Morningstar Corporate Credit Research Highlights

Corporate Credit Spreads Return to Multi-Year Lows: Next Move Will Be Determined by Earnings and Guidance

Morningstar Credit Ratings, LLC
24 October 2016

Credit Market Insights

- Market Data and Insights

Credit Rating Actions

- Rating Affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
AT&T T	BBB	BBB
Verizon Communication VZ	BBB	BBB
Ecolab ECL	BBB+	BBB+
Northrop Grumman NOC	A-	A-
Rockwell Collins COL	A-	A-
Eastman Chemical EMN	BBB	BBB

Recent Notes Published by Credit Analysts

- **Citigroup** Offering New 10-Year Senior Notes
- Despite Challenges, **Wells Fargo** Reports Solid Third-Quarter Results
- Glimpsing Its Potential, **Bank of America** Reports Solid Third-Quarter Results
- **Hasbro** Reports Solid Third-Quarter Results
- **Wells Fargo** Offering New 10-Year Senior Notes
- **Netflix** Reports Third-Quarter Sub Upside Surprise; Cash Flow Remains Burdened by Content Investment
- **Nike** Offering 10- and 30-Year Senior Notes
- **Johnson & Johnson** Reports Solid Performance as U.S. Biosimilar Remicade Nears
- **IBM** Reports Stronger Free Cash Flow; Management Backs Off of Share Repurchases
- **Mondelez** Offering 3-Year and 5-Year Senior Notes to Fund Tender Offer
- **Goldman** Reports Strong Third Quarter Results on Higher Trading Revenue
- **UPS** Offering 10- and 30-Year Notes
- **Philip Morris** Reports Respectable Q3 Results; Battles Contraction, Excise Taxes, and Currency
- **Abbott** Turns in Solid Third Quarter and Gears Up for St. Jude Acquisition
- **Intel**'s Positive Third-Quarter Results Overshadowed by Cautious Fourth-Quarter Guidance
- **Morgan Stanley**'s Third-Quarter Results Show Improvement but Trail Key Peers
- **Dover** Reports Third-Quarter Earnings
- **Halliburton** 3Q Results Better Than Expected; Modest Rebound Led by North American Land Activity
- And many more

Credit Market Insights

Market Data and Insights

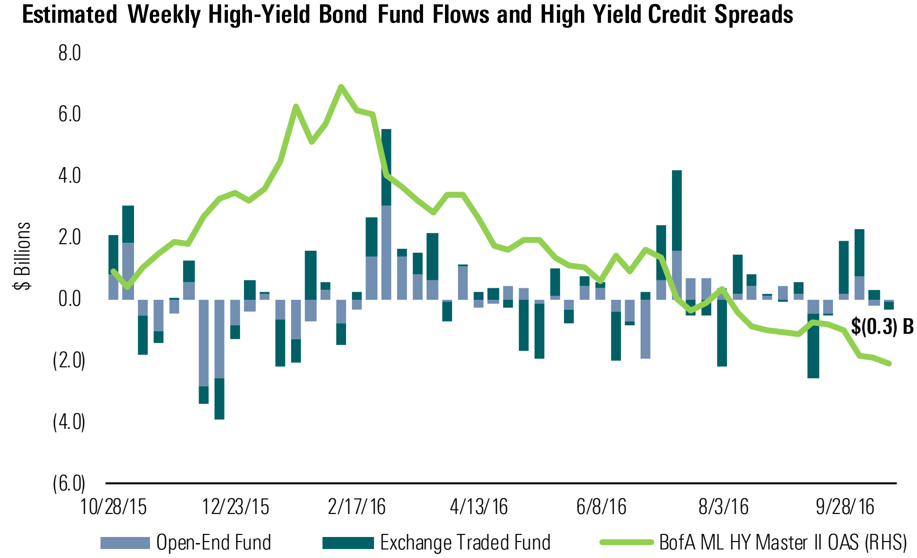
Corporate credit spreads have fully recovered from the panic that gripped the corporate bond markets in early 2016 when oil and commodity prices were hitting multi-year lows. Both the average spread of the Morningstar Corporate Bond Index and the Bank of America Merrill Lynch High Yield Master Index have tightened to multi-year lows, touching the tightest levels that credit spreads have traded at since mid-2015. Within the indexes, energy and basic materials have been some of the best performing sectors year-to-date as oil prices have recovered to back over $50 per barrel and commodity prices in general have risen off their lows and stabilized.

After rising the prior week, interest rates declined last week and returned to the same levels they traded at two weeks ago. The yield on the 5-year Treasury declined 5 basis points to 1.24%, the yield on the 10-year fell 7 basis points to 1.73%, and 30-year decreased 8 basis points to 2.48%. Part of the impetus for interest rates to decline was driven by commentary from ECB President Mario Draghi after the ECB's October monetary policy meeting. With the prospect of the Fed potentially raising the federal-funds rate in December, market participants were beginning to become more concerned about the possibility of tighter global monetary policy. However, these concerns were partially put to rest as the ECB appears to be poised to continue to supply additional liquidity to the global bond markets. Draghi specifically stated that the ECB's monthly asset purchase program would continue to run through March 2017 as scheduled. Further, he stated that a sudden stop to the quantitative easing program "is not in anybody's mind." Considering the ECB pledged to continue its full EUR80 billion per month asset purchase program and is not contemplating an immediate stop to the program at the end of March, then it appears that there remains a much longer runway of monetary stimulus to come.

The new issue corporate bond market began to come back to life last week after slowing markedly in early October. As corporations have begun to release their earnings reports and exit their quiet periods, many management teams have looked to capitalize on the combination of low interest rates and tight credit spreads. With the U.S. presidential election closing in fast, many CFOs may look to lock up funding before any heightened uncertainty may impact the new issue window to the market. In addition, several large acquisitions remain that will require a substantial amount of funding in the debt capital markets. For a list of issuers that we believe may look to tap the debt capital markets in the near term, please refer to our Oct. 20, 2016, publication, "Potential New Issue Supply."

High yield fund inflows slipped into negative territory last week as $300 million of funds were pulled from open end mutual funds and ETF's. However, as compared with typical amount of fund flows, this amount is not meaningful enough to indicate a change in the trajectory of the market. With third-quarter earnings still in early stages, it appears that the market is taking a wait and see attitude to hear from management teams as to the outlook for the fourth quarter before making any investment decisions prior to either committing additional funds or withdrawing funds from this asset class.

Corporate Index Spreads



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

Exhibit 1 Morningstar Credit New Issue Monitor
Week ended Oct. 21, 2016
(000,000s $ unless otherwise noted)

Issuer			Issue				
Name	Ticker	Morningstar Corporate Rating	Size	Coupon	Description	Maturity	Approx Spread to US Treasuries
Bank of America	BAC	BBB	$2,000	2.50%	Senior Notes	2022	+127
Bank of America	BAC	BBB	$500	FLT	Senior Notes	2022	NA
Bank of America	BAC	BBB	$2,500	3.25%	Senior Notes	2027	+150
Citigroup	C	A	€ 1,750	0.75%	Senior Notes	2023	+118(2)
Citigroup	C	A	$3,000	3.20%	Senior Notes	2026	+145
Citigroup	C	A	€ 1,000	1.50%	Senior Notes	2028	+148(2)
JPMorgan Chase	JPM	A-	$2,000	FLT	Senior Notes	2023	NA
Mondelez International Holding Netherlands	MDLZ	BBB(1)	€ 1,750	1.63%	Senior Notes	2019	+75(2)
Mondelez International Holding Netherlands	MDLZ	BBB(1)	€ 500	FLT	Senior Notes	2019	NA
Mondelez International Holding Netherlands	MDLZ	BBB(1)	€ 1,500	2.00%	Senior Notes	2021	+85(2)
Nike	NIKE	AA-	$1,000	2.38%	Senior Notes	2026	+65
Nike	NIKE	AA-	$500	3.38%	Senior Notes	2046	+93
Sprint Spectrum	S	B(1)	$3,500	3.36%	Senior Notes	2021	NA
United Parcel Service	UPS	A+	€ 500	1.00%	Senior Notes	2028	+99(2)
United Parcel Service	UPS	A+	$500	3.40%	Senior Notes	2046	+93
Wells Fargo	WFC	A	$1,000	2.51%	Senior Notes	2023	+164

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

(3) Spread over mid-swaps.

Credit Rating Actions

► Rating Affirmations

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Northrop Grumman NOC	A-	A-
Rockwell Collins COL	A-	A-
Eastman Chemical EMN	BBB	BBB

Affirming AT&T With a Negative Outlook; Financial Flexibility Remains Pressured

Morningstar Credit Ratings is affirming the corporate credit rating of AT&T at BBB but shifting the outlook to negative from stable. MCR's rating reflects the carrier's recent acquisition spree, including an $18 billion purchase of wireless spectrum and the acquisition of DirecTV last year. AT&T's Business Risk has improved modestly since our last review, but has been offset by deterioration in Cash Flow Cushion from a higher volume of intermediate-term debt maturities and a decline in cash reserves.

AT&T has added about $45 billion of net debt over the past two years, while annual EBITDA has increased just $12 billion over the same period. At June quarter-end, net leverage stood at 2.3 times EBITDA compared with 1.8 times at the end of June 2014. We continue to view management's commitment to paying and increasing its common dividend, which represents the largest use of free cash flow, as the most significant impediment to debt reduction. Over the next five years, we project cumulative free cash flow of $32 billion, net of dividends. Over the same period, $46 billion of debt is scheduled to mature, including $7.4 billion over the next 12 months. Even with some modest growth in free cash flow, we still consider it likely that AT&T intends to refinance a good amount of these maturities, particularly if borrowing costs remain low. Assuming modest growth in revenue and an eventual moderation in capital spending, we expect net leverage to gradually decline to 2.0 times by 2018 from its current level of 2.4 times. However, if revenue growth deteriorates or capital spending remains elevated, we would not expect a material improvement in leverage.

Competitively, AT&T continues to hold a solid position in the U.S. telecom market, especially in the wireless business, a position which supports Morningstar, Inc.'s narrow moat. However, we believe intense competition will continue to drive elevated capital spending, overshadowing our forecast of 3% to 4% top-line wireless growth and gradual margin improvement. We also expect the secular decline in fixed-line revenue to remain a modest drag on revenue. In consumer and entertainment, we currently forecast modest revenue growth in the segment through higher revenue per customer despite our expectation of a net decline in satellite customers over the next few years.

Our negative outlook reflects our view that AT&T's financial flexibility is likely to remain pressured by a high dividend payout and significant debt maturities. We are unlikely to upgrade the rating without a meaningful reduction in debt or improvement in net cash flow. We may consider a further downgrade of our credit rating if management continues to pursue debt-financed acquisitions or if operating results deteriorate significantly from our forecast of 1% to 2% revenue growth and margin improvement to 18% by 2020.

Verizon Affirmed at BBB, Stable Outlook; Financial Flexibility Looks Solid Despite Acquisition
Morningstar Credit Ratings is affirming its BBB corporate credit rating on Verizon Communications and initiating a stable outlook. Our rating on Verizon reflects its dominant position in U.S. wireless telecommunications, supported by high brand awareness, extensive investment in spectrum blocks across the U.S., and generally stable postpaid customer growth. Despite stable Business Risk, Verizon's Cash Flow Cushion and Solvency Score remain constrained by debt incurred to fund the acquisition of a minority portion of its wireless business from Vodafone in 2013. Verizon Wireless is the largest U.S.-based wireless network, with 107 million retail connections. With intense competition in U.S. wireless, we expect wireless revenue growth to average about 1% over the next five years. Meanwhile, we expect fixed-line revenue, now 26% of revenue, to remain flat to down slightly while we expect other revenue to grow to about 8% of revenue by 2020 as a result of acquisitions and organic growth from AOL.

During the third quarter, Verizon announced that it agreed to acquire the Internet businesses from Yahoo (not rated) for $4.8 billion. Subsequently, Yahoo disclosed a security breach of its subscriber database and Verizon is now arguing that the material adverse change clause of the merger contract may have been triggered. If so, we believe this may result in a renegotiation of deal terms or termination of the merger. Verizon also announced a $2.4 billion acquisition of Fleetmatics (not rated), a provider of fleet management services.

Assuming for now that the acquisitions are completed in line with the announced terms, we expect the assets to contribute between $400 million and $450 million of annual EBITDA, collectively, based on reported trailing 12-month results. The acquisitions are consistent with management's focus on attracting long-term growth away from its wireless subscriber businesses and leveraging its expansive wireless network investments to provide alternative services. However, we believe it will take a while to nurture these businesses into meaningful revenue and profit contributors. In the meantime, we expect management to continue to prioritize cash flow usage toward other strategic acquisitions, including additional wireless spectrum.

Verizon's net debt ended the June quarter at $97 billion, following the early retirement of $10.5 billion of debt using proceeds from its recent divestiture of wireline assets to Frontier Communications (rating: BB-). If completed, we expect Yahoo and Fleetmatics to add back between $5 billion and $7 billion of net debt, taking net leverage back to around 2.4 times. We also expect Verizon to borrow to bid on the wireless broadcast spectrum auction currently underway, which may temporarily drive leverage above 2.5 times. Over the next five years, Verizon faces $26.4 billion of scheduled debt maturities, which we calculate should be manageable given our forecast of $46.5 billion of cumulative net cash flow after projected dividends during this period.

Our outlook is based on our operating forecast of 2% annual revenue growth over the next five years, in conjunction with average operating margin of 25% and free cash flow averaging around $20 billion per year. We may consider an upgrade of Verizon's credit rating if management reduces leverage below 2.0

times EBITDA within the next five years. Conversely, we may consider a downgrade of the rating if the company abandons balance sheet discipline to pursue additional acquisitions, particularly if cash flow begins to decline meaningfully.

Ecolab Affirmed at BBB+; Moving to a Positive Outlook

We are affirming Ecolab's corporate credit rating at BBB+. We are also shifting our outlook to positive from stable.

Ecolab's rating reflects its strong competitive positions in its institutional and industrial business segments, its consistent free cash flow profile, and the company's moderate balance sheet leverage. Ecolab possesses a narrow economic moat as assigned by Morningstar Inc., which is due to the company's stability and free cash flow generation that arises from its strong market positions in the institutional and industrial markets it serves. These segments offer customers global scale and breadth for cleaning, sanitation and water processing services, and application products. The company's balance sheet debt as of June 30 was $6.9 billion, and its LTM Adjusted EBITDA was approximately $2.9 billion, resulting in debt/LTM adjusted EBITDA of 2.4 times. Off-balance sheet liabilities include approximately $270 million in annual operating leases and nearly $1 billion in pension and post-retirement healthcare liabilities that result in expectations for adjusted debt/EBITDAR of approximately 3 times for 2016. Free cash flow for the latest 12-month period was a robust $1.5 billion with dividends and share repurchases consuming approximately $1 billion of that over the same time period. Notwithstanding the strong free cash flow, the company's energy segment has been weak with first half 2016 sales in this segment down 14% on a fixed currency basis and down 20% on a reported basis versus 2015's first half. Overall, Ecolab's first-half results have been negatively impacted by the weak energy segment with total revenue up only 1% on a fixed currency basis and down 4% on a reported basis.

Going forward, we expect Ecolab to return to modest low-single-digit revenue growth and maintain existing margins. We also expect Ecolab to continue to produce robust free cash flow and that debt/EBITDA will remain slightly above 2 times.

The positive outlook reflects the potential for the rating to be raised over the next 12-24 months. The rating could be upgraded if the company's revenue and cash flow exceed our expectations with existing debt levels or if the company decides to lower its leverage on a permanent basis. These could benefit our Cash Flow Cushion and Solvency Scores. The rating could also improve if we reassess the company's Business Risk to be lower, potentially driven by an upgrade in its economic moat to wide. On the other hand, the rating could be downgraded if we believed leverage would be above our expectations on a consistent basis or if cash flow significantly undershoots our forecasts.

Northrop Grumman's Credit Rating Affirmed at A- and a Stable Outlook Established

We are affirming our A- corporate credit rating on Northrop Grumman, based on its solid business position as a leading defense contractor offset by moderate leverage. We are also establishing a stable outlook.

Northrop's rating reflects its position as one of the largest U.S. defense contractors. Its focus on businesses that can cross-utilize knowledge and capabilities results in a more efficient cost structure. The company has good product diversity including strong positions in programs such as the F-35 and UAVs. In our view, the new B-21 long-range strike bomber--a potentially $80 billion program--enhances the company’s portfolio strength. The firm's Business Risk captures the company's narrow economic moat rating, assigned by Morningstar, Inc., driven by its long history of serving the Department of Defense. Business Risk also reflects a medium uncertainty rating and generally low cyclicality of operating results.

However, Northrop’s substantial share repurchases and addition of debt over the past few years offsets the company’s competitive strengths. Since 2012, gross debt/EBITDA increased from 1 to 2 times, while net debt also increased by about a turn. Total debt ended June at $6.4 billion, compared with $3.9 billion at the end of 2012, with almost $9 billion of share repurchases during that time frame. As a result, Northrop’s rating has become more weakly positioned in the rating category, in our view. However, in the years ahead, we expect credit metrics to stabilize as revenue conditions improve, which should mitigate the firm’s multibillion-dollar share-repurchase authorization. We expect Northrop to show low-single-digit top-line growth as defense budgets reverse after years of decline, along with stable operating margins in the low teens, which should drive modest growth in EBITDA and annual free cash flow of over $1.5 billion. We expect dividends to consume over $600 million of free cash flow, and we expect generally stable debt levels. Underfunded pension plans exceeding $5 billion add well over a turn of additional leverage, although this could decline if interest rates rise. The Cash Flow Cushion reflects Northrop's strong cash generation but also meaningful debt maturities and dividends over our forecast horizon. Acquisitions have tapered off considerably during the past several years, as management has focused on improving profitability.

With the rating positioned at the weak end of the category, we will continue to monitor management's financial discipline regarding even more aggressive share repurchases. If leverage moves modestly higher from here, it may negatively affect our Solvency Score, which would pressure our rating. A meaningful debt-funded acquisition or an asset sale with all proceeds delivered to shareholders could also result in a ratings downgrade. An upgrade is unlikely, but could occur should the company take on a much more conservative financial profile, including debt reduction or more aggressive funding of the pension liability, resulting in meaningfully lower adjusted leverage.

Rockwell Collins Credit Rating Affirmed at A- and a Stable Outlook Established

We are affirming our A- corporate credit rating on Rockwell Collins and establishing a stable outlook. Our credit rating considers Rockwell Collins’ solid business position as a leading supplier of avionics, flight control, communication, and navigation systems. These products, which feed into the commercial, business jet, and defense sectors, typically enjoy high switching costs, strong margins, and solid returns on invested capital. The diversification of end-market users, including the more recent move into information management services, supports the firm’s Business Risk score.

Morningstar Inc. assigns Collins a narrow economic moat driven by the high cost of switching suppliers for the long-term programs to which the firm typically contributes. Collins’ products typically require a certification process, which we believe would be difficult to overcome for new competitors. Further, the intangible asset of its name and reputation as a reliable supplier of critical components to aircraft manufacturers over many decades provides an additional source of competitive advantage and sets a higher barrier to entry. Still, Collins' Business Risk is tempered by its modest size relative to much larger customers as well as the cyclicality inherent in the commercial products side of its business.

Our operating forecast assumes Collins will produce low-single-digit revenue growth over the next five years fueled by renewed growth on the defense side of the business and offset by softness in the business jet market. We expect the large commercial aircraft market to remain solid, although with more tempered growth than in recent years. Historically, Collins has proven adept at generating strong and stable free cash flow throughout the cycle, which we view as a key rating consideration. We expect free cash to comfortably exceed $500 million annually throughout our forecast horizon, though our Cash Flow Cushion is tempered by annual dividends of about $175 million and growing, along with meaningful debt maturities in the next three years. We also expect ongoing share repurchases to continue to absorb any remaining free cash flow. All-in, we expect debt to EBITDA to remain at almost 2 times with total debt in the $2.0 to 2.5 billion range. Including underfunded pensions of over $1 billion, we estimate pension-adjusted leverage will be higher by almost a turn. Finally, we view Collins' healthy operating margins of nearly 20% and double-digit returns on invested capital as supportive of the Solvency Score.

Our stable outlook suggests we do not anticipate a ratings action in the foreseeable future. However, our rating could increase if the firm dedicates more cash to overall debt retirement, which could benefit the Solvency Score and Cash Flow Cushion. If leverage is lowered below 1.5 times on a sustainable basis we may consider an upgrade. On the other hand, if the firm gets more aggressive with capital allocation funded with debt, including acquisitions and returns of capital to shareholders, and leverage is sustained above 2 times, we could consider a downgrade.

Eastman Chemical Affirmed at BBB and a Stable Outlook Assigned

Morningstar Credit Ratings, LLC, is affirming its credit rating of Eastman Chemical at BBB, which reflects its competitive position in the chemicals industry and its financial policies. In addition, a stable outlook is being assigned.

The rating reflects the company's position in key end-user markets, its diversity of chemical products, its low-cost integrated production profile along the acetyl, polyester, and olefin chains, and its moderate financial leverage. Our rating also considers the competitive nature of the chemical industry, the potential impact of raw material cost increases, and the cyclicality of Eastman's end markets. These factors result in moderate risk scores for the company's Business Risk, Cash Flow Cushion, and Solvency Score. Although Eastman is currently experiencing weakness in its business segments, particularly its chemicals intermediates segment, we believe that the company will still be robustly free cash flow positive this year. For 2016, we still expect free cash flow of approximately $900 million. We forecast that Eastman's debt balance will end 2016 at approximately $6.5 billion-$6.8 billion, resulting in debt/EBITDA of approximately 3 times. We forecast leverage will decrease to 2-2.5 times over the next few years and that FCF will average $900 million-$1 billion annually. Our forecasts assume a return to mid-single-digit revenue growth and EBITDA margins of 23%-25%. While Eastman's business segments exhibit competitive advantages, such as the large acetate tow unit, it does not possess an economic moat as assigned by Morningstar, Inc. Eastman's strategy is to be a specialty chemical company with consistent earnings growth and strong cash flow. As part of this strategy, it has embarked on debt-financed acquisitions over the past few years and typically pays down debt with free cash flow.

The rating could be upgraded if the company's cash flow improves substantially or if the company operates with lower leverage on a consistent basis. The rating could be downgraded if its Business Risk increases, if cash flow deteriorates, or if debt levels increase.

Recent Notes Published by Credit Analysts

Citigroup Offering New 10-Year Senior Notes

Market News and Data

Citigroup (rating: A-) is reportedly in the market, offering 10-year senior unsecured holding company notes. According to pricing service Advantage Data, bonds from Citigroup and its key comparables were recently indicated as follows over the nearest Treasury:

Citigroup's 3.40% notes due in 2026 at +138 basis points;
JPMorgan Chase's (rating: A-) 2.95% notes due in 2026 at +125 basis points;
Goldman Sachs' (rating: BBB+) 3.75% notes due in 2026 at +149 basis points;
Bank of America's (rating: BBB) 3.50% notes due in 2026 at +137 basis points.

MCR Credit Risk Assessment

Citigroup is the most global of the large U.S. banks. It organizes its operations into a global consumer bank and an institutional client group, which includes transaction services, a scaled-back investment bank, private banking, and commercial lending. Consumer banking generates about 40% of core earnings, while institutional generates 60%. Overall, 40% of earnings come from the faster-growing emerging economies. While these international exposures and Citi's spotty history create event risk, we consider Citigroup's diverse revenue sources a positive factor in our credit assessment. We continue to be impressed with Citigroup's capital buffers and improving credit quality. As of September, tangible common equity/tangible assets lead its peer group at 10.3%, 24 basis points higher than a year ago, while fully phased Basel III common equity Tier 1 finished the quarter at 12.6%, which also compares favorably with global peers. Asset quality has improved, with nonperforming loans representing 0.94% of total loans and the trailing 12-month charge-offs representing around 1.1% of loans, 17 basis points below the year-earlier level. Reserves are solid, representing around 208% of nonperforming loans. Citi has reduced noncore assets that reside in Citi Holdings, which has contributed to the bank's improved asset quality. These assets have shrunk to 3.4% of total assets at year-end, 45% lower than a year ago. Although Citi's profitability metrics in the 12 months ending in September trail global U.S. peers, with a return on average assets of 0.75% and a return on average common equity of 6.5%, we believe that Citigroup is well-positioned in the A- category because of its strong capital measures and generally improving asset quality.

Despite Challenges, Wells Fargo Reports Solid Third-Quarter Results

MCR Credit Risk Assessment

Despite challenges from its highly publicized sales practice scandal, lower interest rates, and evolving regulatory initiatives, Wells Fargo (rating: A) reported solid third-quarter results on Oct. 14. Net income to common shareholders of $5.2 billion, which included higher litigation accruals decreased 3.7% from a strong year-earlier quarter and increased 1.4% sequentially. Total revenue increased 2.1% year over year. Net interest income, the main driver of the improvement, increased 4.3% despite significantly higher interest expense, which was over 55% higher than a year ago because of higher long-term debt levels. Noninterest income was largely unchanged compared with both the linked and year-earlier period despite a 4.9% increase in mortgage banking income. Higher operating expenses--which increased 7.0% year over year on higher compensation and legal expenses--detracted from results. At the segment level, only community banking, the focus of the recent sales practice scandal, reported lower income than a year ago, down 9.4%. The wholesale banking segment, responsible for about 36% of net income, reported results 6.3% higher, while the smaller wealth management, brokerage, and trust segment reported net income 11.7% higher on higher loan balances and increased assets under management.

The quarterly results also reflected improvements in credit quality. Nonperforming assets decreased 9.8% year over year to represent about 1.1% of average loans, 13 basis points lower than a year ago and 11 basis points sequentially. Net charge-offs decreased 12.9% sequentially due largely to lower oil and gas charge-offs, which decreased 36.1% sequentially. Oil and gas loans outstanding decreased 8.0% year over year and 6.4% sequentially to represent just 1.6% of total loans. Allocated reserves cover 8.7% of energy loans, which compares favorably to peers.

On its earnings call, Wells' recently appointed CEO, Tim Sloan, presented a number of internal reviews aimed at assessing and remediating the impact of its sales practices scandal which cost long-time CEO John Stumpf his job. The reviews are in their initial stages, but early analysis shows modest and often hard-to-determine financial damage to the consumer banking segment. Management cited new consumer checking account volumes 25% below year-earlier levels in September and consumer credit cards 20% below year-earlier levels. In quarters to follow, we will focus our attention on revenue trends in consumer banking to better gauge the longer-term damage to Wells Fargo's reputation and ability to continue generating top-tier earnings.

In an absolute sense, Wells Fargo continues to report results that compare favorably to peers. By our calculations, Wells reported an annualized return on common equity for the quarter of 11.8%, well above that of JPMorgan Chase (rating: A-) at 10.1% and Citigroup (rating: A-) at 6.8%. However, the impact of higher debt levels as well as higher operating and regulatory costs is clear in the lower trend in the company's results over time. Wells generated an average return on equity of 13.6% in the three years ending in September 2015 compared with a return of 11.9% in the most recent 12-month period.

Market News and Data

Given its business model, Wells Fargo can be compared to both large regional banks like U.S. Bancorp (rating: A+) as well as global banks. Wells Fargo' 3.00% notes due in 2026 are indicated by pricing service Advantage Data at +124 basis points over the nearest Treasury, while U.S. Bancorp's 2.375% notes due in 2026 are indicated at +91 basis points over the nearest Treasury. JPMorgan's 2.95% due in 2026 are indicated at +125 basis points, while Citigroup's 3.40% notes due in 2026 are indicated at +138 basis points. Meanwhile, 10-year notes of Bank of America, which we rate BBB, are indicated at +136 basis points.

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Hasbro Reports Solid Third-Quarter Results

MCR Credit Risk Assessment

Hasbro (rating: BBB+) reported third-quarter results for 2016 that reflected strong double-digit revenue gains, which fueled an additional drop in leverage. Third-quarter revenue increased 14% to $1.68 billion, driven by a 57% increase in its Girls product category, which benefited from solid growth in the recently acquired Disney Princess license. Third-quarter adjusted EBITDA increased 13% to $425 million. For the past 12 months, Hasbro's EBITDA totaled $996 million, including margins of 20.5%, about 20 basis points higher than full-year 2015. Trailing 12-month free cash flow generation was $523 million, which was partially distributed to shareholders, including $243 million of dividends and $117 million of share repurchases. Gross debt was $1.5 billion, relatively flat versus the second quarter. Leverage ticked lower again in the third quarter as debt/EBITDA fell to 1.6 times, versus 1.9 times at the end of 2015. Hasbro's balance sheet includes over $800 million in cash, most of which is overseas. Management does not provide explicit guidance; however, for full-year 2016, the company expects strong growth to continue, including operating margins to be in line or slightly higher compared with last year. Ratings reflect the expectation that Hasbro's EBITDA growth and strong free cash flow generation will enable the company to continue meeting its targeted maximum debt/EBITDA ratio of 2.0-2.5 times, along with its stated goal of maintaining a solid investment-grade rating.

Hasbro's BBB+ credit rating continues to reflect a strong competitive position, solid free cash flow generation, and sound credit metrics. Morningstar, Inc. assigns a narrow moat rating to Hasbro. Hasbro estimates it controls approximately 11% of the $24 billion domestic toy market and 9% of the $32 billion European market. The three largest players in the U.S market are Hasbro, Mattel, and Lego, which together account for more than 30% share. Hasbro's market position is reinforced through licensing and entertainment relationships that are difficult to replicate. In addition, Hasbro benefits from a leading position in TV and film, which builds strong loyalty behind the brands it markets. This competitive position buffers risks related to increasing online retail growth, as well as customer concentration risks. Hasbro's top three distributors--Wal-Mart, Target, and Toys 'R' Us--totaled 34% of 2015 sales.

Morningstar Credit Ratings believes that Hasbro is strongly positioned in the BBB+ rating category. Hasbro's operating performance and credit metrics continue to improve and compare favorably with its key competitor in the sector, Mattel (rating: BBB+). Hasbro's stronger revenue growth is largely due to the Disney Princess license win this year. Morningstar, Inc. has assigned narrow moat ratings to both Hasbro and Mattel; however, Mattel's moat trend rating is negative, reflecting its higher exposure to the growth of digital options and e-commerce retailers. In addition, Hasbro maintains adjusted leverage that is over one turn lower than that of Mattel, which pays out dividends that are roughly double those paid out by Hasbro, despite similar cash flow profiles.

Market News and Data

According to the pricing service Advantage Data, Hasbro's 3.15% senior notes due 2021 recently traded at +100 basis points over Treasuries. For comparison, Mattel's 2.35% senior notes due 2021 recently traded +94 basis points over Treasuries. Meanwhile, the Morningstar Industrials BBB+ Corporate Bond Index, which has an average duration of eight years, is at a spread of +151 basis points.

Wells Fargo Offering New 10-Year Senior Notes

Market News and Data

Wells Fargo & Co (rating: A) is reportedly in the market, offering 10-year senior unsecured holding company notes. According to pricing service Advantage Data, bonds from Wells Fargo and its key comparables were recently indicated as follows over the nearest Treasury:

U.S. Bancorp's (rating: A+) 2.375% notes due 2026 at +91 basis points;
Wells Fargo's 3.00% notes due 2026 at +127 basis points;
JPMorgan Chase's (rating: A-) 2.95% notes due 2026 at +127 basis points;
Citigroup's (rating: A-) 3.40% notes due 2026 at +140 basis points;
Bank of America's (rating: BBB) 3.50% notes due 2026 at +140 basis points.

MCR Credit Risk Assessment

Wells Fargo's credit rating benefits from its high-performing banking operations, diverse revenue sources, and consistently strong profits. Wells generates nearly 60% of net income in its community banking segment, 30% in wholesale banking, and the remainder in wealth management and brokerage operations. Third-quarter results were squeezed by lower asset yields and higher funding costs, resulting mainly from a higher balance of long-term debt, which together conspired to reduce net interest margin by 4 basis points sequentially and 14 basis points year over year. Although still higher than peers, Wells' annualized return on common equity during the quarter decreased to 11.8% from 13.0% a year earlier, a trend that we've been observing for the past two years. Credit quality improved modestly during the quarter. Provision expense of $805 million during the third quarter decreased 25.0% from the prior quarter. Although slightly lower than both the prior and year-ago quarters, nonperforming loans finished the quarter representing 1.1% of loans, which is modestly higher than global banking peers.

On its earnings call, Tim Sloan, Wells' recently appointed CEO, presented a number of internal reviews aimed at assessing and remediating the impact of their sales practices scandal, which cost longtime CEO John Stumpf his job. The reviews are in their initial stages, but early analysis shows modest but hard-to-determine financial damage to the consumer banking segment, which was the focus of the scandal. Management cited new consumer checking account volumes at 25% below year-ago levels in September and consumer credit cards 20% below year-ago levels. In upcoming quarters, we will focus our attention on revenue trends in consumer banking to better gauge the longer-term damage to Wells Fargo's reputation and ability to continue generating top-tier earnings.

Netflix Reports Third-Quarter Sub Upside Surprise; Cash Flow Remains Burdened by Content Investment

MCR Credit Risk Assessment

Netflix (rating: BB-) reported its third-quarter results on Oct. 17, reflecting modest U.S. subscriber growth and solid growth from international markets. Net adds in the U.S. were roughly in line with guidance and reflect a sequential pick-up from the June quarter. However, cash flow remained negative as a result of net losses in international markets as well as heavy content investment. We recently affirmed our rating on Netflix at BB- with a stable outlook. Our rating and outlook reflect Netflix's negative free cash flow condition and the need to invest heavily into new programming content and overseas expansion. Over time, we expect leverage to continue to migrate higher, though we view short-term liquidity as adequate to fund operations over the next few quarters.

For the September quarter, Netflix added 3.6 million subscribers. Management is guiding to 5.2 million net adds globally for the fourth quarter, including 1.45 million in the U.S. Revenue increased 31.7%, year over year as a result of subscriber growth as well as an increase in average revenue per subscriber, which grew 7.6% from a year ago as a result of scheduled price increases for certain customers. The company reported its U.S. operating margin up 4 percentage points over a year ago to 36%, while the international operating margin remained negative but improved 1.1 percentage points from second quarter to negative 8.0%. We are assuming the company will continue to make steady progress toward an international margin of at least 3% by 2020.

Netflix’s cash and investments ended the quarter at $1.3 billion, down $491 million from last quarter and down $1.3 billion from a year ago. This primarily reflects the company’s free cash burn rate of $1.2 billion over the past 12 months, including a loss of $489 million in the third quarter. For the full year, management now expects free cash burn of $1.5 billion. Contributing to the net cash usage was a 57% growth in content assets from last year. The company plans to launch 1,000 hours of new original programming by the end of 2017, compared with 600 hours targeted for 2016. As a result, we expect the pace of content investment to continue to keep pressure on operating profit and free cash flow over the next year or two.

We calculate net debt to EBITDA (including the cost of stock compensation) ended the September quarter at 2.0 times, up a turn from last quarter as a result of the decline in cash reserves. For comparison, the company reported a net excess cash balance a year ago of 0.6 times following the company’s debt issuance. For comparison, same-rated T-Mobile’s (rating: BB-) net debt at the end of the June quarter was 2.5 times EBITDA, but has been steadily trending lower on EBITDA growth. T-Mobile also generated free cash flow of $1.3 billion over the 12 months ending in June.

Market Data

According to Advantage Data, Inc., Netflix 5.88% senior notes due 2025 are indicated at a price of $114.25 and a yield to maturity of 3.86% (+227 basis points over the nearest Treasury). For comparison, the yield has tightened by 121 basis points over the past three months, a pace well ahead of peers and the high yield index. Over the same period, T-Mobile's 6.50% notes due 2026 moved 30 basis points tighter and are now indicated at a yield of 4.55% to the 2024 par call (+334 basis points over Treasuries). Meanwhile, the BofA Merrill Lynch BB rated high-yield index was reported at a spread of +304 basis points, or 33 basis points tighter from three months ago. Over the same period, the BofA Merrill Lynch B rated index moved 75 basis points tighter and is now quoted at +477 basis points.

Nike Offering 10- and 30-Year Senior Notes

Market News and Data

Nike (rating: AA-) is reportedly in the market, offering 10- and 30-year senior unsecured notes. The company filed a preliminary supplement to the prospectus dated July 31, 2016. Nike is expected to use the proceeds for general corporate purposes. According to pricing service Advantage Data, bonds with intermediate-term maturities from Nike and its key comparables were recently indicated over the nearest Treasury as follows:

Wal-Mart Stores (rating: AA) 2.55% notes due in 2023 at +50 basis points;
Nike (rating: AA-) 2.25% notes due in 2023 at +49 basis points;
Costco (rating: AA-) 2.25% notes due in 2022 at +50 basis points;
Home Depot (rating: A+) 2.125% notes due in 2026 at +73 basis points.

Also, the Morningstar Industrials AA- Corporate Bond Index, which has a 6-year duration, is at a spread of +86 basis points.

According to pricing service Advantage Data, bonds with long-term maturities from Nike and its key comparables were recently indicated over the nearest Treasury as follows:

Wal-Mart Stores (rating: AA) 4.30% notes due in 2044 at +102 basis points;
Nike (rating: AA-) 3.875% notes due in 2045 at +99 basis points;
Home Depot (rating: A+) 4.25% notes due in 2046 at +106 basis points.

MCR Credit Risk Assessment

Nike's AA- credit rating is based on its dominant position in the athletic footwear and apparel industry, strong cash flow, and a conservative balance sheet. Nike is the most dominant player in the $300 billion-plus global athletic footwear, apparel, and equipment market. Morningstar, Inc. assigns Nike a wide moat based on competitive advantages that include its brand image, scale, global and historic sponsorships, and negotiating power with suppliers and retailers. Still, Nike's rating reflects a highly competitive market that is strongly correlated to GDP growth. Nike's increasing emphasis on direct-to-consumer channels requires greater investment and higher overhead, and profits tend to be more cyclical with the economy.

Johnson & Johnson Reports Solid Performance as U.S. Biosimilar Remicade Nears

MCR Credit Risk Assessment

On Oct. 18, Johnson & Johnson (rating: AAA) reported solid revenue growth in the third quarter of 4% in constant currency bolstered by a 9% jump in worldwide pharmaceutical sales. Importantly, the company maintained its sales guidance for 2016 of between $71.5 billion and $72.2 billion on a reported basis despite a greater possibility of an introduction of a biosimilar version of J&J's best-seller Remicade (represents around 10% of total sales) in the U.S. before the end of the year. Pfizer (rating: AA-) recently announced that Inflectra (infliximab-dyyb) may be available in the U.S. market at a 15% discount as soon as late November.

J&J's AAA credit rating exemplifies the company's leadership across the healthcare spectrum, exceptional cash flow generation, and its net cash position. The firm has earned a wide moat from Morningstar Inc. due to its diverse operations spanning pharmaceuticals, medical devices, and over-the-counter medicines that buffers J&J from weakness in a particular segment at any given time. In addition, a highly productive pharmaceutical research program plans to ready 10 potential blockbusters for regulatory registration in 2015-19, which should help offset expected patent losses in the commercial portfolio. We expect that J&J can keep sales erosion to a moderate level upon the launch of a U.S. biosimilar Remicade given that 70% of patients on Remicade are stable and may resist switching to the new biosimilar, while the lack of interchangeability between the therapies cannot prompt a switch. Accordingly, we maintain our view that the company can sustain revenue and EBITDA increasing in the low-single-digits through 2020 compounded annually.

J&J manages an impeccable balance sheet even after EUR 4 billion in debt offerings in the second quarter. The firm's debt load of approximately $27 billion was far outweighed by cash and investments of around $40 billion at the end of the third quarter. Per our calculation, gross debt leverage slightly rose to 1.1 times for the latest 12 months ended in September from 0.8 times at the end of 2015, but the company still enjoys a net cash position. We believe J&J can easily manage its well-laddered debt maturities with substantial free cash flow averaging nearly $17 billion annually over the next five years. However, we would note that the company's profit growth outlook is weak and ranks near the bottom of the large pharmaceutical industry, which may have prompted authorization program in November 2015 of a $10 billion share-repurchase with around 75% of the authorization to be satisfied by the end of 2016. Already, annual dividends of more than $8 billion and current share repurchases of over $5 billion have consumed almost all free cash flow for the 12 months ending in June.

Market Data

According to the pricing service Advantage Data, J&J's 2.45% senior notes due 2026 recently traded at +51 basis points over the nearest Treasury. For nearest comparison, Eli Lilly's (rating: AA) 2.75% senior notes due 2025 and Novartis' (rating: AA) 3.0% senior notes due 2025 recently traded +55 basis points and +61 basis points, respectively. Each of the spreads is tighter than the Morningstar AAA Industrials Index at +68 basis points and the Morningstar AA Industrials Index at +85 basis points.

IBM Reports Stronger Free Cash Flow; Management Backs Off of Share Repurchases

MCR Credit Risk Assessment

International Business Machines (rating: A+) released its third-quarter operating results on Oct. 18. Our credit rating reflects IBM's weakening Business Risk, Cash Flow Cushion, and Solvency scores as the company works to pivot its portfolio toward high-growth businesses away from legacy technology that remains in secular decline.

IBM's reported $19.2 billion of revenue for the third quarter, flat from a year ago but down 1.0% on a constant-currency basis, implies a net positive impact from currency movements after a string of many quarters of currency headwinds. Management also indicated that acquisitions contributed 2 percentage points of growth. During the quarter, the company once again benefited from revenue growth in strategic initiatives, which grew 15% year over year and now account for 40% of revenue. Growth in this segment was led by cloud up 42% year over year, stronger sequentially from last quarter. Analytics grew 14%, while mobile and security also maintained solid growth, though the latter two segments remain minor contributors to the strategic segment. Meanwhile, we estimate IBM's legacy segment revenue declined around 10% from a year ago (once again driven by a 21% decline in systems revenue). IBM's operating margin improved sequentially, to 17%, but is still 3 percentage points lower than a year ago as a result of a mix shift toward higher-growth, but lower-margin services as well as acquisitions and investments.

IBM's cash and investments ended the September quarter at $10 billion, $649 million lower than the previous quarter. We calculate that consolidated net debt was 2.0 times EBITDA compared with 2.1 times last quarter, but up a half-turn over a year ago. The improvement during the quarter was the product of a $2 billion decline in total debt, offset by a slight decline in trailing four-quarter EBITDA and the decline in cash. Financial services debt totaled $26.0 billion at the end of the quarter, down slightly from last quarter, backed by $24.4 billion of finance receivables. Non-investment-grade exposure within these receivables continues to creep higher, now at 49% compared with 45% a year ago.

Trailing four-quarter free cash flow grew 6% to $14.8 billion, year over year, marking a second consecutive quarter of growth. Acquisitions totaled $7.9 billion, though no significant transactions were completed during the September quarter. Meanwhile, total payout declined to 57% of free cash flow compared with an average of 65% over the past five quarters. Net share repurchases totaled $3.3 billion over the past four quarters compared with $3.9 billion a year ago, while dividends are running 11% higher at $5.2 billion.

Market Data

IBM's 3.45% senior notes due in 2026 are indicated at a spread of +84 basis points over the nearest Treasury, unchanged since mid-July. Among comparable issuers, we note Applied Materials (rating: A+) 3.90% notes due in 2025 are indicated at +99 basis points, also unchanged from mid-July. Meanwhile, Oracle's (rating: AA-) 2.65% notes due in 2026 are indicated at +92 basis points, 14 basis points tighter from mid-July. Over the same period, the Morningstar Industrial Corporate A+ index tightened about 6 basis points and is now quoted at +99 basis points.

Mondelez Offering 3-Year and 5-Year Senior Notes to Fund Tender Offer

Market News and Data

Mondelez International Holding Netherlands B.V., a wholly owned subsidiary of Mondelez International (rating: BBB), is reportedly in the market offering $2.5 billion of new fixed and floating rate notes maturing in 2019 and 2021. The notes are unconditionally and irrevocably guaranteed by the parent company, and proceeds from the offering are expected to be used to fund all or part of the company's $2.5 billion tender offer, address near-term debt maturities, or for general corporate purposes.

According to pricing service Advantage Data, bonds with near to intermediate term maturities from Mondelez and its key comparables were recently indicated over the nearest Treasury as follows:

Mondelez's (rating: BBB) 2.25% senior notes due 2019 traded recently at +62 basis points
Kellogg's (rating: BBB) 4.15% senior notes due 2019 are indicated at +68 basis points
Kraft Heinz Co's. (rating: BBB-) 2.8% senior notes due 2020 recently traded at +70 basis points

MCR Credit Risk Assessment

Mondelez's rating reflects the cash flow generative ability of the company's leading global brands that includes seven brands with individual annual sales over $1 billion. Mondelez holds the number one global market share positions in biscuits, chocolates, and candy, and the number two position in gum. The company's portfolio includes such notable brands as Oreo, Cadbury, LU, and Trident. Factored into our rating is the company's wide economic moat, assigned by Morningstar Inc. and derived from Mondelez's economies of scale and resulting from its expansive global network--with more than 75% of revenue derived outside of North America.

Improvements in Mondelez's credit profile are somewhat distorted by restructuring efforts and the negative effect of currency due to weakening macroeconomic conditions in emerging markets from which 40% of its revenue are derived. However, the company continues to report positive organic revenue growth and strong adjusted operating growth on a constant currency basis.

For the latest 12-month period ended June 30, 2016, total debt to adjusted EBITDA was 3.8 times, EBITDA to interest 8.0 times, and free cash flow (cash flow from operation less capital expenditures and dividends) was $2.0 billion for the period. Leverage is high for the rating category. However the pervasiveness of Mondelez's leading brands, free cash flow generation, its strong presence in the faster growing international market, a good Business Risk score, and low Distant to Default score fully supports the rating.

Our estimate is that leverage would decline to about 3.5 times in the intermediate term. Mondelez reiterated its commitment to achieving 17%-18% adjusted operating margins in 2018, due to overhead cost reduction resulting from zero-based budgeting initiatives. We do not anticipate meaningful debt reduction, and as a result, Mondelez's credit profile is likely to improve only with better operating performance. We believe that with activist shareholder Nelson Peltz on the board of directors, management will stay focused on achieving its operating margin goal. Nonetheless, activist investors tend to raise event risk as they prod companies to take actions that bolster shareholder value often at the detriment of bondholders. Also, given Mondelez's earlier bid for the Hershey Company, we believe the company has above-average mergers and acquisitions risk.

Goldman Reports Strong Third Quarter Results on Higher Trading Revenue

MCR Credit Risk Assessment

Goldman Sachs Group (rating: BBB+) reported its best quarter of the trailing seven, with an annualized return on average common equity of 11.1% by our calculations. Goldman's returns topped all global bank peers that have reported results thus far with the exception of Wells Fargo (rating: A), which reported a return on equity of 11.8% for the quarter. Total revenue at the firm increased 19.1% year over year and 3.0% sequentially. Results during the quarter were positively affected by higher trading revenue in the company's institutional clients services segment, which increased 16.7% compared with the year-earlier quarter. Revenue from fixed income, currencies, and commodities increased 34.4% from a weaker year-earlier quarter on higher revenue in credit, rates, and mortgage trading which were partially offset by lower revenue in currency and commodity trading. Equity trading increased a more modest 1.8% year-over-year due mainly to higher derivatives trading revenue. Revenue in Goldman's investing and lending segment more than doubled from a year earlier to $1.4 billion on significantly stronger revenue from public equity investments. Higher investment income from debt securities also contributed to the solid results for the segment. Although less of an improvement than the other segments, investment management revenue increased 4.4% year over year on higher incentive fees. Total assets under supervision in the segment increased 2.8% sequentially and 13.4% year over year to $1.35 trillion at quarter end. Positive asset flows in long-term fixed-income strategies and market appreciation were the primary drivers of the improved results. Despite higher underwriting revenue, which increased 17.7% compared with the year-earlier quarter, investment banking was the only segment to report lower revenue during the quarter on lower financial advisory fees compared with a strong year-earlier quarter. Management didn't seem overly concerned with the drop-off, citing a record backlog of deals in the pipeline. Higher expenses, which increased 10.1% year over year on higher compensation expenses, detracted from consolidated results. However, noncompensation expenses benefited from modest legal expense of $46 million during the quarter relative to $416 million reported in the year-earlier quarter. In general, total legal expense in the 12 months ending in September of over $2.0 billion significantly detracted from reported results.

Market Data

Given its business model as an investment bank, Goldman Sachs can be compared with close peer Morgan Stanley (rating: BBB) as well as global banks that include significant investment banks in their overall operations. According to pricing service Advantage Data, Goldman Sachs' 3.75% notes due in 2026 recently traded at +148 basis points over the nearest Treasury. By comparison, JPMorgan Chase's (rating: A-) 2.95% due in 2026 are indicated at +127 basis points, while Citigroup's (rating: A-) 3.40% notes due in 2026 are indicated at +144 basis points. Meanwhile, 10-year notes of Morgan Stanley are indicated at +141 basis points, while those Bank of America, which we also rate BBB, are indicated at +142 basis points.

UPS Offering 10- and 30-Year Notes

Market News and Data

UPS (rating: A+) is in the market today issuing 10- and 30-year notes, with a reported deal size of $1 billion. According to the preliminary prospectus dated Oct. 19, 2016, UPS will use the proceeds for general corporate purposes, including the repayment of commercial paper--$2.75 billion was outstanding as of June 30, 2016.

According to pricing service Advantage Data, bonds with intermediate to long-term maturities for UPS and its key comparables were recently indicated over the nearest treasury as follows:

Intermediate Maturities
UPS' 2.45% notes due 2022 recently traded at +36 basis points
Canadian National's (rating: A) 2.75% notes due 2026 are indicated at +76 basis points
Union Pacific's (rating: A) 2.75% notes due 2026 are indicated at +76 basis points

Long-Term Maturities
UPS' 3.625% notes due 2042 are indicated at +99 basis points
Canadian National's 3.20% notes due 2046 are indicated at +106 basis points
Union Pacific's 3.35% notes due 2046 recently traded at +106 basis points

MCR Credit Risk Assessment

Our A+ credit rating for United Parcel Service blends its strong competitive advantages with the high leverage attributed to its large unfunded pension liabilities and operating leases on facilities and aircraft. UPS has developed a massive, integrated global shipping network with breadth that is almost impossible to replicate, helping the firm garner a wide economic moat, as assigned by Morningstar, Inc., that supports its Business Risk pillar. UPS has monetized this competitive advantage into returns on invested capital of around 15% per year and interest coverage of nearly 10 times, bolstering its Solvency Score. Leverage is reasonable, with total debt/adjusted EBITDA of 1.4 times as of June 30, 2016. However, UPS has substantial operating leases and unfunded pension liabilities (nearly $11 billion as of December 2015), so adjusted debt/EBITDAR is closer to 3.0 times, which constrains our rating.

Philip Morris Reports Respectable Q3 Results; Battles Contraction, Excise Taxes, and Currency

MCR Credit Risk Assessment

Philip Morris International's (Rating: A-) third-quarter revenue and operating earnings were in line with our expectation. Revenue net of excise taxes increased 0.8% relative to the prior year to $6.982 billion, as negative currency effects, volume contraction, and higher excise taxes were offset through pricing. Excluding unfavorable currency, net revenue increased 3.6% on pricing of $440 million during the quarter. Reported operating income for the period increased 0.6% to $2.977 billion, and increased 4.3% excluding the negative impact of currency. Philip Morris continues to demonstrate exceptional pricing power and is expecting $500 million-$600 million of pricing in the fourth quarter of 2016; we anticipate that this will fully offset cigarette shipment declines, which were 5.4% for the quarter and 3.9% for the first nine months of the year. Our expectation is that the industry contraction remains at mid-single-digits, similar to management's forecast of a decline for the year, in line with the year-to-date trend. However, we believe that higher excise taxes and negative macroeconomics factors in emerging markets may further exacerbate and prolong volume declines.

Stagnation and slower economic growth resulted in weak volumes in emerging markets. The declines were due mainly to lower cigarette industry volume in Argentina, Indonesia, the Philippines, and Russia, as well as lower cigarette market share, notably in North Africa, the Philippines, and Russia, which was partly offset by market share growth in the EU region. Marlboro continues to increase its international market share, which increased 30 basis points to 10.1%, up from 9.8% during the prior year period. Philip Morris also registered market share gains in four of its top six largest markets in the EU region. Furthermore, the top-line performance is healthy on a constant-currency basis, and increases were as follows: 4.7% in Asia; 3.9% in the European Union; 3.0% in Eastern Europe, the Middle East, and Africa, or EEMA; and 1.6% in Latin America and Canada. Another significant bright spot in the company's results consisted of gains in IQOS, its smokeless cigarette heated tobacco product, whose stick shipment volume reached 2.1 billion units, an increase of over 900 million relative to the second quarter. Although the primary volume driver was Japan, the company reported that all markets contributed to the growth. We view electronic and smokeless cigarettes as the next-generation tobacco product and critical to the industry's long-term growth. Compared with the company's cigarette shipments, smokeless sticks are still in their infancy and just under 1%.

By continuing to offset industry volume contraction, Philip Morris demonstrates excellent pricing ability, which is critical for a tobacco company to maintain its credit profile. The company's total debt/adjusted EBITDA was 2.7 times for the trailing 12 months ended Sept. 30, which is slightly high for the rating category, but similar to the 12 months ended June 30. EBITDA/interest was estimated at 10 times for the latest 12 months ended Sept. 30. Philip Morris' debt levels were stable compared with the prior quarter-end; however, its cash balance increased $1.070 billion to $4.884 billion at Sept. 30. While the negative effect of currency can distort a company's financials, persistent negative foreign exchange can also affect its cash flow and credit profile. As a result, Philip Morris placed a moratorium on share repurchases in 2015 to support its credit rating.

Market Data

Philip Morris International is the world's largest tobacco company, and owing to legal and regulatory risk germane to specific countries and/or regions, it should be compared with other global players, such as British American Tobacco (rating: BBB+). Philip Morris International's (rating: A-) 2.75 notes due 2026 recently were indicated by pricing service Advantage Data at +84 basis points over the nearest Treasury, while British American Tobacco's 3.95% notes due 2025 are indicated at +118 basis points over the nearest Treasury. British American Tobacco's leverage, at 3.8 times, is more than one turn higher than Philip Morris', and its operating margins are 500 basis points lower.

Abbott Turns in Solid Third Quarter and Gears Up for St. Jude Acquisition

MCR Credit Risk Assessment

On Oct. 19, Abbott Laboratories (rating: A/UR-) reported solid third-quarter financial results, and the ongoing uncertainty around pending acquisitions remains the key reason for our rating review. Operationally, Abbott turned in a solid quarter that allowed it to raise the midpoint of its adjusted 2016 earnings per share guidance to $2.19 to $2.21 from $2.14 to $2.24 on the second-quarter call and from $2.10 to $2.20 initially in 2016. Overall sales grew 4% on an operational basis during the quarter, despite a 1% decline in its nutritional business related to ongoing weakness in China as a result of increased discounting related to oversupply issues in anticipation of pending regulatory changes in 2018 and distribution channel shifts. Helping to offset nutritional weakness, the medical device business improved, posting 6% operational growth with particular strength from its diabetes devices (13% operational growth) on a strong launch of the continuous glucose monitoring system, Freestyle Libre, in international markets. Of note, Abbott submitted that system for review in the U.S. this quarter, too, which could positively affect this key geographic region (2% U.S. diabetes care decline in the third quarter) within the next year or so, if approved.

From a credit perspective, our rating still remains under review with negative implications related to the pending acquisitions of St. Jude Medical (rating: A/UR-) and Alere (not rated). On pro forma basis for both acquisitions, management initially planned to boost debt leverage to about 4.5 times EBITDA from roughly 2 times. Deleveraging will be the firm's main capital-allocation priority after that, and management plans to reach 3.5 times by the end of 2018 and deleverage further over time. Given this expected increase in leverage, these pending transactions may cut into its credit profile if they are completed as planned. On the pending St. Jude acquisition, Abbott's management team appears confident that the deal will close as expected by the end of 2016, despite reports in the media about cybersecurity concerns on St. Jude's medical devices. More uncertainty surrounds the Alere transaction, and management's enthusiasm for that deal has been constrained by the target's financial reporting delays, product recalls, and government investigations. Alere is now suing Abbott to complete the transaction. If the Alere deal falls apart, Abbott may not need to increase its leverage as substantially as initially planned. Also in September, Abbott announced plans to sell its vision-care business to Johnson & Johnson (rating: AAA) for about $4 billion. Those expected proceeds could buoy Abbott's financial health relative to its initial plan, as well. Given these uncertainties, our A ratings for both Abbott and St. Jude remain under review with negative implications.

Market Data

We use companies like Baxter (rating: A-), Becton Dickinson (rating: BBB+) and Zimmer Biomet (rating: BBB+) as key comparables for both Abbott and St. Jude.

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

Abbott's 2.55% notes due in 2022 at +70 basis points,
St. Jude's 3.25% notes due in 2023 at +116 basis points,
Baxter's 1.70% notes due in 2021 at +71 basis points,
Becton's 3.13% notes due in 2021 at +69 basis points,
Zimmer's 3.15% notes due in 2022 at +110 basis points.

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

Abbott's 2.95% notes due in 2025 at +110 basis points,
St. Jude's notes 3.88% notes due in 2025 at +143 basis points,
Baxter's 2.60% notes due in 2026 at +109 basis points,
Becton's 3.73% notes due in 2024 at +104 basis points,
Zimmer's 3.55% notes due in 2025 at +152 basis points.

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

Abbott's 5.30% notes due in 2040 at +170 basis points,
St. Jude's notes 4.75% notes due in 2043 at +183 basis points,
Baxter's 3.50% notes due in 2026 at +145 basis points,
Becton's 4.69% notes due in 2044 at +150 basis points,
Zimmer's 4.45% notes due in 2045 at +178 basis points.

Intel’s Positive Third-Quarter Results Overshadowed by Cautious Fourth-Quarter Guidance

MCR Credit Risk Assessment

Intel (rating: AA-, stable outlook) reported third-quarter revenue growth of 9% year over year, fueled by positive growth across its core segments. However, management downplayed this strength through its cautious fourth-quarter guidance. Our AA- credit rating reflects Intel’s solid Business Risk and Solvency scores, which remain well supported by the company’s position as the world’s largest semiconductor company. Our rating outlook is stable. Despite moderating revenue growth, we expect the company to continue to produce strong operating margins and free cash flow.

For the third quarter, Intel’s Data Center revenue increased 10% from a year ago, led by higher sales volume and helped by a modest increase in selling prices. Meanwhile, inventory build in personal computing pushed Client Computing higher by 5%, the first up-quarter in nearly two years. Non-GAAP gross margin came in at a strong 64.8%, up nearly 6 percentage points from a year ago, attributable mainly to higher sales volumes across the product portfolio as well as lower production costs on 14nm and Altera-related adjustments. Results were nearly 2 percentage points ahead of management's guidance. However, despite a generally positive quarter, management is cautious in its outlook for the fourth quarter, guiding to flat sequential revenue and a non-GAAP gross margin of 63%. Management held its 2016 capital spending target at $9.5 billion, up 30% from 2015.

Total debt ended the quarter at $27.6 billion, down $1 billion from last quarter on repayment of commercial paper. Meanwhile, cash and investments was $17.8 billion, unchanged from last quarter. With a modest decline in EBITDA offsetting the reduction in debt, Intel's gross leverage remained at 1.2 times trailing EBITDA during the third quarter and net debt at 0.4 times EBITDA. Over the past 12 months, Intel produced free cash flow of $10.6 billion, down 12% as a result of an 18% growth in capital expenditures ahead of its 10-nanometer platform launch next year. As an offset, the company remained conservative with share repurchases, spending less than $500 million during the third quarter and $2.6 billion over the past year, down 32% from the prior period. Total shareholder payout as a percentage of free cash flow has settled into the 65% area.

Market Data

Intel's 2.6% notes due 2026 are currently indicated at +66 basis points over the nearest Treasury, 17 basis points tighter from July 20. Over the same period, the Morningstar Corporate AA- Index widened by 3 basis points. Meanwhile, Cisco Systems' (rating: AA, stable outlook) 2.95% notes due 2026 are indicated at +65 basis points, unchanged relative to July. Apple’s (rating: AA-, negative outlook) 3.25% notes due 2026 are indicated at +77 basis points, 13 basis points tighter from July.

Morgan Stanley’s Third-Quarter Results Show Improvement but Trail Key Peers

MCR Credit Risk Assessment

Morgan Stanley (rating: BBB, stable) reported decent third-quarter results that included net income available to common shareholders of $1.5 billion, which was sharply higher than $0.9 billion reported in the year-earlier quarter and 6.5% higher than the prior quarter. However, overall profitability, as measured by annualized return on common equity, was 8.7% during the quarter, which represented an improvement from 8.3% reported in the prior quarter and 5.6% a year ago but trails levels reported by key peers including Goldman Sachs (rating: BBB+, stable) at 11.1% and JPMorgan Chase (rating: A-, stable) at 10.1%. Results benefited from higher revenue during the quarter, which increased 21.5% compared with year-earlier levels after adjusting for the impact of interest rate changes. Interestingly, revenue was unchanged compared with the prior quarter. Similar to peers, fixed income trading revenue jumped 61.1% compared with a relatively weak year-earlier quarter on improved conditions in credit and rates products. The increase was particularly noteworthy since the revenue was generated by 25% fewer employees than a year ago. Equity trading revenue of $1.9 billion was largely unchanged relative to the year-earlier period and decreased 12.2% compared with the prior quarter. Surprisingly, debt underwriting revenue decreased 2.7% year over year, representing a departure from peers that have reported sharp gains in debt underwriting revenue during the quarter. Wealth management, Morgan Stanley’s largest segment by revenue, reported relatively modest gains in revenue, up 6.6% from a year earlier. At the consolidated level, Morgan Stanley made progress controlling costs. Although compensation costs increased 19.2% compared with the year-earlier quarter because of higher revenue, non-compensation costs decreased 14.9% led by lower legal expenses during the quarter. In general, net income to common shareholders of $4.8 billion for the 12 months ending September benefited from minimal legal and regulatory expense compared with over $3.6 billion of legal expense reported during the same period a year earlier.

We were pleased to see Morgan Stanley's already strong regulatory common equity Tier 1 capital increase during the quarter to 16.9% of risk-weighted assets on a transitional basis and 15.9% on a fully phased basis, levels that materially exceed peer averages around 12%. Capital measures benefited from lower risk-weighted assets compared with a year earlier, which reflects the firm's shift in emphasis to wealth and investment management from trading and the overall de-risking of the firm. However, tangible capital actually trails peer averages at 7.5% of tangible assets compared with a peer average around 8%, which represents a negative factor in our Solvency Score assessment. Management expects to increase capital returns to shareholders in the future once it gains clarity on various outstanding regulatory issues. In the meantime, it is comfortable holding excess regulatory capital balances.

Market Data

Given its business model as an investment bank, Morgan Stanley can be compared with close peer Goldman Sachs as well as global banks that include significant investment banks in their overall operations. According to pricing service Advantage Data Inc., Morgan Stanley's (rating: BBB, stable) 3.125% notes due 2026 recently traded at +138 basis points over the nearest Treasury. By comparison, JPMorgan Chase's (rating: A-, stable) 2.95% due 2026 are indicated at +130 basis points, while Citigroup's (rating: A-, stable) 3.40% notes due 2026 are indicated at +144 basis points. Meanwhile, 10-year notes of Goldman Sachs (rating: BBB+, stable) are indicated at +148 basis points, while those of Bank of America Corp (rating: BBB, stable) are indicated at +141 basis points.

Dover Reports Third-Quarter Earnings

MCR Credit Risk Assessment

Dover (rating: A-, negative) reported third-quarter earnings that were consistent with its announced guidance revision last week when it lowered its full-year numbers, noting that the prolonged slump in oil and gas and general industrial end-market weakness weighed on results. The firm reiterated its guidance, expecting full-year revenue to decline 4%-5% and produce EPS of $3.00-$3.05--this compares with its second-quarter guidance of negative revenue growth of 3%-5% and EPS of $3.35-$3.45. Our expectations that a difficult operating environment would cause leverage to increase supported our negative outlook when we downgraded Dover in June.

For the quarter, revenue declined 4.5%, with net acquisitions boosting growth 2%, offset by a 7% fall in organic revenue. Energy, 16% of sales, was the biggest detractor, with revenue contracting 25%, (24% organically), and bookings falling 23% compared with last year. Engineered systems (33% of revenue) eked out a small 1% increase in organic growth, driven by a 5% increase in printing and identification (roughly 56% of the segment's sales), but the remaining businesses produced organic revenue declines. Profitability suffered mightily--the energy segment was the hardest hit--and EBITDA contracted 35% to

$297 million while EBITDA margins fell 800 basis points to 17.4% as a result. Free cash flow declined $54 million to $189 million, and the firm paid $69 million in dividends. Sequentially, cash increased $260 million to $515 million, boosted by commercial paper draws of $177 million. The firm ended the quarter with $3.1 billion of debt, and the earnings decline contributed to leverage increasing 0.4 turns to 2.6 times.

Market Data

Dover's (rating: A-, negative) 3.15% notes due 2025 are currently indicated at +91 basis points over the nearest Treasury, according to pricing service Advantage Data. Although they compete in some business segments, diversified peer Parker Hannifin (rating: A) and Illinois Tool Works (rating: A) are reasonable comparables for Dover. The Parker Hannifin 3.30% notes due in 2024, are indicated at +84 basis points over the nearest Treasury, while the ITW's 3.50% notes due in 2024, have recently traded in small sizes in the range of +59 bps to +64 basis points over the nearest Treasury. Relatively speaking, Dover's Business Risk suffers from its smaller revenue base--$6.7 billion in revenue versus $11.4 billion for Parker and $13.3 billion for ITW--Dover's weakening financial outlook, and its large energy exposure. Moreover, Dover's outsize energy exposure--16% versus approximately 6% for Parker Hannifin and roughly 3% for ITW--has hurt operating performance and resulted in increase leverage.

Halliburton 3Q Results Better Than Expected; Modest Rebound Led by North American Land Activity

MCR Credit Risk Assessment

On Oct. 19, Halliburton (rating: BBB+, negative outlook) reported third-quarter 2016 revenue of $3.8 billion, $1.7 billion (31%) lower than the $5.6 billion reported in third-quarter 2015. However, total cash generated by operating activities was approximately $1.0 billion, including a decrease in working capital of $537 million and a tax refund of $430 million, but before capital expenditures of $178 million.

On a sequential basis, demand for oilfield services in North America marginally improved in the third quarter, but international demand continued to shrink, driven primarily by a decline in drilling and well completions, as well as continued pricing pressure. On the earnings conference call, management said that the modest recovery underway in Halliburton's North American land-based service activity is being led by rig additions in unconventional oil and gas basins (Texas Permian, for example). Furthermore, although cautious about the fourth quarter because of holiday and potential seasonal weather-related down times, management looks for continued North American land-based recovery in early 2017, commodity prices permitting. International demand for oilfield services is foreseen reaching bottom in the first half of 2017. Management believes meaningful activity increases by exploration and production companies will not start until oil is sustained above $50 per barrel, but given the harsh down cycle that producers have endured the past two years and a cautious current mindset, pricing may have to go higher.

As of September, Halliburton's liquidity remains good, with $3.3 billion in cash and equivalents and an estimated $3.0 billion currently available under its revolving credit facility. Based on actual year-to-date results and the company’s activity guidance for the fourth quarter, we maintain our total 2016 company revenue forecast to be $15 billion-$16 billion but expect EBITDA margin (excluding impairments and Baker Hughes-related termination fee and charges) of 13%-14%, slightly less than our prior 14% estimate. Halliburton continues to aggressively manage operating costs to match the current revenue environment. There is no change to Halliburton’s 2016 capital budget of $850 million from prior guidance, which is about $1.3 billion (61%) below $2.2 billion spent last year.

Based on our revenue, operating cost, and capital expenditure projections and using depreciation, depletion, and amortization of $1.5 billion, we now estimate 2016 free cash flow (after capital expenditures and dividends) to be nearly break-even, less than our prior estimate of $200 million-$300 million. Halliburton has $45 million due in 2017 and $800 million in 2018, so its debt maturity schedule does not pose an immediate concern.

At the end of September, total debt was $12.3 billion and net debt $9.0 billion. We estimate last 12-months' debt/EBITDA for Halliburton to be 5.5 times and net leverage 4.0 times, with the total debt ratio having increased by 1.5 turns and net leverage by 2.6 turns since the end of 2015 as cash was drawn down to pay Baker Hughes the breakup fee of $3.5 billion during the second quarter.

Market Data

Halliburton's 3.5% notes due in 2023 recently traded at +137 basis points over the nearest Treasury, 8 basis points wider from July 20 (date of second-quarter earnings report). Over the same period, the Morningstar Corporate BBB+ Index tightened by 8 basis points. Meanwhile, National Oilwell Varco’s (rating: BBB+, negative outlook) 2.6% notes due in 2022 recently traded at +206 basis points, 7 basis points tighter from July. Schlumberger Holdings' (rating: A+) 3.625% notes due in 2022 recently traded at +93 basis points, 37 basis points tighter relative to July.

Quest Boosts Free Cash Flow Outlook for 2016 and Maintains Leverage in Third Quarter

MCR Credit Risk Assessment

On Oct. 20, Quest Diagnostics (rating: BBB+, stable outlook) reported solid third-quarter operating results that allowed it to increase free cash flow guidance for 2016. During the quarter, underlying revenue grew 2% on similar volume growth and flat revenue per requisition. This growth follows the trends of previous quarters in 2016, and along with operating efficiencies, these trends allowed management to increase its cash flow guidance for 2016. Management now expects operating cash flow of $1 billion in 2016 (up from $880 million expected previously) and capital expenditures of about $250 million in 2016 (or at the low end of its previous target of $250 million to $300 million). With that new guidance, Quest now expects free cash flow of about $750 million, or in line with recent trends, versus roughly $600 million previously.

We expect continued growth of free cash flow in the long run, and Quest pointed to several new relationships that could contribute to its positive growth trajectory on the call. We are particularly intrigued by its new collaborations with HCA Holdings (rating: BB, stable outlook) and International

Business Machines (rating: A+, negative outlook). For example, Quest is managing the inpatient laboratory operations of six HCA hospitals in the Denver area. If that relationship is positive, we would not be surprised to see Quest's services expand to other hospitals in the HCA system, which is the largest private hospital system in the U.S. We are also intrigued by its collaboration with IBM's Watson product, where Quest's testing capabilities should help oncologists match patients with various cancer therapies and clinical trials based on their specific DNA sequence. This collaboration could position Quest to be on the front lines of companion diagnostics in cancer therapies.

Despite these positive operational trends, Quest's financial health remained relatively stagnant in the third quarter. Total debt stayed at $3.8 billion as of September, or gross debt/EBITDA of 2.7 times by our estimates. In the first half of 2016, the firm already reached its goal of returning more than half of expected annual free cash flow to shareholders, so we were pleased to see the firm reduce it share repurchases to just $50 million in the third quarter. That allowed cash to rise in the third quarter to $406 million, and net debt/EBITDA declined slightly to 2.4 times as of September by our estimates. Overall, this quarter's results reinforced our stable outlook on the firm's BBB+ credit rating.

Market Data

Quest's closest comparable from a business and credit perspective is Laboratory Corp of America Holdings (rating: BBB+, stable outlook). Despite its similarity in credit quality, Quest's bonds recently traded at tighter spreads than LabCorp's bonds in the roughly 5- to 10-year maturity bucket. However, LabCorp's bonds recently traded at tighter spreads than Quest in the roughly 30-year maturity bucket.

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

Quest's 2.50% notes due in 2020 at +89 basis points
LabCorp's 2.63% notes due in 2020 +102 basis points

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

Quest's 3.45% notes due in 2026 at +124 basis points
LabCorp's 3.60% notes due in 2025 +142 basis points

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

Quest's 4.70%% notes due in 2045 at +190 basis points
LabCorp's 4.70% notes due in 2045 +166 basis points

Roche Reports Third-Quarter Results Paralleling 2016 Guidance

MCR Credit Risk Assessment

On Oct. 20, Roche (rating: AA-) reported revenue growth in the third quarter of 2% in constant currency, consisting of a 2% rise in worldwide pharmaceutical sales and an 8% jump in diagnostics revenue. While this performance weakened somewhat from previous quarters, the nine-month sales increase of 4% is in line with the firm's expectation of low- to mid-single-digit sales growth for the full year. Notably, uptake has been solid for three new cancer therapies introduced over the past year: Alecensa for ALK+ non-small cell lung cancer, Cotellic for combination use with Zelboraf in skin cancer, and immuno-oncology cornerstone Tecentriq for its first indications in bladder cancer and metastatic NSCLC. Collectively, these treatments generated sales of CHF 229 million so far in 2016. Strong performance of new medicines gives us confidence that the firm can overcome eventual biogeneric competition in the coming years to its best-selling cancer drugs – Rituxan, Avastin, and Herceptin--that presently represent about 40% of total revenue.

From a credit perspective, Roche has been financially conservative by opting for small acquisitions to fill research gaps and limiting shareholder returns to a dividend alone. As a result, the firm's credit profile remains strong, with CHF 7 billion in cash and investments compared with CHF 23 billion in total debt at last count as of the end of June for gross debt and net debt leverage of 1.2 times and 0.8 times, respectively, for the trailing 12 months ended in June. Free cash flow that we estimate at almost CHF 14 billion annually on average through 2020 should be more than enough to satisfy coming long-term debt maturities during that period, which total nearly 28% of total borrowings, and to pay a healthy dividend. Currently, Roche targets a dividend payout ratio of 60% and accordingly paid around CHF 7 billion for the latest 12 months ended in June. We expect the firm to remain disciplined with capital deployment, but would not be surprised by a series of tuck-in asset purchases that could modestly move leverage higher.

Market Data

For closest comparisons to Roche's notes, we look to similarly rated companies, Pfizer (rating: AA-) and Bristol-Myers Squibb (rating: AA-, stable outlook). Also, we look for comparison with higher-rated Eli Lilly (rating: AA, stable outlook) and Merck (rating: AA). The Morningstar AA Industrials Index was most recently at +84 basis points, which is most comparable to the 10-year maturity bucket.

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

Roche's 2.875% notes due in 2021 at +55 basis points;
Merck's 1.8% notes due in 2020 +27 basis points;
Eli Lilly's 1.95% notes due in 2019 +37 basis points;
Pfizer's 1.95% notes due in 2021 at +41 basis points;
Bristol-Myers Squibb's 2.0% notes due in 2022 +40 basis points.

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

Roche's 2.625% notes due in 2025 at +72 basis points;
Merck's 2.75% notes due in 2025 +76 basis points;
Eli Lilly's 2.75% notes due in 2025 +54 basis points;
Pfizer's 2.75% notes due in 2026 at +69 basis points;
Bristol-Myers Squibb's 3.25% notes due in 2023 +40 basis points.

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

Roche's 4.0% notes due in 2044 at +87 basis points;
Merck's 3.7% notes due in 2045 +93 basis points;
Eli Lilly 3.7% notes due in 2045 +93 basis points;
Pfizer's 4.4% notes due in 2044 at +109 basis points;
Bristol-Myers Squibb's 4.5% notes due in 2044 +99 basis points.

Reynolds American Reports Decent Third-Quarter Results; Growth Slows, Margins Expand

MCR Credit Risk Assessment

Reynolds American (Rating: BBB, stable) third-quarter revenue was weaker than anticipated, growing 1.4% to $3.2 billion. Operating income excluding asset impairment charges surged 18.3%, greater than expected, to $1.5 billion. The increase was mainly due to net price realization of 3.9% in the third quarter. The increase in the top line was attributed to slightly higher volumes from Newport, Santa Fe's Natural America Spirit cigarette brand and America Snuff, the company's moist tobacco business. Natural American Spirit brand and American Snuff contributed 10.1% and 8.8 % to Reynolds American's total operating income respectively.

The U.S. cigarette industry volume declines are tracking better than our expectation of mid-single digit, which is attributed to the improved macroeconomic environment. Reynolds American reported that it expects an industry run rate of 2.5% for the year, after experiencing declines of 3.4% in the third quarter and 1.8% for the first nine months. Reynolds American's third-quarter cigarette volume was down 1.5% from the prior-year quarter and retail cigarette market share for RAI's increased three tenths of a percentage point from the prior-year quarter to 34.6%. Newport and Natural America Spirit were responsible for the market share increase. Newport is now fully integrated and currently represents almost half of Reynolds American's cigarette volume. Newport, which is a premium cigarette and priced accordingly, is also providing a mix benefit and contributing to higher operating margins. Reynolds American reported that Newport's volume in the third quarter was up almost 1% versus the prior year and its retail market share increased 40 basis points to 13.9%.

U.S. cigarette consumption has been declining for decades and as a result, new product development is crucial for the longer-term viability of the industry. We view electronic and smokeless cigarettes as the next-generation tobacco products and critical to the industry's long-term growth. Reynolds American indicated that its Vuse Digital Vapor cigarettes continue to grow volume and lead the category with market share more than 3 times its closest competitor in traditional retail channels. However, the company did not disclose any further detail regarding Vuse.

Higher pricing is expected to more than offset cigarette industry volume contraction, which is critical for a tobacco company to maintain its credit profile. Reynolds American expects cigarette volume declines to track within their historical range of down 2%-4% annually. Reynolds American total debt/adjusted EBITDA was 2.4 times for the latest 12 months ended Sept. 30, in line with the rating category considering the industry’s above-average regulatory risk and litigation risk. Reynolds American leverage is only slightly better than it was for the 12 months ended June 30.

EBITDA/interest was estimated 8 times for the latest 12 months ended Sept. 30. The company’s debt level was $13.2 billion only modestly lower than the prior quarter-end and its cash balance was stable at $1.9 billion at period end. Management stated that they were within the top end of their long-term target leverage range of 1.5 times to 2.5 times of total debt/EBITDA and given the relatively low interest rate outlook, along with their improving interest coverage, that they are comfortable operating at the higher end of their target leverage range. Management emphasized measures that it has taken to further enhance shareholder value, and reiterated a previously announced increase in the dividend payout ratio to 80% and the company's $2 billion share repurchase program, which is scheduled for completion by year-end 2018. Reynolds American purchased $75 million of its common stock during the third quarter under this new authorization.

Market Data

The U.S. tobacco industry is essentially a duopoly, with Reynolds American and Altria Group (Rating: BBB, stable) controlling approximately 85% of the market. Altria is the industry leader and the largest firm with a just-over 50% market share and Reynolds American (Rating: BBB, stable), operating as the second-largest and a strong competitor with approximately a 34.6% market share. Reynolds American 4.45% notes due 2025 were indicated by pricing service Advantage Data at 135 basis points over the nearest Treasury while Altria Group 2.625% notes due 2026 are indicated at 86 basis points over the nearest Treasury. As an additional comparable, Kraft Heinz Company (Rating: BBB-, positive) 3.0% notes due 2026 were indicated at 123 basis points over the nearest Treasury. We expect Kraft Heinz leverage to be in the mid-high 3.0 times by year-end. Altria's overall credit measures align at the high end of the rating category. Its total debt/EBITDA is 1.5 times, almost a full turn less than Reynolds American and its owns a 10.5% stake in the combined SABMiller/Anheuser-Busch InBev. Altria's precombination stake in SABMiller was worth in excess of $20 billion.

Illinois Tool Works Reports Record Third-Quarter Results

MCR Credit Risk Assessment

Illinois Tool Works’ (rating: A) enterprise strategy initiative continued to shine through as the company delivered record quarterly results, although the performance only led to a muted guidance increase. The firm raised the low-end of its 2016 earnings per diluted share guidance, boosting the midpoint to $5.61 from $5.60 per share, but maintained organic revenue growth of 1% to 2%.

Revenue increased 4% versus the year-ago period, driven by a 2% increase in organic sales--the firm's product line simplification was a 1% headline. Geographically, North American revenue increased 1%, Europe, Middle East, and Africa was up 3%, and China grew 13%. The firm's welding segment (10% of sales) was hardest hit by the industrial end-market malaise, with revenue falling 9%, while automotive, the firm's largest segment at 22% of sales, increased 25% (7% organically), as the company outgrew automotive build rates across the globe. The firm's enterprise initiative again bolstered profitability, with reported margins up 40 basis points to 23.1%. Margins excluding acquisition dilution expanded 120 basis points to 23.9%. Margins gains were most pronounced in testing, measurements, and electronics (15% of sales), increasing 440 basis points to 21%, while welding margins expanded 170 basis points to 26.5% despite the top-line decline. As a result, we estimate EBITDA grew 5% to $923 million. The firm produced $543 million in free cash flow, down roughly $100 million from last year, and returned approximately $700 million to shareholders via dividends and repurchases. The company completed its purchase of Engineered Fasteners and Components for $450 million, which we suspect explains the majority of the $529 million increase in debt. The firm ended the quarter with cash of $2.3 billion and debt of $7.7 billion, resulting in leverage of 2.2 times, up 0.1 turns from last quarter.

Finding a direct peer is a tall order, but diversified peers Parker Hannifin (rating: A) and Dover (rating: A-, negative) provide some decent comparables. ITW is benefiting from strong profitability improvements and a better end-market composition. Nearly 60% of ITW's business is tied to consumers, while approximately 80% of Parker's business is exposed to general industrial markets and roughly 15% of Dover's sales is tied to energy.

Market Data

ITW's 3.50% notes due in 2024 have recently traded in small sizes in the range of +59 basis points to +64 basis points over the nearest Treasury. According to pricing service provider Advantage Data, the Parker Hannifin 3.30% notes due in 2024 are indicated at +84 basis points over the nearest Treasury, while the Dover 3.15% notes due in 2025 are indicated at +93 basis points.

EBay Reports Mixed Third-Quarter Results

MCR Credit Risk Assessment

EBay (rating: BBB+) reported mixed results for the third quarter that ended Sept. 30. While the company raised full-year revenue guidance again, gross merchandise volume growth decelerated and margins compressed. EBay reported an 8% revenue increase to $2.2 billion on a currency-neutral basis, including growth in all segments. Total transaction revenue increased 5% to $1.7 billion including 31% revenue growth at StubHub to $261 million. Classifieds revenue increased 11% to $197 million. However, total gross merchandise volume growth decelerated to a 2.6% year-over-year growth rate in the third quarter, down from 3.9% in the second quarter. Also, gross merchandise volume growth rates decelerated to 23% at StubHub compared with 34% in the second quarter. EBay added another 1 million active buyers, which now total 165 million. Third-quarter adjusted operating margins declined 200 basis points year over year to 29.9%, largely due to the mix shift to StubHub, which has a lower gross margin, increased investments in marketplace structured data initiative, and a continued negative currency impact. EBITDA decreased 4% year over year to $819 million, while margins fell 370 basis points versus last year.

EBay generated $617 million of free cash flow in the third quarter and paid out $500 million for share repurchases, which remains consistent with an expected $500 million-$600 million per quarter. For the last 12 months, revenue and EBITDA was $8.9 billion and $3.5 billion, respectively. Free cash flow for the last 12 months was $2.7 billion, which approximately equaled share repurchases totaling $2.6 billion. Total debt was $9.0 billion on Sept. 30, including $2.25 billion of new debt raised during the first quarter of 2016. The ratio of total debt/adjusted EBITDA was 2.6 times. EBay maintains a very liquid balance sheet including cash and nonequity investments totaling over $10 billion, most of which is held in international accounts. Accordingly, eBay's balance sheet is in a net cash position.

Full-year 2016 revenue growth guidance is now $8.95 billion-$9.0 billion. This represents 6%-7% growth compared with 2%-5% growth expected at the beginning of the year. While previous second-quarter guidance included free cash flow of $2.2 billion to $2.4 billion, the expected proceeds of $1.2 billion from asset sales will affect this estimate depending on the tax implications of the divestiture. Morningstar Credit Ratings, LLC's rating on eBay contemplates the maintenance of its current liquid balance sheet and credit metrics, despite the potential for continued margin pressure, EBITDA declines, and modest acquisition activity.

EBay has a narrow economic moat as assigned by Morningstar, Inc., which is supported by a network effect. EBay's 165 million active buyers worldwide create a barrier to entry. Still, recent gross merchandise volume growth remains in the low- to mid-single-digit range, which is less than midteens industry growth, and suggests potential customer migration to Amazon.com (rating: BBB+).

Morningstar Credit Ratings believes eBay is fairly positioned in the BBB+ rating category due to its solid cash flow generation and the maintenance of substantial liquidity, despite a negative moat trend as assigned by Morningstar, Inc. The company's nearest comparable in the online retailing sector is Amazon, which we view as strongly positioned in its rating category. Amazon has a wide economic moat with a stable trend as assigned by Morningstar, Inc. In addition, Amazon is posting strong double-digit revenue, EBITDA, and free cash flow growth rates. Similar to eBay, Amazon's balance sheet net leverage is minimal and it carries substantial liquidity. For comparison, we look to another retailer, Nordstrom (rating: BBB+, stable outlook). MCR views Nordstrom as weakly positioned in its rating category due to its higher leverage, substantial negative retained free cash flow after dividends and share repurchases, and declining EBITDA. MCR believes that Hasbro (rating: BBB+) is strongly positioned in the BBB+ rating category; its operating performance and credit metrics continue to improve. Morningstar, Inc. has assigned a narrow moat rating to Hasbro. Mattel (rating: BBB+) is assigned a narrow moat and a negative moat trend by Morningstar, Inc. Further, Mattel carries substantially higher debt leverage for its rating category than its peers. Finally, similar rated Bed, Bath & Beyond (rating: BBB+) is weakly positioned in its rating category as evidenced by declining revenue, EBITDA, and margins, as well as deteriorating credit metrics. Bed, Bath & Beyond has been assigned no moat by Morningstar, Inc.

Walgreens Delays Rite Aid Acquisition Until Early 2017

MCR Credit Risk Assessment

On Oct. 20, Walgreens Boots Alliance (rating: BBB-) reported solid fiscal fourth-quarter operating results and gave guidance about its pending acquisition of Rite Aid (not rated). In constant currency, quarterly sales grew nearly 3% year over year and adjusted operating income grew 7% (10% in constant currency), reflecting general cost efficiencies primarily in its international and wholesale operations. Overall, Walgreens continues to seek adjusted earnings per share growth in the low-double digits in the long run including repurchases, which should satisfy shareholders, in our opinion.

From a credit perspective, the major event of the quarter was the Rite Aid acquisition delay. Both companies have agreed to push back the pending closing date of the acquisition until Jan. 27, or three months after the initial projected merger date of Oct. 27. Walgreens management expressed confidence that the deal would close by early calendar 2017 and suggested that antitrust clearance would be possible with the sale of the 500-1,000 stores previously highlighted in a September press release. Of note, Walgreens' debt now reflects the financing for the Rite Aid transaction after the company issued $6 billion in new bonds in early June. At the end of August, Walgreens owed $19 billion in debt and held $10 billion of cash on its books, which should help it finance the $17 billion Rite Aid acquisition (including the assumption of Rite's $7 billion of net debt). On a pro forma basis for the combined entity, we estimate that lease-adjusted leverage will stand in the low-to-mid 4s if the deal closes as planned. For comparison, CVS Health's (rating: BBB+) lease-adjusted leverage was inflated in the mid-3s as of June (above its 2.7 times long-term target) because of recent acquisition activity.

Market Data

Walgreen's closest comparable from a business and credit perspective is CVS Health, and Walgreen's bonds typically trade wider than CVS's bonds. However, both issuers' bonds typically trade tighter than the Morningstar Corporate Bond Index when adjusted for rating. We also use Express Scripts (rating: A-) as a key comparable in the pharmaceutical supply chain, and we note that Express Scripts' bond spreads are currently wider than comparable bonds from Walgreens, despite Express Scripts' multiple-notch higher rating than Walgreens by our methodology.

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

Express Scripts' (rating: A-) 3.30% notes due 2021 at +83 basis points
CVS's (rating: BBB+) 2.80% notes due in 2020 at +70 basis points
Walgreen's (rating: BBB-) 2.60% notes due in 2021 at +93 basis point

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

Express Scripts' (rating: A-) 4.50% notes due 2026 at +162 basis points
CVS's 2.88% (rating: BBB+) notes due in 2025 at +115 basis points

Walgreen's (rating: BBB-) 3.45% notes due in 2026 at +130 basis points

Also, for comparison to the approximately 10-year bonds, we highlight Morningstar's Corporate Bond Index adjusted for rating as follows:

A- at +121 basis points
BBB+ at +149 basis points
BBB at +171 basis points
BBB- at +209 basis points

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

Express Scripts' (rating: A-) 4.80% notes due 2046 at +203 basis points
CVS's (rating: BBB+) 5.13% notes due in 2045 at +142 basis points
Walgreen's (rating: BBB-) 2.50% notes due in 2046 at +166 basis points

According to pricing service Advantage Data, Steel Dynamics' 5.25% notes due on April 15, 2023, recently traded at a yield of 4.01% to the first call in 2018. For comparison, Commercial Metals' (rating: BB+, negative outlook) 4.875% notes due on May 15, 2023, recently traded at a yield of 4.69% to maturity. Meanwhile, the BofA Merrill Lynch BB Index's yield-to-worst is 4.39%.

Steel Dynamics Reports Third-Quarter Results, Announces $450 Million Share Repurchase Program

MCR Credit Risk Assessment

Steel Dynamics (rating: BB+; stable outlook) reported third-quarter results on Oct. 20 and posted adjusted EBITDA for the quarter of $359 million versus $340 million sequentially and $214 million in the year-ago period. Free cash flow for the quarter was $136 million and for the first nine months was $520 million. This compares with $134 million and $622 million in the year-ago periods. Debt was largely unchanged for the quarter at $2.6 billion, as was cash and equivalents on hand of approximately $1 billion. The company also has additional liquidity through its undrawn $1.2 billion revolving credit facility due in 2019. Steel Dynamics' sales for the quarter were up slightly to $2.1 billion from $2.0 billion sequentially and $1.95 billion in the same quarter a year ago. Steel volumes were down approximately 9% quarter over quarter, but price realizations were up $100 per ton (15%) to $740 per ton versus the second quarter's realizations.

Last 12-month adjusted EBITDA was slightly over $1 billion, resulting in debt/last 12-month adjusted EBITDA of approximately 2.6 times, which is in line with our expectations for the rating category. As a result of its strong free cash flow and robust cash balance, the company also announced a $450 million share repurchase program, reflecting its confidence in its ability to continue to generate strong free cash flow even in less-than-robust steel market conditions. The $450 million represents approximately 7% of the company's market capitalization. The new share repurchase program replaces the existing one and is expected to be completed in 18-24 months. Free cash flow should exceed the repurchase amount over this time period.

The company commented that its domestic steel demand outlook was essentially unchanged, with continued weakness in heavy equipment, agricultural, and energy markets but improvement in construction markets and automotive markets remaining strong. Steel Dynamics also said that customers were recently hesitant to buy ahead of anticipated scrap price decreases indicating a potentially seasonal weaker fourth quarter in terms of shipments and prices. Our rating continues to reflect the company's low-cost operating profile in the steel industry coupled with its growth ambitions and financial leverage target of net debt/EBITDA of less than 3 times. Historically, Steel Dynamics' gross debt/EBITDA leverage has generally ranged between 3.0 and 4.0 times over the last five years. The company's nearest maturity is approximately $600 million due in the second half of 2019. Its senior notes also possess early call dates, with some beginning this year.

Market Data

According to pricing service Advantage Data, Steel Dynamics' 5.25% notes due on April 15, 2023, recently traded at a yield of 4.01% to the first call in 2018. For comparison, Commercial Metals' (rating: BB+, negative outlook) 4.875% notes due on May 15, 2023, recently traded at a yield of 4.69% to maturity. Meanwhile, the BofA Merrill Lynch BB Index's yield-to-worst is 4.39%.

Verizon Reports Mixed Wireless Results in Third Quarter, Recent Issuance Has Increased Net Debt

MCR Credit Risk Assessment

Verizon Communications (rating: BBB, stable outlook) reported its third-quarter results, which reflected headwinds from competition from other wireless carriers, a negative impact from the Samsung Note 7 recall, and an uptick in subscriber activity in FiOS installations following last quarter's weakness as a result of a labor stoppage. The carrier reported a net loss of 36,000 phone customers during the quarter, compared with 430,000 of net adds last year, though overall retail connections increased 3%. Postpaid churn also increased sequentially, ending the quarter at 1.04%. Our rating on Verizon reflects its dominant position in U.S. wireless telecommunications, supported by high brand awareness, extensive investment in spectrum blocks across the U.S., and generally stable postpaid customer growth. Despite stable Business Risk, Verizon's Cash Flow Cushion and Solvency Score remain constrained by debt incurred to fund the acquisition of a minority portion of its wireless business from Vodafone in 2013.

Adjusted for installment billings, wireless service revenue increased 2.3%, or roughly in line with customer growth. With over 60% of postpaid customers now on unsubsidized phone plans, management expects to resume revenue growth by the end of next year. Notwithstanding weak top-line results, a decline in equipment costs contributed to a 1.7-percentage-point improvement in margin. In wireline, reported revenue declined 2.3%, while non-GAAP wireline EBITDA margin improved just under 2.5 percentage points from a year ago. Revenue declines were primarily attributable to small business (down 5.3%) and wholesale (down 3.9%). Revenue for consumer retail, the largest component of the segment, was flat as FiOS net connections rebounded from the labor dispute earlier this year.

This past summer, Verizon raised $6.2 billion from new senior notes and an additional $2.6 billion through ABS notes backed by handset receivables. As a result, net debt increased $3 billion during the third quarter to $100 billion, or 2.4 times trailing EBITDA by our calculation. We expect additional issuance over the coming year to fund the pending acquisitions of Yahoo (not rated) and Fleetmatics (not rated), assuming they are completed as announced. We also expect Verizon to be an active bidder in the wireless broadcast spectrum auction, which is currently under way. As a consequence of these endeavors, we project net leverage to return to at least 2.5 times by the end of 2017. However, management reiterated its intent to return to its pre-Vodafone financial condition by year-end 2019, which we believe would involve net debt below 2.0 times on a sustainable basis. In the meantime, Verizon's financial flexibility remains solid. Over the past 12 months, the company produced $11.5 billion of free cash flow and $2.5 billion, net of dividends. Short-term debt payable over the next 12 months is $3.9 billion, supported by cash on hand of $6.1 billion.

Market Data

Verizon's recently issued 2.63% notes due 2026 are now indicated at +119 basis points over the nearest Treasury, roughly unchanged from the new issue price on Aug. 1. AT&T's (rating: BBB, negative outlook) 4.13% notes due 2026 are indicated at +146 basis points, 14 basis points tighter since Aug. 1. Meanwhile, the Morningstar Industrial Corporate BBB rated Index, now quoted at +168 basis points, is 18 basis points tighter over the same period.

Mattel's Third-Quarter Results Demonstrate Stabilization

MCR Credit Risk Assessment

Mattel (rating: BBB+) reported third-quarter results (ended Sept. 30) that demonstrated a stabilization in revenue, EBITDA, and margins for the first time since losing the Disney Princess license at the beginning of the year. Mattel reported flat third-quarter gross revenue (and a 1% increase in constant currency) of $1.8 billion. Excluding Disney Princess, worldwide gross sales increased in the low-double-digit range (in constant currency). Mattel recorded solid quarter-over-quarter revenue gains in its three largest brand categories, including Fisher-Price (up 6%), Barbie (16%), and Wheels (6%). While gross margins declined 60 basis points due to negative currency effects, Mattel's cost-saving efforts bolstered EBITDA margins 30 basis points over last year to 22.5%. Third-quarter adjusted EBITDA grew 2% over last year to $404 million. For the last 12 months through the third quarter, revenue was $5.6 billion, or 1.4% behind full-year 2016 revenue, while adjusted EBITDA was $934 million, or 2.1% behind full-year 2016 EBITDA. For full-year 2016, Mattel forecasts flat revenue growth (excluding a 2%-4% negative currency impact); gross margins of 48.5%, which is 60 basis points higher than the 47.9% gross margin recorded in the last 12 months; and cost savings of $55 million to $65 million.

Free cash flow was $363 million over the last 12 months, which does not cover its $518 million annual dividend payout. Mattel continued to refrain from share repurchases given the increase in debt leverage over the past couple of years. Debt leverage is typically highest at the end of the third quarter as a result of seasonal working capital needs. At Sept. 30, adjusted debt/EBITDAR was 2.6 times. Cash balances were near $300 million and net debt/EBITDA was 2.3 times. After the typically strong cash-flow-generating fourth quarter, Mattel expects cash balances will increase to its target of $800 million to $1 billion at year end. During the third quarter, Mattel raised $350 million in new senior unsecured notes with proceeds expected to retire a $300 million notes issue due in November. Gross debt totaled $2.4 billion at Sept. 30. Adjusted debt increases by $1.1 billion for liabilities related to operating leases and pension liabilities, with adjusted leverage increasing to 3.4 times. At the end of the third quarter, the debt/capitalization ratio was 50%, substantially above management's target ratio of 35%. Morningstar Credit Ratings, LLC's rating on Mattel reflects the expectation that operational improvements will result in declining leverage over the next few years.

Mattel has a narrow economic moat and negative trend ratings as assigned by Morningstar, Inc. The three largest companies in the toy market--Mattel, Lego, and Hasbro (rating: BBB+)--together control over 30% of the fragmented U.S. market. These significant market shares, along with existing licensing and entertainment relationships, provide substantial barriers to entry for other competitors. Mattel will be challenged to keep pace with the growing long-term trend toward digital play as well as risks related to e-commerce retailers discounting pricing to maintain certain inventory levels.

MCR believes Mattel is fairly positioned in the BBB+ rating category. Mattel commands a leading competitive position offset by recent deterioration in operating performance and increasing debt leverage. For comparison, MCR believes that Hasbro is strongly positioned in its rating category as its operating performance and credit metrics continue to improve. Hasbro maintains adjusted leverage that is over one turn lower than that of Mattel along with a lower shareholder distribution rate relative to cash flow. Morningstar, Inc. has assigned a narrow moat rating along with a stable trend to Hasbro.

Market Data

According to the pricing service Advantage Data, Mattel's 2.35% senior notes due in 2021 recently traded +83 basis points over Treasuries. For comparison, Hasbro's 3.15% senior notes due in 2021 recently traded at +94 basis points over Treasuries.

We See AMD's Operating Uncertainty Remaining High Despite Solid Third-Quarter Results

MCR Credit Risk Assessment

Advanced Micro Devices (rating: CCC) released third-quarter operating results on Oct. 20 that reflected a solid uptick in both graphics and semicustom chip sales. The company also completed a $1.5 billion capital raise, including both common stock and convertible senior notes.

The company reported computing and graphics segment revenue up 11% year over year from an increase in mobile computing sales, while revenue for the embedded and semicustom segments jumped 31% as a result of the new Xbox One console launch. However, management's fourth-quarter and full-year guidance suggests that the third-quarter performance is not likely to repeat. Meanwhile, the mix shift toward semicustom revenue in the quarter contributed to the 60-basis-point decline over a year ago in gross margin to 31.5%.

Advanced Micro Devices ended its third quarter with $1.3 billion of cash on hand and total debt of $1.9 billion (including the new convertible notes at full par value). Total debt declined by $606 million during the quarter, driven by the repurchase of portions of the 6.75% notes due in 2019, the 7.75% notes due in 2020, and credit facility borrowings. After the quarter, the convertible notes issue was upsized to $805 million, and the company repurchased the remaining $208 million of 2020 senior notes. Advanced Micro Devices now has full availability under its $500 million 2018 credit facility and $162 million of new capital remaining, net of completed debt repayments. Management expects cash to end the fourth quarter higher, in line with its forecast of positive free cash flow for the full year. For the year to date, the company has burned $154 million of free cash flow, and we calculate that the company will need to generate nearly $180 million in the fourth quarter to break even based on management's operating guidance. While the company has meaningfully reduced the outflow of cash, we continue to view management's guidance for full-year positive cash flow as optimistic. Longer-term, guidance is for net debt of close to zero and total debt/EBITDA of around 2 times. We believe this suggests that management expects revenue to eventually return to quarterly run rates of around $1.7 billion in sales and around $190 million in EBITDA, a level of profitability not achieved since 2011.

The recent capital raise should give the company more flexibility to absorb future operating losses while it continues to invest in new product development and the marketing of existing products. However, our long-term fundamental outlook for the business remains cautious. With the secular decline in personal computer sales, demand for Advanced Micro Devices' traditional processors are likely to continue declining. Meanwhile, order flow for its semicustom chip products remains lumpy and difficult to predict while category revenue remains highly dependent on seasonal game console volumes. Our current credit rating reflects the challenging operating conditions the company is likely to continue facing in the coming years. While the company appears to be moving closer to restoring a break-even profitability position, uncertainty over future results remains very high.

Market Data

Advanced Micro Devices' 7% notes due in 2024 recently traded at a price of $97.13, or a yield of 7.50% to maturity and +589 basis points over the nearest Treasury. For comparison, Sprint's (rating: B, negative outlook) 7.63% notes due in 2025 are indicated at a yield to maturity of 7.46%, or a spread of +581 basis points. Both Advanced Micro Devices and Sprint notes remain wider than the BofA Merrill Lynch Index levels for B rated credits at +464 basis points, but well inside of the CCC index at +1,114 basis points.

AT&T Reportedly in Advanced Talks With Time Warner

MCR Credit Risk Assessment

The financial press, including Reuters and the Wall Street Journal, are reporting that AT&T (BBB, negative) is involved in advanced talks to merge with Time Warner (BBB+, stable) for a combination of cash and stock. At present, we consider the outcome of any discussions that are occurring as highly speculative and may not result in a material transaction. Also unclear is whether other bidders may be interested in pursuing Time Warner. Morningstar Credit Ratings is actively monitoring developments around this situation. Our negative outlook on AT&T's credit rating reflects our view that its financial flexibility is likely to remain pressured by a high dividend payout and significant debt maturities. We also view management's aggressive approach toward acquisitions over the past two years as a key contributor to high uncertainty around the credit.

Details around AT&T's motivation for Time Warner are scarce, though we suspect that AT&T may be attracted to the prospect of linking Time Warner's media brands, including HBO, CNN, and Warner Brothers, with its DirecTV video delivery platforms, including its fledgling streaming video concept, DirecTV Now. However, we generally remain skeptical of AT&T's ability to deliver long-run competitive returns on invested capital from its video distribution business. It is also unclear how AT&T will be able to derive synergies from pairing a proprietary video streaming platform (DirecTV Now) with a DSL broadband service that still depends on legacy copper phone wire for delivery in many geographic areas. A merger with Time Warner would not appear to address these concerns. Another potential challenge to AT&T is that its management has no particular expertise in running a media company, so it will likely be reliant on incentivizing existing Time Warner management to stay on after the merger.

However, assuming the two companies do come to terms on a full merger, we believe that AT&T would structure the deal to include a significant amount of debt in the financing package. Time Warner's market capitalization is currently around $73 billion, up 16% from Oct. 19, the last trading day before press reports of AT&T's early discussions with the company surfaced. At the end of June, AT&T reported net debt of 2.3 times EBITDA, while Time Warner's net debt was 2.8 times its EBITDA. We note that AT&T's offer to purchase DirecTV in 2014 included 30% of the total transaction value in cash, which increased net debt from 1.8 times EBITDA to around 2.5 times. Were the company to follow a similar strategy, we believe pro forma leverage may end up closer to Time Warner's current level of 2.8 times.

The combined companies would generate about $61 billion of annual EBITDA and $21 billion of free cash flow, based on the trailing 12-month period ended June 30. Given the deal structuring assumptions above, we believe that the combined dividend payout would approach $13 billion, or roughly 61% of pro forma free cash flow without synergies.

In 2014, Twenty-First Century Fox (not rated) offered $85 per share for Time Warner, but later withdrew its offer. Since mid-July 2014, the price of Fox' common stock has declined 26%, while Time Warner's has increased 26% over the same period, making it less likely that Fox would be inclined to compete at a higher price, in our view.

Market Data

According to data from FINRA TRACE, AT&T's 4.13% senior notes due 2026 traded at +168 basis points over the nearest Treasury today following the reports of advanced merger talks, or between 25 and 30 basis points wide of the level at the close on Oct. 19. Meanwhile, according to Advantage Data, Inc., Time Warner's 2.95% notes due 2026 are indicated at +138 basis points, or 20 to 25 basis points wider over the same period. We also note that Discovery Communications' (BBB, negative) 4.9% notes due

2026 are indicated at +195 basis points, while Viacom's (BBB, stable) 3.45% notes due 2026 are indicated around +170 basis points.

Schlumberger Posts Decent 3Q Results; Cameron Integration Remains Ahead of Plan

MCR Credit Risk Assessment

Leading oil-services company Schlumberger (rating: A+) reported third-quarter 2016 revenue of $7.0 billion, $1.8 billion (17%) lower than $8.5 billion revenue in third-quarter 2015. Commensurate with this, operating cash flow for third-quarter 2016 was $1.4 billion, $1.1 billion (45%) less than $2.5 billion for the year-ago quarter. The third-quarter 2016 numbers include Cameron, purchased by Schlumberger on April 1.

On a sequential basis, demand for Schlumberger's oilfield products and services both within and outside North America slightly declined in the third quarter, suggesting that activity has stabilized or nearly so. Similar to other oilfield-services companies, Schlumberger experienced a modest uptick in North American land-based service activity. However, this was mostly offset by continued weakness in the Gulf of Mexico, Alaska and offshore eastern Canada. Internationally, increased activity in Saudi Arabia, Kuwait, and Australia and seasonal strength in Russia was offset by continued weakness in the Far East and Latin America. Despite continued pressure on pricing, tremendous internal cost and efficiency improvements have allowed Schlumberger to maintain pretax operating margins above 10% and to continue to generate free cash flow, more than covering capital expenditures and dividends. For year-to-date 2016, Schlumberger reported $1.5 billion in free cash flow. Furthermore, the integration of Cameron into Schlumberger appears to be ahead of schedule, with cost- and revenue-related synergies coming about faster than planned.

Although Schlumberger did not give explicit forward-looking guidance, on the earnings conference call management stated that Cameron segment revenue will likely be flat to lower for the next few quarters and that it is too soon to say whether total company revenue in 2017 will be higher than in 2016. However, management commentary suggests that exploration and production in certain geographies is poised to increase, assuming oil prices continue to rise. In particular, management likes company prospects in the Middle East, Russia, and North America.

As of September, Schlumberger's liquidity remains excellent, with $10.8 billion in cash and equivalents and an estimated $3.6 billion available on its $6.8 billion combined credit facility and commercial paper program. Management guidance for 2016 capital expenditures is $2.0 billion, slightly lower than $2.2 billion budgeted, previously. Upcoming maturities of fixed-rate public notes include $1.5 billion due in 2017 and $1.6 billion in 2018.

At the end of September, total debt was $21.2 billion and net debt $10.5 billion. We estimate the ratio of total debt/trailing 12-month EBITDA to be 2.5 times and net leverage 1.2 times, higher than 2.1 times and 0.9 times at year-end 2015, respectively.

Market Data

Schlumberger can be compared with Halliburton (rating: BBB+, negative outlook), a large, diversified oilfield-services peer. According to pricing service Advantage Data, the 4.0% notes due on Dec. 21, 2025, from Schlumberger Holdings, the principal U.S. subsidiary of Schlumberger, recently traded at +130 basis points over the nearest Treasury. By comparison, Halliburton’s 3.80% notes due in 2025 recently traded at +155 basis points. Elsewhere within the energy industry, the 3.326% notes due on Nov. 17, 2025, from Chevron (rating: AA-) recently traded at +80 basis points over and Occidental Petroleum's (rating: AA-) 3.40% notes due in 2026 have been trading at +98 basis points over the nearest Treasury.

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