS plans to merge with Aetna for an enterprise value of \$77 billion, and that

acquisition promises to boost pro forma gross leverage to the mid-4s if it closes as expected. With no further major acquisition activities on the horizon, CVS plans to suspend its share-repurchase program and flatline its dividend to quickly deleverage. Specifically, management aims to reduce gross leverage to the mid-3s in the next couple years and low 3s in the long term. However, that projected leverage is higher than the firm's previous goal, and the company's willingness to boost and keep leverage well above its previous target suggests a downgrade may be warranted in the merger scenario.

On a stand-alone basis and in the merger scenario, CVS's Business Risk pillar looks likely to remain robust and influenced by Morningstar's Equity Research Group's wide moat assessment, along with its large size and predictable cash flows. CVS already operates as a top-tier pharmacy benefit manager and pharmacy retailer. Adding a top-tier medical benefit manager to the mix strengthens the Business Risk and will also boost its diversification measure in this pillar.

Our under review negative status for CVS suggests that a downgrade is likely if the company combines with Aetna as currently planned. Rising leverage and related costs look set to cut into the firm's Cash Flow Cushion and Distance to Default pillars enough to downgrade by one notch in that scenario. If this merger is not completed as planned due to regulatory or other concerns, though, our stand-alone rating of BBB+ for CVS could remain appropriate. Overall, we do not envision a scenario where we would upgrade our rating in the near term, given the firm's weakness in its BBB+ rating as a stand-alone entity. An upgrade would require a significant change in CVS' capital-allocation priorities that results in lower leverage than its previous 2.7 times lease-adjusted leverage target on a sustainable basis.

Eaton's Rating Affirmed at BBB+ With Positive Outlook

Morningstar Credit Ratings, LLC is affirming our BBB+ corporate credit rating on Eaton Corp PLC. Eaton's fortunes have improved since we last reviewed our rating, but we want to see a sustained improvement in profitability and further deleveraging before we upgrade it. We still see a pathway for a rating upgrade in the near future and have thus retained our positive outlook.

Our BBB+ credit rating reflects Eaton's strong competitive position combined with increased leverage after its 2012 acquisition of Cooper Industries. Since then, management has restored its credit measures by retiring \$2.1 billion in debt, but has also relaxed its leverage target to around 2.5 times. Eaton participates in four different businesses, but its roots are in power management and distribution in various but predominantly industrial, end markets. Its entrenched positions, specifically aerospace, have helped it earn a narrow economic moat rating from Morningstar's Equity Research Group related to its brand name and the resulting switching costs from embedded products on a customer's platform. These competitive advantages benefit its Business Risk score, but its heavy industrial and reduced aftermarket business—Cooper diluted the aftermarket business to around 20% today from 35%—hurt its customer concentration and cyclical scores. Eaton has monetized its advantages into impressive returns on invested capital excluding goodwill and interest coverage ratios that support its Solvency Score. We forecast that EBITDA margins will expand to 17% during our forecast period, and that the company will generate free cash flow of \$2.6 billion on average during the period, or around 11% of sales. Eaton faces meaningful maturities during our forecast period, plans to return copious amounts of cash to

shareholders through dividends and share repurchases, and possibly pursue acquisitions. These factors weigh on its Cash Flow Cushion.

We have assigned Eaton a positive outlook. Eaton's prospects have brightened throughout 2017 on the back of a strong showing from its hydraulics segment, and we think that the strong industrial economy should support Eaton's prospects into 2018. We expect that further profitability expansion will lead to modest natural deleveraging that could raise both the Solvency Score and Cash Flow Cushion enough to warrant a one-notch upgrade in the near future. Alternatively, our rating could come under pressure if Eaton decides to pursue a large-scale, debt-funded acquisition. Management commented recently that reinvesting in its business takes precedent while also noting an interest in inorganic opportunities to augment its electrical and aerospace business. In this scenario, we believe a debt-funded deal could weaken our Solvency Score and Cash Flow Cushion enough to warrant at least a one-notch downgrade.

Johnson Controls' Rating Affirmed at BBB+ With Stable Outlook

Morningstar Credit Ratings, LLC is affirming our BBB+ corporate credit rating on Johnson Controls International PLC, which reflects its solid competitive position offset by meaningful debt maturities. The company has reduced outstanding debt by \$700 million over the past two quarters and used proceeds from its recent Scott Safety sale to repay an incremental \$1.9 billion of debt subsequent to the fiscal year-end. Despite the leverage reduction, our outlook remains stable, as we think management will look to stay around its target of 2.5 times.

Johnson Controls is a leading automotive battery provider with nearly 33% market share, and it merged with Tyco in 2016 to expand into building technologies and solutions. The company's strong brand name, cost advantages, and inherent customer switching costs have resulted in Morningstar's Equity Research Group awarding it a narrow economic moat rating, which benefits its Business Risk score. However, the score is offset slightly by our assessment of its limited market exposure, which affects its product and customer concentration score. Johnson Controls has historically monetized its competitive position into strong profitability, but returns on invested capital are negatively affected by the Tyco merger, and its elevated leverage and low quick ratio result in an average Solvency Score. Over the next five years, we forecast that Johnson Controls will produce average free cash flow of \$3.5 billion per year, while aspiring to maintain a 35%-40% dividend payout ratio. The company faces a heavy maturity schedule, although the closing of its Scott Safety sale provides further proceeds to retire debt. Combined, these factors weigh down its Cash Flow Cushion score.

We expect that our rating will remain at the current level over the next few years. Johnson Controls has mostly delivered on its commitment to reduce leverage after its Tyco acquisition. After its October debt repayment, we estimate that gross leverage is down nearly 1.0 turn to 2.7 times. We think efficiency gains and synergies should boost profitability and combined with meaningful debt repayment, with further help leverage should remain at pre-Tyco levels going forward. If Johnson Controls decides to further retire debt, then we would expect that an improvement in the Solvency Score and Cash Flow Cushion could result in a one-notch upgrade. Moreover, greater-than-expected synergies from the Tyco merger could result in a further boost to returns on invested capital that could lift the Solvency Score

even further. Conversely, should the company decide to operate with higher leverage or should its Tyco synergies prove elusive, then we think pressure the Cash Flow Cushion and Solvency Scores and could result in at least a one-notch ratings downgrade.

Honeywell's Rating Affirmed at A With Stable Outlook

Morningstar Credit Ratings, LLC is affirming our A corporate credit rating on Honeywell International Inc. Our issuer rating reflects Honeywell's favorable Business Risk and Solvency Score pillars, offset by its penchant for acquisitions. This affirmation also contemplates the changes to Honeywell's portfolio it announced in October. A few diversified industrial firms have pursued a transformative acquisition after simplifying their businesses, and we wonder if Honeywell is contemplating a similar strategy. It already tried to acquire a rival in 2016, and it is operating under its leverage target. That said, we think Honeywell's stand-alone credit profile warrants a stable outlook at this time.

Honeywell operates in disparate end markets, including aerospace, automation and control, and performance materials. The switching costs in aerospace are a major contributor to Morningstar's Equity Research Group wide moat, which benefits its Business Risk score. Honeywell has converted its entrenched position into a solid aftermarket business and high-margin software business—software-enabled products represented roughly 60% of 2016 revenue. In turn, Honeywell has delivered impressive returns on invested capital and interest coverage ratios. Honeywell also operates with substantial cash holding, and this balance produces a strong quick ratio. Combined, these factors support its Solvency Score. We forecast that Honeywell will produce average annual free cash flow of around \$6.6 billion over our forecast period. However, management wants to increase the dividend more quickly than earnings and at a minimum maintain a flat share count. It will also pursue acquisitions as a primary tool for growth, especially now that the company has announced its portfolio transformation plan. Previously, management had mentioned deal capacity of around \$20 billion over the next three years. Last, it faces average debt maturities of \$1.3 billion per year over the next five years. Collectively, these factors weigh on the Cash Flow Cushion.

Honeywell's outlook remains stable based on the strength of its stand-alone credit profile. We expect that debt levels will rise commensurate with earnings growth and leverage will remain around current levels. Management expects to seek inorganic opportunities, and we incorporate modest acquisition spending within our forecast. However, we think that the portfolio transformation could forebode a potential large-scale deal, as the company looks to monetize the expected \$3 billion in dividend proceeds from the announced spin-offs. Already, we estimate the company is operating nearly half a turn below its 2.3-2.5 times leverage goal. If management attempts to reel in a large prize, then we could downgrade our rating at least one notch, as added leverage would pressure the Solvency Score and Cash Flow Cushion. Alternatively, should management choose to forgo future acquisitions and focus on organic growth, then we could envision a one-notch credit rating upgrade.

Emerson's Rating Affirmed at A+; Negative Outlook Intact Due to M&A Concerns

Morningstar Credit Ratings, LLC is affirming our A+ corporate credit rating on Emerson Electric Co. Our rating incorporates Emerson's competitive position offset by the potential risk from mergers and

acquisitions. Emerson's financial results are beginning to improve after years of low energy activity roiled its prospects. However, the company's aggressive M&A strategy gives us pause, since the failed bid to acquire Rockwell Automation Inc (A, stable) was meaningfully above its stated guidance. As such, we are maintaining our negative outlook, as we think a potential deal would result in a downgrade.

Emerson is a global leader in providing automation and commercial and residential solutions. Its immense installed base creates high customer switching costs that contribute to Morningstar's Equity Research Group's wide economic moat rating, which supports its Business Risk pillar. Emerson sells to myriad customers, but its exposure to energy, roughly 50% of sales, detracts from the score. Also, management has shown a willingness to pursue leverage-increasing acquisitions, including the recent \$29 billion offer for Rockwell Automation, and this risk weighs on our Business Risk pillar. Emerson has monetized its competitive position into solid returns on invested capital, although low energy prices have depressed these metrics somewhat. Over the next five years, we forecast that Emerson will generate \$2.6 billion in average free cash flow, increase its generous dividend (currently about \$1.25 billion) with earnings, and repurchase \$1 billion of shares over the next 12 months. Emerson faces a manageable debt maturity profile, and these factors contribute to an average Cash Flow Cushion score.

We assign Emerson a negative outlook. Emerson's credit profile deteriorated alongside the fall in energy prices, but the recent improvement in fortunes has slowly started to counteract the damage. However, we view the company's M&A strategy as a credit negative. Emerson had previously communicated a desire to grow inorganically, mentioning a targeted range of \$5 billion-\$8 billion, funded in part with incremental debt. However, that target proved woefully inadequate, as Emerson recently raised its third offer for Rockwell Automation to \$29 billion before withdrawing the offer Nov. 28. Should Emerson pursue another merger, then rising leverage could hurt its Solvency Score and Cash Flow Cushion enough to result in at least a one-notch downgrade. Conversely, our rating could increase if Emerson were to reconsider its acquisition strategy entirely. This less aggressive capital-allocation stance would improve its Business Risk and result in a possible one-notch ratings upgrade.

Parker Hannifin's Rating Affirmed at A- With Stable Outlook

Morningstar Credit Ratings, LLC is affirming our A- corporate credit rating on Parker Hannifin Corp. Our rating on Parker reflects the company's solid Business Risk profile offset by elevated leverage related to its recent Clarcor acquisition. Management noted that the integration is under way, although we think it is still too early in the process to proclaim the deal a success. Parker remains committed to reducing leverage, but we think the initial progress is insufficient to indicate a future ratings action at this juncture. As a result, our outlook remains stable.

Parker's motion and control products are integral components throughout the manufacturing process. Parker's broad product offerings as a systems integrator and its brand name have enabled the company to garner a narrow economic moat from Morningstar's Equity Research Group that helps support its Business Risk score. Still, Parker primarily sells into general manufacturing, which hurts its customer concentration and cyclical scores, although this concern is partially allayed by its large aftermarket exposure (54% of pro forma sales). Parker has historically monetized its competitive position into solid

returns on invested capital and interest coverage ratios. However, the incremental leverage has caused a temporary increase in the total liabilities-to-total asset ratio and depressed the quick ratio, constraining its Solvency Score. We forecast that Parker will generate \$1.5 billion of free cash flow annually over the next five years. However, the company faces a sizable debt maturity schedule and is targeting a 30% dividend payout ratio. In total, these factors work to produce an average Cash Flow Cushion score.

Our outlook on Parker remains stable. Over time, we expect that gross leverage will contract to around 2.0 times, consistent with management's plan to redeem \$1.3 billion in debt by 2020. Should the deleveraging prove permanent, then we expect this would have a positive effect on both its Solvency Score and Cash Flow Cushion that could lead to a one-notch upgrade. However, recent commentary suggests that Parker may look for future deals to augment its current product offering. Should the company deviate materially from its deleveraging goal or if the Clarcor merger produces underwhelming results, then we think this could pressure the company's credit metrics, specifically its Solvency Score and Cash Flow Cushion. In this scenario, we could envision a rating downgrade of a notch or more.

Amgen's A Credit Rating Affirmed With a Stable Outlook

Morningstar Credit Ratings, LLC is affirming Amgen Inc.'s A rating and stable outlook, reflecting our expectation that the firm can withstand branded and biosimilar competition to its aging pharmaceutical portfolio via research innovation and attractive demand for its novel medicines. In addition, our confidence that Amgen can effectively manage its balance sheet while greatly rewarding shareholders informs our stable outlook.

Amgen faces rising biosimilar and brand-name drug competition to its maturing biopharmaceutical portfolio, specifically anemia medicine Epogen and neutropenia treatments Neulasta and Neupogen, which lose all patent protection by 2017 and together represent almost 30% of company sales. Plus, Amgen's top-selling medicine Enbrel (about 24% of total sales) contends with a growing number of next-generation autoimmune disorder therapies. Revenue concentration on these older medicines pressures our Business Risk pillar. Despite these risks, we think that Amgen may maintain revenue growth in the low-single-digits through 2021 compounded annually. We base this modest growth assumption mainly on sustained demand for osteoporosis treatment Prolia, increased use of cancer drug Kyprolis from expanding indications, and rising uptake of cholesterol-lowering medicine Repatha following positive cardiovascular outcome data. We also see good contributions from Amgen's expanding biosimilar portfolio, potential promising migraine medication Aimovig, and next-generation osteoporosis medicine candidate Evenity. We estimate EBITDA growth slightly ahead of sales performance through 2021 as Amgen has successfully held down operating expenses through its transformation efforts since 2014. These efforts along with the dissolution of the Enbrel copromotion agreement with Pfizer have allowed Amgen to achieve its goal (during 2017) of adjusted operating margin in the range of 52%-54% by 2018. This solid operational outlook gives us confidence that Amgen can effectively manage its balance sheet while greatly rewarding shareholders, which positively influences our Cash Flow Cushion, Solvency Score, and Distance to Default pillars.

Amgen maintains a heavy debt load as it prioritizes cash flows toward shareholder returns over debt reduction. This was evident during 2017 as Amgen chose to refinance \$3.8 billion of debt maturing in the second quarter that kept gross debt elevated at \$35.8 billion at the end of the third quarter or gross debt leverage of 2.8 times for the trailing 12 months, by our estimates. Most recently, the firm issued \$1.0 billion in new 10-year senior notes in November 2017 for general corporate purposes including share repurchases. Amgen can easily manage coming debt maturities totaling \$12 billion through 2021 with cash and investments of \$41.4 billion as of Sept. 30 and free cash flow that we see averaging almost \$9 billion per year through 2021. However, we expect steady EBITDA generation may be the main contributor to keeping debt leverage relatively constant over the next few years given Amgen's low priority to reduce its debt burden. The company's top focus for cash flows remains shareholder rewards as it targets returning 60% of adjusted net income on average in 2014-18 via a rapidly rising dividend and aggressive share repurchasing. Accordingly, Amgen expects to repurchase a total of \$2.5 billion-\$3.5 billion of shares in 2017. For the 12 months ended in September, Amgen paid \$3.3 billion in dividends and repurchased \$3.4 billion in equity (about \$2.4 billion in the first nine months of 2017), compared with \$10.5 billion in free cash flow. In October, Amgen's board once again increased authorization of the share-repurchase program to a total of \$5 billion from \$1.7 billion at the end of the third quarter of 2017. Beyond satisfying its shareholder rewards goal, we see Amgen increasing its M&A focus toward later-stage research assets shifting from early-stage candidates.

Our stable outlook on Amgen's rating considers the growth potential of promising new medicines, Repatha and Kyprolis, to help replace losses arising from brand name and biosimilar competition to the firm's medicine portfolio with an emphasis on expiring drugs, Epogen, Neulasta, and Neupogen. Positive momentum to the rating may follow greater-than-anticipated uptake of potential medicines Aimovig and Evenity as well as accelerating demand for Repatha that benefits our Cash Flow Cushion pillar while easing concentration risk in the aging portfolio that would strengthen our Business Risk pillar. However, if there is a significant deviation from our operational performance estimates, most likely resulting from slower-than-expected demand for Repatha or Kyprolis, our Cash Flow Cushion may deteriorate and stress the current rating. Additionally, the rating may be pressured by large leveraging transactions, such as heavy business development or aggressive share repurchases that significantly stress leverage over the long run and tamps down our Solvency Score pillar.

Recent Notes Published by Credit Analysts

Valeant Issues \$1 Billion of Private Unsecured Notes and Tenders for \$1 Billion of Existing Notes

Market Data

Valeant Pharmaceuticals International, Inc. (B-, negative) is in the market with a proposed private offering of \$1 billion in unsecured senior notes maturing in 2025. According to its press release Dec. 4, net proceeds will be used to fund a cash tender offer (announced the same day) for up to \$1 billion of aggregate principal amount of its outstanding 5.38% senior notes due 2020 and Valeant Pharmaceuticals International's outstanding 7.00% senior notes due 2020 and 6.38% senior notes due 2020. The firm also intends to reduce \$175 million in outstanding borrowings against its revolving credit agreement.

We compare Valeant's unsecured 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 (B, negative) and healthcare provider Tenet Healthcare Corp (B-, stable). Valeant's unsecured bonds recently traded tighter than Endo's bonds by around 170 basis points and close to those at Tenet. All bond data is sourced from Interactive Data, which can be seen as follows:

Valeant's 6.13% notes due in 2025 at 85.75, yield to maturity of 8.79%, and spread to maturity of +649 basis points.

Endo's 6.00% notes due in 2025 at 77.75, yield to maturity of 10.50%, and spread to maturity of +820 basis points.

Tenet's 7.00% notes due in 2025 at 90.50, yield to worst of 8.72%, and spread to worst of +640 basis points.

MCR Credit Risk Assessment

Valeant is in the midst of reducing a highly elevated debt leverage profile (a remnant from its prior rollup strategy from 2010 to 2015) over the next few years. Since Valeant made its initial statement in August 2016 that it would reduce debt by \$5 billion over the course of 18 months (or February 2018), it has reduced its total debt load by \$3.39 billion, composed of \$969 million repaid in the second half of 2016 and \$2.42 billion in the first nine months of 2017. Into the fourth quarter, the firm further decreased its debt burden with repayment of \$1.05 billion in secured term loans using proceeds from the iNova divestment and cash flows and refinanced \$1 billion of senior notes due in 2020 with secured private-placement bonds. Considering the added term loan reduction, total debt reduction totaled \$4.44 billion, nearing Valeant's \$5 billion target. Valeant believes it has already satisfied its debt-reduction goal, but it includes debt repayment of \$847 million that occurred in the second quarter of 2016, before setting its target. The total debt balance stood at \$27.43 billion on Sept. 30, or gross debt leverage (total debt/adjusted EBITDA) of 7.2 times for the trailing 12 months. With Valeant's growing cash and investments of \$1.97 billion, net debt leverage was 6.7 times.

While our negative outlook reflects our view that the firm may have trouble further reducing total debt, we are much less skeptical that Valeant can achieve its original debt-reduction goal, given free cash flow that we expect to average \$1.3 billion over the next five years, as well as other assets slated for

divestment in the near term, namely Sprout Pharmaceuticals. The firm has plenty of breathing room to repair its businesses, given that it has satisfied all of its mandatory term loan amortization and has no significant debt maturities through 2020. In addition, it is no longer restricted by a maximum secured leverage covenant in its amended term loan agreement, but is bound to maintaining this leverage at or below 3.00 times in its revolving credit facility. Secured leverage stood at 2.5 times for the latest 12 months at the end of the third quarter, by our estimation. The firm also has leeway under a minimum interest coverage covenant of 1.50 times in its revolver, given that the measure stood at 2.1 times for the trailing 12 months ended Sept. 30.

Valeant is contending with operational underperformance that includes lower-than-expected results from its dermatology business and recent divestitures (iNova, Dendreon, and skin care brands CerAve, AcneFree, and Ambi). Incorporating continued pressure on the dermatology business and recent divestitures (Dendreon, iNova, its skin-care brands, and Obagi), the firm lowered its outlook for sales for 2017 to \$8.65 billion-\$8.80 billion from \$8.7 billion-\$8.9 billion on its second-quarter teleconference (and from \$8.9 billion-\$9.1 billion originally). However, Valeant maintained its expectation for adjusted EBITDA of \$3.60 billion-\$3.75 billion, despite the asset sales. We still think Valeant can achieve revenue growth in the low single digits compounded annually through 2021, given its corporate portfolio, which 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.

Duke Realty Issuing New 10-Year Bonds to Repay Revolver and for General Purposes

Market Data

Duke Realty Corporation (BBB+, stable) is reportedly in the market with a \$300 million 10-year senior unsecured offering. The issuer is Duke Realty LP. Net proceeds are expected to be used to pay down outstanding borrowings on the firm's \$1.2 billion revolving credit facility, and the balance will be for general corporate purposes. Duke Realty also filed a preliminary supplement to the prospectus dated April 30, 2015.

Duke Realty's rated industrial real estate investment trust peers are Prologis, Inc. (A-, stable) and Liberty Property Trust (BBB, stable). The following pricing data is from Interactive Data. In the 10-year area, spreads over the nearest Treasury from these issuers were:

Prologis' \$750 million 3.75% bonds due in 2025 at +69 basis points.

Duke Realty's \$375 million 3.25% bonds due 2026 at +104 basis points.

Liberty Property's \$400 million 3.25% bonds due 2026 at +112 basis points.

The Morningstar BBB+ Corporate Bond Index is currently priced at +123 basis points.

MCR Credit Risk Assessment

We launched coverage on Duke Realty with a BBB+ rating and a stable outlook in October 2017, which was supported by solid Business Risk and Cash Flow Cushion pillars, which are somewhat curbed by a weaker Solvency Score. Contributing to Business Risk is Duke's high-quality, largely unencumbered portfolio of bulk warehouse facilities, which is uniquely positioned to capture robust e-commerce demand. At an average age of 11 years, Duke's portfolio is the youngest among its peers; it is also among the largest in terms of average facility size, which results in lower capital expenditure and tends to draw higher-credit tenants with lower turnover. Larger average building size can also drive higher rent levels upon renewal. We believe that credit is further supported by some of the lowest leverage metrics among its industrial REIT peers, in particular debt/EBITDA and secured leverage.

The increase in debt would result in debt/EBITDA increasing to 5.3 from 4.9 times before any EBITDA contribution from related investment activity and is in line with our expectations given that the company was at the low end of its targeted leverage range. We expect Duke will prudently manage acquisition and development spending, primarily utilizing proceeds from dispositions, augmented by a combination of debt, equity, and internally generated cash as necessary. Should Duke approach \$1 billion in EBITDA while making meaningful strides in terms of portfolio quality, such as higher average rents and a relatively smaller noncore portfolio, we may consider upgrading the credit rating. Conversely, in the case of a reversal in its commitment to unsecured borrowing and an unencumbered portfolio, or excessive development risk—which we would view as its development pipeline at around 20% of total assets—neither of which we currently expect, we would likely downgrade the credit rating.

DaVita Selling DMG Segment to UnitedHealth's Optum Unit*MCR Credit Risk Assessment*

On Dec. 5, DaVita Inc (BB+, negative) announced plans to sell its DaVita Medical Group (DMG) segment to UnitedHealth Group Inc (non-NRSRO rating A-, negative) for \$4.9 billion in cash. This transaction is scheduled to close in 2018. At first glance, we do not expect this deal to significantly change our credit views of either firm involved in the transaction.

From DaVita's perspective, this divestiture appears strategically sound given the continued struggles of the DMG division under its ownership since purchasing Healthcare Partners in 2012 for \$4.4 billion. Notably, when DaVita released its third-quarter results in November, ongoing weakness in the DMG segment caused the firm to underperform expectations for the quarter and cut its outlook for 2017. Specifically, the DMG segment reported a net revenue decline of nearly 2% year over year to \$1.2 billion and an operating loss of \$5 million on an adjusted basis. Given these results, management reduced its 2017 adjusted operating income guidance for the segment to \$50 million-\$85 million from \$110 million-\$150 million previously on higher-than-expected medical costs related to patient acuity and a delay in a Medicare-related payment relative to the third quarter of 2016. On the third-quarter call, management said all options were on the table for the struggling DMG segment, and that has come to fruition with this sale announcement.

With the proceeds from this planned divestiture, DaVita plans to reduce debt and make share repurchases. As of September, its net leverage stood at 3.4 times by our estimates, or near the top end of its 3.0-3.5 times target range. Planned debt reduction with these divestiture proceeds could help push leverage down a bit and strengthen DaVita's currently weak position in the BB+ rating category. As of November, the firm was authorized to repurchase \$1.2 billion in shares, and we would not be surprised to see that authorization rise substantially, given the company's plan to make large share repurchases in the next couple of years with this divestiture's proceeds.

In regards to UnitedHealth Group, the deal is a bit puzzling, given the weak performance at DMG. However, the company's OptumCare segment has a history of acquiring and successfully integrating smaller medical providers, and the deal is relatively small compared with UnitedHealth Group's overall size (roughly \$214 billion market capitalization). Seeing as how the deal will be financed on an all-cash basis, potential debt issuance could modestly raise UnitedHealth Group's debt/trailing 12-month EBITDA to around 2.0-2.1 times and debt/capital to 40%-42%, which is within our current range of expectations for the company's financial leverage.

Market Data

In the healthcare services sector, we compare DaVita's bonds with bonds from HCA Healthcare Inc (BB, stable). DaVita's bonds recently traded at a wider yield than similar bonds from HCA. All of the following bond data was sourced from Interactive Data.

DaVita's 5.00% notes due 2025 at 99.72, a yield to maturity of 5.04%, and a spread to maturity of +273 basis points.

HCA's 5.88% notes due 2026 at 106.38, a yield to worst (2025 call date) of 4.87%, and a spread to worst of +255 basis points.

Martin Marietta Materials Issuing \$1.4 Billion in Notes to Fund Acquisition

Market Data

Martin Marietta Materials Inc. (BBB-, stable) is reportedly in the market Dec. 6 issuing \$1.4 billion in notes to fund its acquisition of Bluegrass Materials and for refinancing its \$300 million 6.6% notes due 2018. The issuance's tenors will be 2-year floating rate notes, 10-year notes, and 30-year notes.

According to Interactive Data, Martin Marietta's 3.45% notes due June 1, 2027, recently traded at a spread of +121 basis points to the nearest Treasury. Similar-rated competitor Vulcan Materials' (BBB-, stable) 3.9% notes due April 1, 2027, recently traded at a spread of +125 basis points. For an index comparison, we look to the Morningstar BBB- Corporate Bond Index, which is at a spread of +157 basis points.

MCR Credit Risk Assessment

Martin Marietta's rating reflects its high risk profile for its Business Risk and moderate risk profile for its Cash Flow Cushion offset by low risk profiles for its Solvency Score and Distance to Default. The company's business risk is negatively affected primarily by a combination of its product concentration

and industry cyclicalities. The company does possess a narrow moat, as assigned by Morningstar's Equity Research Group, which factors positively into its Business Risk. As the second-largest producer of construction aggregates in the U.S., Martin Marietta is somewhat protected from new competition by high barriers to entry and the costs of building new quarries, which is the basis for its narrow moat. The firm consistently produces free cash flow and we expect that to continue.

The Bluegrass Materials acquisition for \$1.6 billion will add 23 active sites across Georgia, South Carolina, Maryland, Kentucky, and Tennessee. We estimate that after closing, the acquisition will raise debt/EBITDA to approximately 3.0 times from approximately 1.8 times as of Sept. 30. Management has stated it intends to get to its targeted debt/EBITDA level of 2.0-2.5 times approximately 12-18 months after the transaction closes.

Baker Hughes Issuing New 144A Notes to Fund Tender and Share Buybacks

Market Data

Baker Hughes, a GE Co. (BBB+, stable) is reportedly in the market Dec. 6 with a 144A offering of 5-, 10-, and 30-year notes. Proceeds will be used to fund a cash tender offer (announced on Dec. 4) for up to \$897 million aggregate principal amount of certain outstanding debt securities and for general corporate purposes, including a share buyback. The tender offers consist of offers to purchase for cash: \$197 million of 6.00% senior notes due 2018, \$525 million of 7.50% senior notes due 2018, and up to \$175.0 million in aggregate of \$113 million of 8.55% debentures due 2024 and \$306 million of 6.875% notes due 2029. A sweetened early tender offer provision (which expires Dec. 15) encourages holders of the existing 2024 and 2029 notes to participate in the tender. The tender offer for the 2018 notes expires Dec. 10, and the tender offer for the 2024 and 2029 notes expires Jan. 2, 2018. In effect, the private offering would allow Baker Hughes to push out debt maturity to a later date.

For market comparables, we reference Schlumberger Ltd. (A+, stable) and Halliburton Co. (BBB+, stable), large, diversified oilfield service peers. We also include National Oilwell Varco Inc. (BBB+, negative), a smaller, more focused oilfield service peer. The following market pricing data was sourced from pricing service Interactive Data as of Dec. 6.

In the 5-year area, comparable issues are indicated as follows:

Schlumberger 2.40% notes due 2022 at +46 basis points.

Baker Hughes 3.20% notes due 2021 at +52 basis points.

Halliburton 3.25% notes due 2021 at +57 basis points.

National Oilwell Varco 2.60% notes due 2022 at +87 basis points.

In the 10-year area, comparable issues are indicated as follows:

Halliburton 3.80% notes due 2025 at +101 basis points.

Morningstar's BBB+ Corporate Bond Index is at +123 basis points.

In the 30-year area, comparable issues are indicated as follows:

Baker Hughes 5.13% notes due 2040 at +126 basis points.

Halliburton 4.50% notes due 2041 at +156 basis points.

National Oilwell Varco 3.95% notes due 2042 at +206 basis points.

MCR Credit Risk Assessment

Our BBB+ credit rating on newly formed Baker Hughes reflects the company's global standing as a leading integrated supplier of oilfield product and service offerings, downstream equipment, and digital technology. With many decades of experience, the company's long-standing reputation as an innovator and technology leader engenders strong customer relationships and ensures a steady stream of business. The company's large size, leading segment market shares, and solid Cash Flow Cushion help offset a no-moat rating (as assigned by Morningstar's Equity Research Group), product and customer concentration, and end-market cyclicalities, placing overall Business Risk near the middle of the spectrum.

Regarding leverage, we estimate the ratio of total debt/trailing EBITDA gradually declining to 1.2 times by 2022 from about 2 times at year-end 2017. We forecast revenue to grow at a gradual (4%) rate per year and EBITDA margins to expand to 13% in 2022 from 12% in 2017 as the company benefits from an eventual rebound in global oilfield service activity and ongoing merger synergies. After capital expenditures and dividends, we estimate Baker Hughes will be free cash flow positive through 2022.

Our rating outlook is stable and assumes Baker Hughes is able to incrementally reduce its financial leverage as merger-related synergies are realized and global demand and the pricing outlook for oilfield services gradually improve. However, the rating could be revised higher if the oilfield services recovery or merger synergies progress at a faster-than-expected rate, allowing the company to accelerate debt reduction. We do not currently envision a scenario where we would downgrade our rating in the near term. However, our rating could come under pressure if profitability improvements do not materialize, or if the company engages in a large share-repurchase program funded with debt, which could negatively affect our Cash Flow Cushion and Solvency scores.

Federal Realty Issuing New 10-Year Bonds to Redeem Notes

Market Data

Federal Realty Investment Trust (A-, stable) is in the market Dec. 7 with a \$150 million 10-year senior unsecured offering. The notes represent a follow-on issuance of Federal Realty's 3.25% notes due 2027, \$300 million of which were previously issued in June and will become part of the same series. According to the company's regulatory filing Dec. 7, the net proceeds will be used to redeem the firm's \$150 million 5.90% notes due April 1, 2020. Any remaining proceeds will be used for general corporate purposes. Federal Realty on Dec. 7 filed a preliminary supplement to the prospectus dated May 8, 2015.

Federal Realty's rated retail REIT peers are Kimco Realty Corporation (BBB+, stable), Regency Centers Corporation (BBB+, stable) and Weingarten Realty Investors (BBB, stable). The following pricing data is from Interactive Data as of Dec. 6.

In the 10-year area, spreads over the nearest Treasury from these issuers are:

Kimco's \$400 million 3.8% bonds due 2027 at +132 basis points.

Regency Center's \$350 million 3.6% bonds due 2027 at +124 basis points.

Weingarten's \$250 million 3.25% bonds due 2026 at +142 basis points.

The Morningstar A- Corporate Bond Index is currently priced at +87 basis points.

MCR Credit Risk Assessment

We launched coverage on Federal Realty on Nov. 10 with an A- rating and a stable outlook. Our rating is reinforced by Federal's very high-quality portfolio of shopping centers and mixed-use projects combined with an experienced and conservative management team that drives a strong Business Risk pillar relative to its retail peers as well as other REITs. The rating is further supported by a strong Cash Flow Cushion, which benefits from an unencumbered portfolio of top-quality assets. However, Business Risk and Cash Flow Cushion are somewhat offset by a modestly weaker Solvency Score, which is driven by modestly higher leverage and lower coverage metrics.

Despite the relatively low number of locations represented in Federal Realty's portfolio compared with more geographically diversified peers, these affluent and densely populated metro markets represent between one third and two fifths of all retail spending in the United States.

We do not foresee improvement in Federal Realty's rating. In our view, an upgrade would probably require significant increases in size and diversity to achieve meaningful improvement in what is already among the highest scores in Business Risk. Our rating assumes improvements in components of Federal Realty's Solvency Score, capital structure and interest coverage, as current development projects are completed. Barring these improvements, likely from missteps with the REIT's high-profile mixed-use developments, which would also suggest deterioration in factors affecting Business Risk, we would probably downgrade the rating. ■■

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