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Morningstar Corporate Credit Research Highlights

Surging Interest Rates Hardly Dent Demand for Corporate Bonds

Morningstar Credit Ratings, LLC
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Credit Market Insights

Surging U.S. Interest Rates Hardly Dent Demand for Corporate Bonds

Interest rates in the United States have generally been on a gradually rising trend for the past few years as the Federal Reserve has been hiking them to normalize monetary policy. More recently, interest rates began rising after the European Union announced its plan to begin pulling back on its asset-purchase program in Europe. Then, following strong economic metrics and intimations from U.S. monetary policy officials that rates still have much further to rise, U.S. interest rates spiked significantly higher across the entire yield curve last week. The contagion sent interest rates higher across other sovereign bond markets as well.

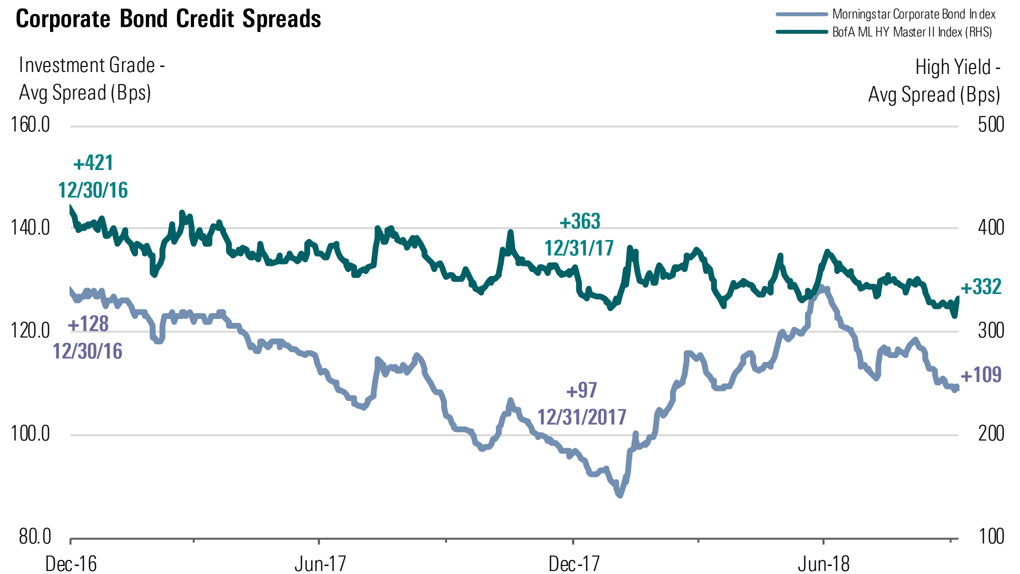
While the yield on the 2-year Treasury rose only 6 basis points to 2.88% last week, the middle and longer ends of the curve rose much more. In the belly of the curve, the 5-year increased 12 basis points to 3.07%, and in the longer end, the 10-year increased 17 basis points to 3.23% while the 30-year spiked 19 basis points to 3.40%. The yields on both the 2- and 5-year bonds have long been steadily marching higher in conjunction with the rising federal-funds rate and are at their highest levels since mid-2008. While the yield on the 10-year has not increased as much as the shorter-dated bonds thus far this year, it is quickly catching up and is at its highest level since mid-2011.

Short-term rates will probably continue to be under pressure over the course of the next year. According to the CME's FedWatch Tool, the market is pricing in an 82% probability of a quarter-point hike following the December Federal Open Market Committee meeting. According to market pricing, the Fed will have at least one more rate hike in store for 2019 and possibly two. The futures market is pricing in an 89% probability that the federal-funds rate will increase to 2.50% or higher following the October 2019 meeting and a 61% probability that the federal-funds rate will be 2.75% or higher.

In Europe, prices for Italian sovereign bonds have been under significant selling pressure for the past few months as investors are once again increasingly concerned about the country's finances. Most recently, the bond prices plummeted following Italy's announcement that its budgeted deficit for 2019 would breach the EU's limit. Currently, Italy's debt/GDP ratio is the second highest in the EU, surpassed only by long-beleaguered Greece. While there was a slight rebound in September, Italian sovereign debt continued its downward trajectory last week. The yield on Italy's 2-year bond rose 32 basis points to 1.34%, and in the longer end of the curve, the yield on Italian 10-year bonds rose another 27 basis points to 3.42%.

Germany's 2-year bond still trades at a negative yield of 0.51%, and German 10-years trade at 0.57%. As an indication of the market's risk perception of Italian default or redenomination risk, the spread between Italian and German debt has widened to 285 basis points. The current rates for Italian sovereign debt rival the highest interest rates the bonds have traded at since mid-2014, when they were recovering from the Italian banking crisis. Contagion from rising rates generally, and the weakening Italian bonds specifically, has spread to the equity market in Europe. Italy's FTSE MIB declined 1.77% following the 3.72% drop it suffered the prior week. Germany's DAX dropped 1.10%, France's CAC declined 2.44%, and Spain's IBEX fell 1.44%.

While interest rates on sovereign bonds surged higher, corporate credit spreads on investment-grade corporate bonds held steady and high-yield bonds backed off slightly. The average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade market) tightened 1 basis point to +109 last week. In the high-yield market, the BofA Merrill Lynch High Yield Master Index widened 8 basis points to +332.



Source: Morningstar,Inc., BofA Merrill Lynch Global Indexes. Data as of 10/05/2018.

Even with volatility poking its head out in the equity market, the investment-grade new issue market easily absorbed Comcast's (BBB+, negative) $27 billion multitranche offering. According to Bloomberg, this is the fourth-largest bond offering in the corporate investment-grade market. Proceeds from the offering will be used to fund the takeover of SKY plc (not rated). Morningstar Credit Ratings, LLC downgraded its corporate rating on Comcast to BBB+ on July 18 and moved the outlook to negative from stable. The downgrade reflected Comcast's weaker stand-alone Business Risk and Distance to Default scores, offset by a stronger Solvency Score and stable Cash Flow Cushion. The negative outlook recognizes the potential for additional pressure on Cash Flow Cushion and Solvency Score from the Sky acquisition.

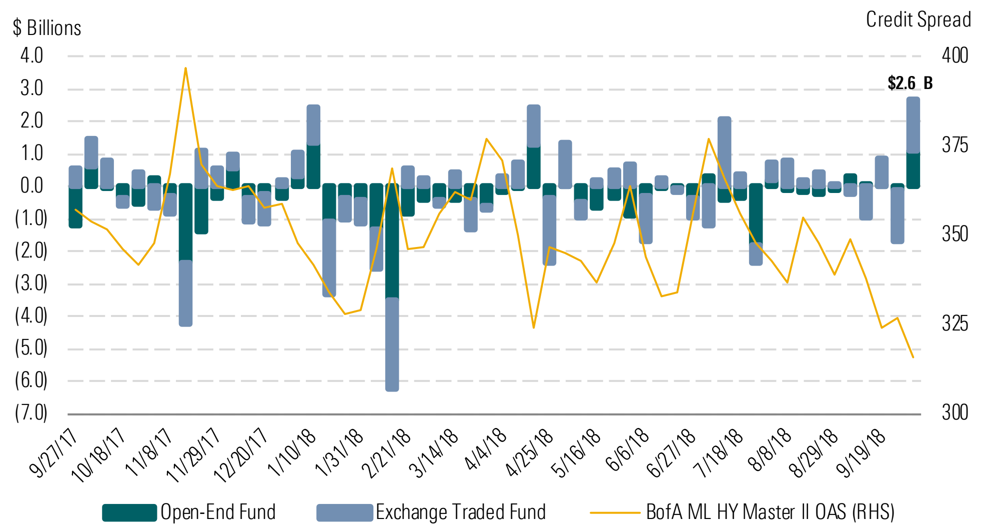
MCR's rating on Bed Bath & Beyond (rating: BB+, negative) is one to two notches lower than the other credit rating agencies', and the company's recently released second-quarter earnings reinforced our negative outlook on the company's credit risk. The rating reflects MCR's outlook for weakening revenue, margins, return on invested capital, and lower free cash flow. While the company continues to experience strong sales from its online channels, which MCR estimates to be growing in the double-digit range, comparable sales at its stores fell in the mid-single-digit range. Gross margins declined compared with last year and were hurt by the faster growth of lower-margin online sales that we estimate to represent over 15% of total revenue. EBITDAR fell 19% to $315 million, and margins eroded 260 basis points to 10.7%. As a result, the company lowered its revenue and margin guidance for fiscal 2018.

For greater detail regarding our credit ratings as well as for access to our corporate credit research and notes, please visit www.morningstarcreditratings.com.

Weekly High-Yield Fund Flows

After 12 months of relatively subdued volatility in net fund flows in the high-yield space, inflows came rushing back last week. Net inflows totaled $2.5 billion, consisting of $1.6 billion among high-yield exchange-traded funds and $1.1 billion of inflows across high-yield open-end mutual funds.
Year to date, fund flows have registered a total outflow of $13.8 billion, consisting of $2.5 billion of net unit redemptions across ETFs and $11.3 billion of redemptions among open-end funds.

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



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

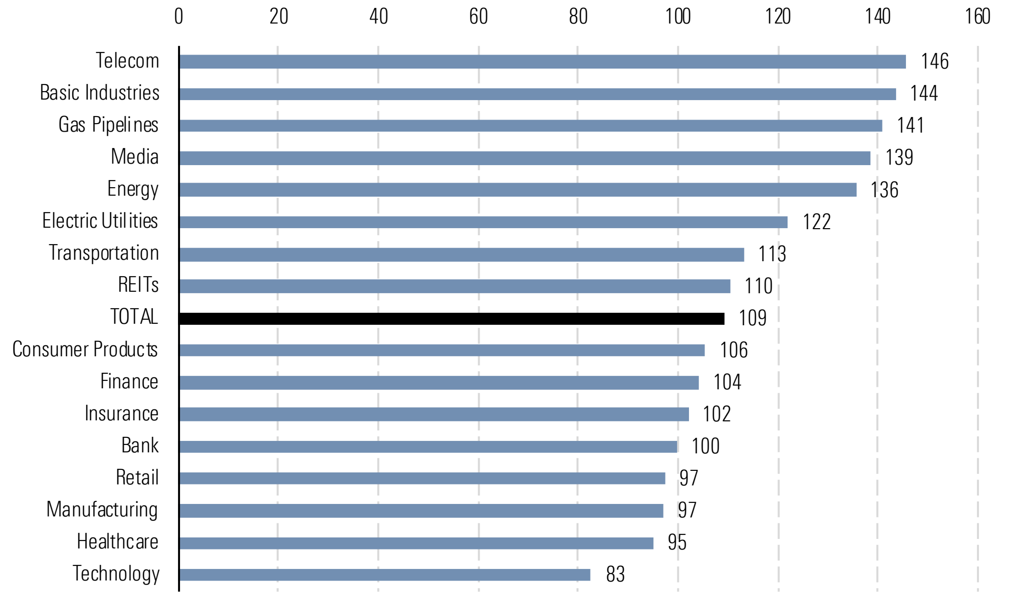
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	Spread (bps)	MTD Spread Chg (bps)	YTD Spread Chg (bps)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	**A-**	**5,137**	**6.8**	**109**	**(0)**	**13**	**(0.98)**	**(3.15)**
FINANCIAL	**A-**	**1,478**	**5.3**	**101**	**1**	**18**	**(0.74)**	**(2.51)**
Bank	A-	902	4.7	100	1	19	(0.64)	(2.15)
Finance	A	262	5.5	104	1	17	(0.83)	(3.03)
Insurance	A	216	8.0	102	(1)	16	(1.14)	(4.01)
REITs	BBB+	89	6.0	110	1	6	(0.81)	(2.28)
INDUSTRIAL	**A-**	**2,995**	**7.4**	**112**	**(1)**	**11**	**(1.07)**	**(3.41)**
Basic Industries	BBB	245	7.3	144	(5)	15	(0.79)	(3.57)
Consumer Products	BBB+	358	7.4	106	1	22	(1.30)	(4.60)
Energy	A-	403	7.2	136	(1)	14	(1.09)	(2.95)
Healthcare	A-	432	7.6	95	0	6	(1.15)	(3.85)
Manufacturing	A-	464	5.9	97	1	16	(0.81)	(2.94)
Media	BBB+	169	8.4	139	(4)	9	(1.01)	(3.61)
Retail	A-	169	7.6	97	(1)	10	(1.13)	(3.62)
Technology	A+	349	7.1	83	(1)	5	(1.00)	(2.91)
Telecom	BBB+	165	9.0	146	(2)	3	(1.28)	(2.51)
Transportation	BBB+	175	8.8	113	0	15	(1.23)	(4.54)
UTILITY	**BBB+**	**614**	**8.5**	**130**	**0**	**10**	**(1.34)**	**(4.03)**
Electric Utilities	A-	355	9.0	122	1	19	(1.46)	(5.27)
Gas Pipelines	BBB	242	7.7	141	(1)	(3)	(1.16)	(2.22)
Rating Bucket								
AAA Bucket		122	7.5	46	(1)	(3)	(1.08)	(3.42)
AA Bucket		504	5.7	61	0	3	(0.80)	(2.11)
A Bucket		1,919	6.7	88	(0)	14	(1.00)	(3.46)
BBB Bucket		2,592	7.0	141	(1)	13	(1.00)	(3.09)
Term Bucket								
1-4	A-	1,668	2.3	63	1	6	(0.15)	0.31
4-7	A-	1,180	4.7	101	0	21	(0.53)	(1.60)
7-10	A-	898	6.9	125	(0)	19	(1.06)	(3.63)
10PLUS	A-	1,391	13.4	158	(2)	13	(2.21)	(7.68)

Data as of 10/05/2018

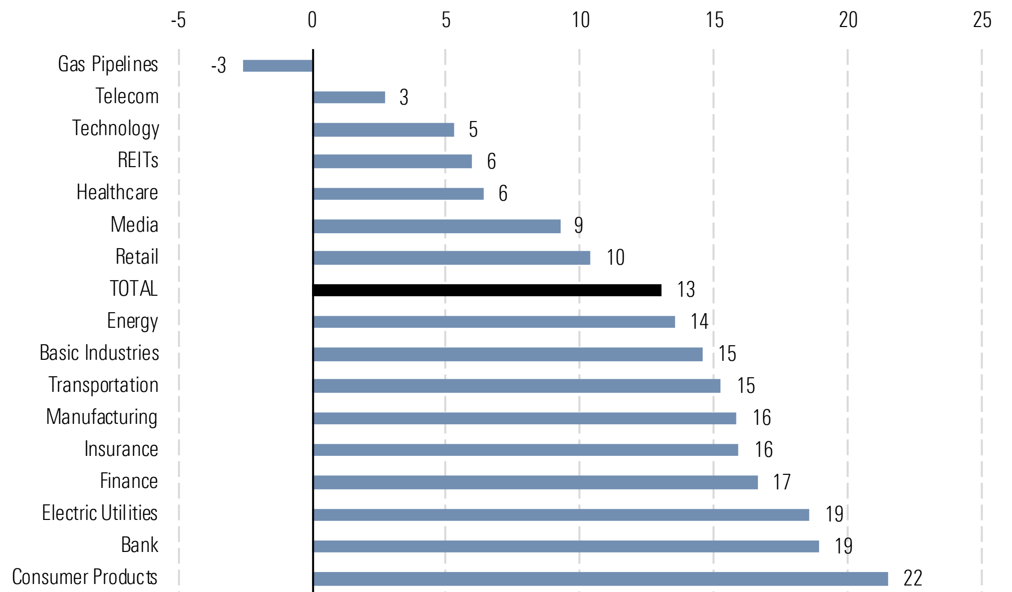
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



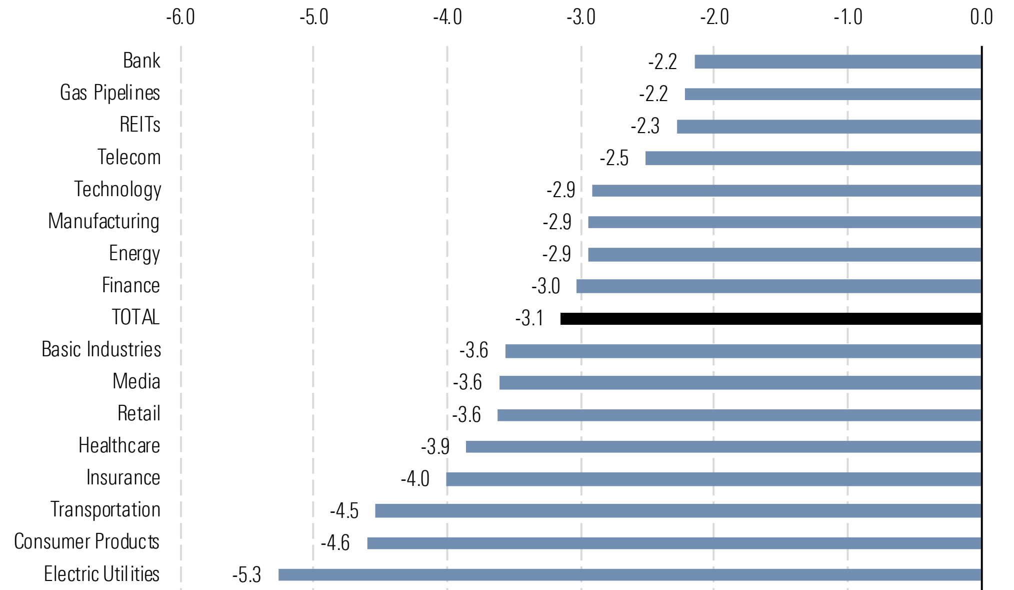
Source: Morningstar, Inc.

Exhibit 3 Morningstar Corporate Bond Index YTD Spread Change



Source: Morningstar, Inc.

Exhibit 4 Morningstar Corporate Bond Index YTD Return



Source: Morningstar, Inc.

Recent Notes Published by Credit Analysts

Camden Property Trust (A-, Stable) Issues New 10-Year Unsecured Notes, Reduces Secured Debt

Market News and Data

Camden Property Trust (A-, stable) is reportedly in the market Oct. 2 with a $400 million, 10-year offering of senior unsecured notes. Net proceeds are expected to be used to pay down the outstanding balance on the company's unsecured line of credit, which was drawn primarily to repay about $380 million of secured debt. Any remaining proceeds are expected to be used for general corporate purposes. Camden filed a preliminary supplement to the prospectus dated May 15, 2017.

Camden's rated multifamily real estate investment trust peers are AvalonBay Communities (A-, stable), Equity Residential (A-, stable), and Essex Property Trust (BBB+, stable). The following pricing is from Interactive Data as of Sept. 28. Relevant spreads over the nearest Treasury from these issuers were:

- Camden's $250 million 3.50% bonds due in 2024 at +104 basis points
- AvalonBay's $450 million 3.20% bonds due in 2028 at +88 basis points
- Equity Residential's $500 million 3.50% bonds due in 2028 at +91 basis points
- Essex's $350 million 3.63% bonds due in 2027 at +126 basis points

The A- Morningstar Corporate Bond Index is currently priced at +101 basis points.

MCR Credit Risk Assessment

Camden's A- rating and stable outlook are supported by moderate Business Risk, Cash Flow Cushion, and Solvency Score pillars. Camden's Business Risk reflects its high-quality portfolio of apartment complexes in a variety of markets across the U.S. as well as its experienced management team that has guided the company through multiple economic cycles. Camden has a moderate level of development risk, with several active projects underway. Camden has lower leverage than its peers and the second-highest interest coverage in the group.

Following the use of proceeds to retire a significant portion of secured debt, we anticipate that Camden's ratio of secured debt/gross assets will shrink to about 6% from 10%, providing additional flexibility to the balance sheet. We expect Camden to continue to manage its development program, funded partially through property dispositions, along with further issuance of debt and equity, and internally generated cash. The portfolio has been performing well and within our expectations, with same-store revenue and net operating income for the first half of 2018 up 3.3% and 3.6%, respectively, over the same period in 2017.

To achieve an upgrade, Camden would need to expand into more markets and grow its presence in its current markets while improving its balance sheet and achieving higher profitability; this seems unlikely at this time. Conversely, a period of excessive development coinciding with the end of the current economic expansion could pressure leverage and coverage metrics to the extent that a downgrade would be a consideration.

Comcast (BBB+, Negative) Announces 12-Part Senior Notes Issue to Fund Sky Takeover

Market News and Data

Comcast Corp. (BBB+, negative) is in the market with new senior notes to fund its takeover of Sky Plc (not rated). As proposed, the offering includes up to 12 parts, including 2-, 3-, and 5.5-year floating- and fixed-rate tranches and 7-, 10-, 12-, 20-, 30-, and 40-year fixed-coupon maturities. The senior notes will complement $15 billion of term loan credit facilities that Comcast has signed to help fund its acquisition of Sky. On Sept. 22, Comcast outbid Twenty-First Century Fox (not rated) to acquire Sky with a bid of GBP 17.28 per share, or a market value of just under $40 billion, based on the Sept. 28 British pound/U.S. dollar exchange rate. According to a preliminary prospectus filed Oct. 2, the proposed senior notes will be guaranteed by Comcast Cable Communications LLC and NBCUniversal, consistent with Comcast's other senior notes. The notes will not include any upstream guarantees from Comcast Bidco or any of its subsidiaries, including Sky.

We believe the two closest comparable peers to Comcast are Walt Disney (A+/UR-) and CBS Corp. (BBB, stable). We are also referencing Verizon Communications (BBB, stable) and the recent 10-year notes issued by Interpublic Group (BBB, stable). According to pricing from Interactive Data as of Oct. 1, senior notes in the 10-year area of Comcast and its peers are indicated as follows:

- Comcast's existing 3.15% notes due 2028 at +102 basis points
- Disney's 2.95% notes due 2027 at +63 basis points
- CBS' 3.38% notes due 2028 at +147 basis points
- IPG's 4.65% notes due 2028 at +165 basis points
- Verizon's 4.15% notes due 2027 at +106 basis points

According to data from Morningstar, Inc., the BBB+ category of the Morningstar Corporate Bond Index was +130 basis points as of Oct. 1.

MCR Credit Risk Assessment

Comcast reported cash on hand at June 30 of $5.7 billion and total debt of $64.6 billion. Net debt represented about 2.0 times trailing 12-month EBITDA. At Comcast's final bid, we estimate that net debt of the combined company will increase to 3.0 times pro forma EBITDA, which includes $30 billion-$35 billion of acquisition debt and $8.8 billion of debt assumed from Sky. For comparison, we believe Disney's pro forma net debt may increase above 2.0 times to complete its acquisition of core assets from Fox. Meanwhile, Verizon's net debt was at 2.4 times and CBS' at 3.1 times as of June 30. Based on our preliminary analysis, we believe Comcast's net debt should gradually return to the 2.0 times area in three to four years following the deal close, provided that management remains committed to debt reduction.

Morningstar Credit Ratings, LLC downgraded its corporate rating on Comcast to BBB+ on July 18 and moved the outlook to negative from stable. Our downgrade reflected Comcast's weaker stand-alone Business Risk and Distance to Default scores, offset by a stronger Solvency Score and stable Cash Flow Cushion. The negative outlook recognizes the potential for additional pressure on Cash Flow Cushion and the Solvency Score from the Sky acquisition.

In addition to the proposed senior notes, Comcast has signed term credit agreements for up to $15 billion. These facilities include a GBP 7 billion ($9.1 billion) two-tranche term loan signed in April and a $6 billion four-year term loan signed in August. The company reports that $7.6 billion has been drawn against the April term loan facility, $1.5 billion against Comcast's $7 billion revolving credit facility (due 2021), and $3 billion of commercial paper outstanding as of Sept. 28.

To date, Comcast has already accumulated a 37.7% holding of Sky shares, for which we estimate that it borrowed as much as $14.6 billion to acquire. Fox announced Sept. 26 that it intends to sell its 39% stake, valued at $15.1 billion, into Comcast, giving Comcast control of approximately 77% of Sky shares, more than enough to ensure shareholder approval.

Comcast continues to guide to $5 billion of share repurchases for 2018, of which just under $3 billion were completed in the first half of the year. Management has announced it will suspend the repurchase program in 2019 while it digests the Sky acquisition.

Bed Bath & Beyond (BB+, Negative) Lowers Full-Year Guidance After Weak 2Q

MCR Credit Risk Assessment

Bed Bath & Beyond's (rating: BB+, negative) second-quarter results, reported Sept. 26, confirm our negative outlook. The company's rating and outlook reflect weakening revenue, margins, return on invested capital, and lower free cash flow, despite good liquidity.

Bed Bath & Beyond reported revenue of $2.9 billion in the fiscal second quarter ended Sept. 1, which represented a 0.6% decline in comparable sales. While the company continues to experience strong sales from its online channels, which we estimate to be growing in the double-digit range, comparable sales at its stores fell in the mid-single-digit range. Gross margins declined 270 basis points compared with last year and were hurt by the faster growth of lower-margin online sales that we estimate to represent over 15% of total revenue. Also, growth in Bed Bath & Beyond's loyalty program, Beyond+, which has a 20% discount benefit, pressured margins. EBITDAR fell 19% to $315 million, and margins eroded 260 basis points to 10.7%.

The company lowered revenue and margin guidance for fiscal 2018. Comparable sales growth is now expected to be relatively flat for the year, compared with previous expectations in the low single digits. Likewise, earnings are expected to come in at the low end of previous guidance. Nevertheless, management did not revise its long-range forecast, which includes moderate declines in operating profit through the end of fiscal 2019, followed by earnings growth in 2020. Bed Bath & Beyond's Solvency Score remains weak, based in part by MCR's lower forecast EBITDA margins and single-digit returns on invested capital over the next several years.

Bed Bath & Beyond's gross debt remains unchanged from the $1.5 billion debt issuance in fiscal 2014, which was used for share repurchases. However, debt leverage continues to increase due to EBITDA declines. At the end of the second quarter, adjusted debt totaled $6.4 billion, including $4.9 billion of capitalized operating leases (8 times rent). Total adjusted debt/EBITDAR was 4.1 times and 3.4 times on

a net basis, flat with year-end fiscal 2017. The company's moderate Cash Flow Cushion reflects good liquidity and an extended debt maturity schedule. Liquidity includes cash and short-term investments totaling $1.1 billion and a $250 million revolver, and its first debt maturity is not until 2024. Year-to-date share repurchases have been modest, at $63 million, as the company focuses on capital preservation necessary to support its transformation initiatives.

Bed Bath & Beyond's rating continues to reflect moderate Business Risk based on its solid market position in the U.S. home furnishing industry, operating over 1,500 stores. Various initiatives are underway to improve revenue growth and profitability, including expansion into decorative furnishings, remodeling stores, inventory optimization, and personalized marketing. Still, the company operates in a very competitive retail sector that is increasingly penetrated by online rivals exerting pricing pressure. The negative outlook reflects ongoing uncertainty and a lack of visibility into the company's market environment over the next two years. We believe the company may continue to experience substantial pricing and margin pressure, which could limit the effectiveness of initiatives undertaken by the company to stabilize operations.

Market Data

According to Trace, Bed Bath & Beyond's $300 million 3.749% notes due 2024 are indicated at +291 basis points over the nearest Treasury. By comparison, Macy's (rating BBB-, negative) $500 million 3.625% notes due 2024 are at +141 basis points. Hanesbrands' (rating BBB-, stable) $900 million 4.625% notes due 2024 are at +217 basis points. Additionally, the BBB- Morningstar Corporate Bond Index is at a spread of +162 basis points.

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