Morningstar Corporate Credit Research Highlights

After shallow sell-off, corporate credit spreads stabilize.

Morningstar Credit Research
21 August 2017

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Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Ingersoll-Rand **IR**	BBB+	BBB

- Rating affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Waste Management **WM**	BBB+	BBB+
Republic Services **RSG**	BBB+	BBB+
3M **MMM**	AA-	AA-

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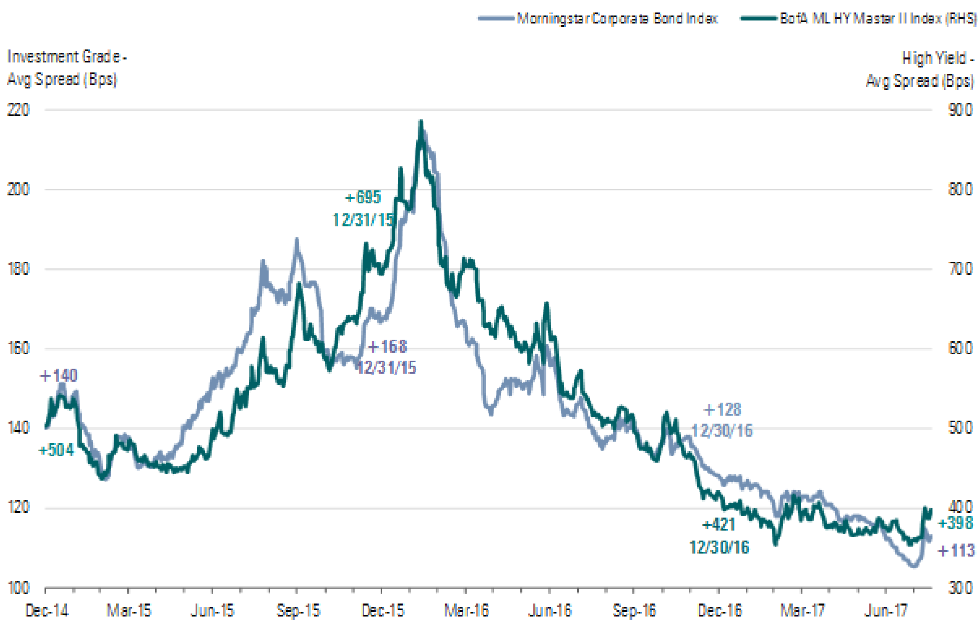
Credit Market Insights

After Shallow Sell-Off, Corporate Credit Spreads Stabilize

Credit spreads in the corporate bond market stabilized last week after a brief sell-off the prior week pushed spreads higher. The average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade bond market) tightened 2 basis points to +113, and the average credit spread of the BankAmerica Merrill Lynch High Yield Master Index tightened 2 basis points to +398.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., BofA Merrill Lynch Global Indexes. Data as of 08/18/2017.

While activity in the corporate bond markets typically experiences a seasonal slowdown in August, as many investors and investment bankers are on vacation, the new-issue market remained active last week. As evidence, even though issuers typically shy away from the new-issue market in August, Amazon.com (A, stable) issued a $16 billion, seven-part transaction with maturities ranging from three to 40 years. Proceeds from the new senior notes will be used as part of its planned financing to complete its acquisition of Whole Foods. Amazon's A rating reflects ongoing improvement in its competitive position as evidenced by a multiyear expansion in EBITDA margins and return on investment, along with the maintenance of moderate leverage and excellent liquidity. While MCR believes the transaction will have a negligible impact on Amazon's credit risk, the acquisition marks an important milestone in Amazon's grocery business. While Amazon's current grocery offering is largely limited to online shopping, it is testing a fully automated grocery store near its headquarters. MCR anticipates that Whole Foods' 460 stores in the United States, Canada, and the United Kingdom will be integrated with AmazonFresh, providing online delivery as well as a location for customer pickup.

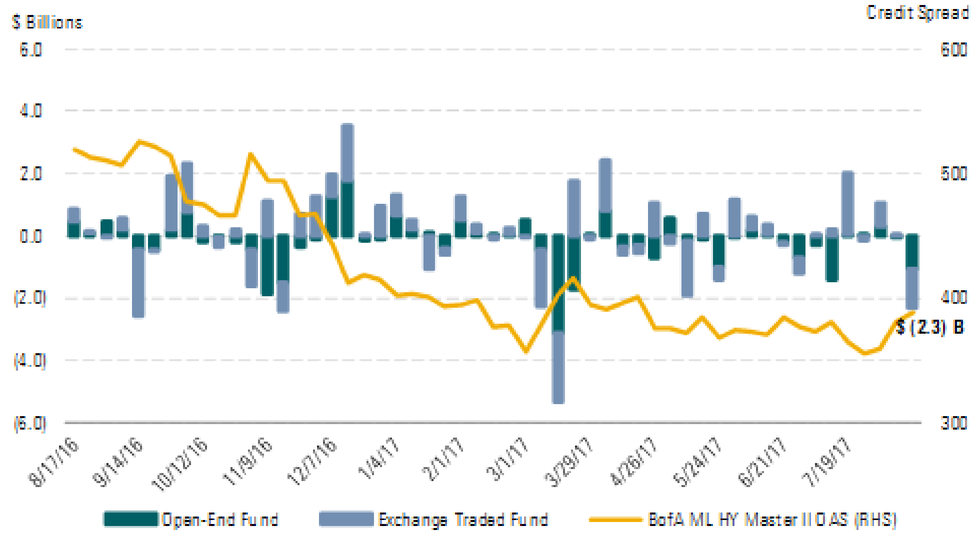
Earlier this month, British American Tobacco (BBB, stable) decided to issue $17.25 billion worth of bonds to fund its acquisition of Reynolds Tobacco. This transaction is the second-largest corporate bond deal issued this year, surpassed only by AT&T's (BBB/UR-) $22.5 billion transaction, which itself was the third-largest corporate bond deal in history. The proceeds from the AT&T transaction will be used as the final installment for the permanent financing of its pending acquisition of Time Warner (rating: BBB+/UR-). In addition, McCormick & Co. (A+/UR-) had issued $2.5 billion of new bonds two weeks ago to finance its acquisition of Reckitt Benckiser's food division.

With the largest of the transactions expected to fund mergers and acquisitions out of the way, the remainder of August should be relatively quiet. Second-quarter earnings reports have wound down and, except for some additional pressure in the retail sector, have been generally in line with the usual amount of hits and misses. Thus far, our corporate credit analyst team has not discerned any significant change to their sector outlooks. From a macroeconomic perspective, economic metrics remain strong, and the GDPNow forecast published by the Federal Reserve Bank of Atlanta for third-quarter GDP growth has risen to 3.8%. However, the Federal Reserve's annual economic policy symposium held in Jackson Hole, Wyoming, is this week. The conference will be closely watched, as Federal Reserve Chair Janet Yellen is scheduled to speak on Aug. 25 at 10 a.m. Eastern Standard Time. As part of her speech, which is expected to address financial stability, she may also provide additional information on the Fed's view toward its balance sheet normalization plans. In addition, European Central Bank President Mario Draghi is scheduled to attend the symposium. Any comments from Draghi will be closely scrutinized in case he alludes to any changes to the timing and composition of the ECB's quantitative easing program.

While the Fed did not make any changes to its monetary policy at its July meeting, its recently released minutes revealed that it remains concerned about a potential resurgence in inflation and that it has not changed its expectation for the economy to expand at a consistent rate. Assuming there aren't any significant negative catalysts before the next Fed meeting, the market is expecting that the Fed will begin its balance sheet normalization program in September. To start winding down the size of its balance sheet, the Fed will begin to gradually reduce the amount of interest income and principal repayments it reinvests by $10 billion per month. Once the reduction program begins, the Fed will then increase the amount of reduction by $10 billion per month until it reaches a cap of $50 billion per month. The Fed will then let $50 billion per month roll off its balance sheet until it decides that it is no longer holding more securities than necessary to implement its monetary policy.

Through the week ended Wednesday, Aug. 16, investors pulled $2.3 billion of assets out of the high-yield market. Among the open-end funds, investors withdrew $1.0 billion of funds, and across the high-yield exchange-traded funds, there was $1.3 billion of net units redeemed.

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



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

Exhibit 1 Morningstar Credit New Issue Monitor
Week ended Aug. 18, 2017
(000,000s $ unless otherwise noted)

Issuer			Issue				
Name	Ticker	Morningstar Corporate Rating	Size	Coupon	Description	Maturity	Approx Spread to US Treasuries
Amazon	AMZN	A	$1,000	1.90%	Senior Unsecured	2020	+40
Amazon	AMZN	A	$1,000	2.40%	Senior Unsecured	2023	+60
Amazon	AMZN	A	$2,000	2.80%	Senior Unsecured	2024	+75
Amazon	AMZN	A	$3,500	3.15%	Senior Unsecured	2027	+90
Amazon	AMZN	A	$2,750	3.88%	Senior Unsecured	2037	+105
Amazon	AMZN	A	$3,500	4.05%	Senior Unsecured	2047	+125
Amazon	AMZN	A	$2,250	4.25%	Senior Unsecured	2057	+145
Apple	AAPL	AA-	CAD 2,500	2.51%	Senior Unsecured	2025	+81.4(1)
Bank of New York Mellon	BK	A	$750	3.30%	Senior Unsecured	2029	+108
Laboratory Corp	LH	BBB+	$600	3.25%	Senior Unsecured	2024	+120
Laboratory Corp	LH	BBB+	$600	3.60%	Senior Unsecured	2027	+135
Lear	LEA	BBB-	$750	3.80%	Senior Unsecured	2027	+167
Philip Morris	PM	A-	$750	2.38%	Senior Unsecured	2022	+70
Philip Morris	PM	A-	$500	3.13%	Senior Unsecured	2027	+95
Western Union	WU	A-	$250	L+80	Senior Unsecured	2019	NA
Western Union	WU	A-	$500	3.60%	Senior Unsecured	2022	+155

Source: Bloomberg, company SEC filings
(1) Spread over Canadian Treasuries.

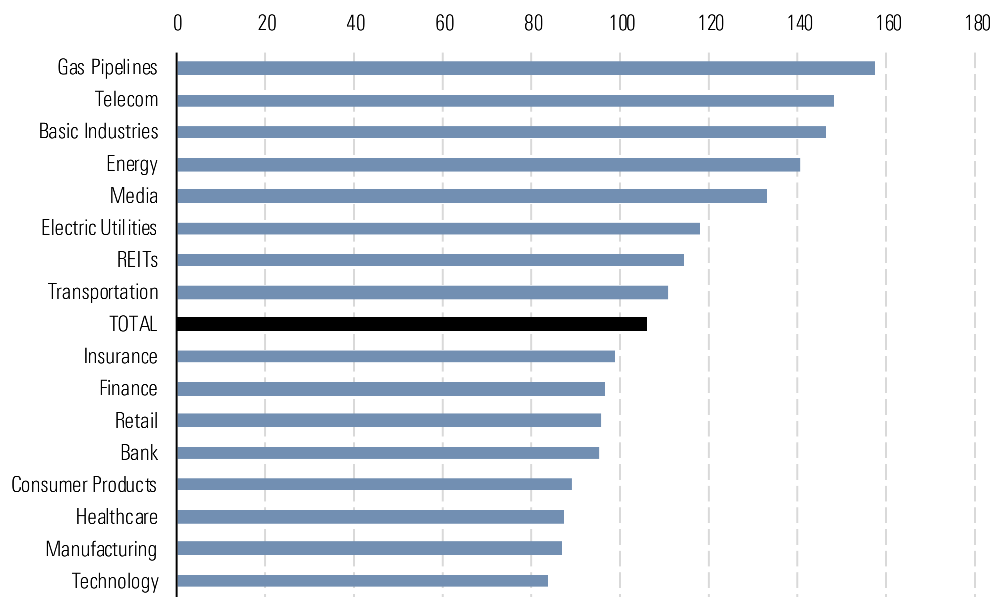
Exhibit 2 Morningstar, Inc. Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	Spread (bps)	MTD Spread Chg (bps)	YTD Spread Chg (bps)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	**A-**	**4,794**	**6.9**	**113**	**8**	**(15)**	**0.23**	**4.91**
FINANCIAL	**A-**	**1,466**	**5.5**	**99**	**4**	**(23)**	**0.36**	**4.55**
Bank	A-	891	5.1	98	4	(24)	0.30	4.36
Finance	A	276	5.6	102	6	(19)	0.29	4.36
Insurance	A	214	7.9	101	3	(21)	0.70	5.96
REITs	BBB+	76	5.9	113	1	(22)	0.67	5.21
INDUSTRIAL	**A-**	**2,758**	**7.6**	**118**	**10**	**(12)**	**0.12**	**5.00**
Basic Industries	BBB+	220	7.7	151	7	(29)	0.31	7.45
Consumer Products	A-	312	7.6	98	9	(9)	0.18	4.53
Energy	A-	408	7.3	149	11	(6)	0.20	5.17
Healthcare	A-	399	7.8	101	14	(14)	(0.21)	5.38
Manufacturing	A-	412	6.3	94	7	(16)	0.19	4.00
Media	BBB+	192	8.4	151	17	(7)	(0.29)	5.37
Retail	A-	161	8.2	105	10	(3)	0.26	4.35
Technology	A+	317	7.2	92	8	(13)	0.18	4.65
Telecom	BBB+	151	8.6	158	9	0	0.22	4.38
Transportation	BBB+	140	9.0	116	6	(17)	0.38	5.83
UTILITY	**BBB+**	**531**	**8.6**	**138**	**6**	**(14)**	**0.54**	**6.06**
Electric Utilities	A-	312	9.1	117	3	(19)	0.86	6.44
Gas Pipelines	BBB	209	7.7	167	12	(9)	0.05	5.51
Rating Bucket								
AAA Bucket		112	8.2	61	5	(5)	0.35	4.33
AA Bucket		484	6.0	70	4	(13)	0.35	3.73
A Bucket		1,854	6.9	89	5	(17)	0.35	4.58
BBB Bucket		2,344	7.1	146	11	(18)	0.10	5.53
Term Bucket								
1-4	A-	1,520	2.4	68	4	(25)	0.15	2.30
4-7	A-	1,160	4.7	95	6	(20)	0.24	4.33
7-10	A-	895	7.1	127	10	(10)	0.30	5.41
10PLUS	A-	1,219	13.9	168	11	(7)	0.27	8.09

Data as of 08/18/2017

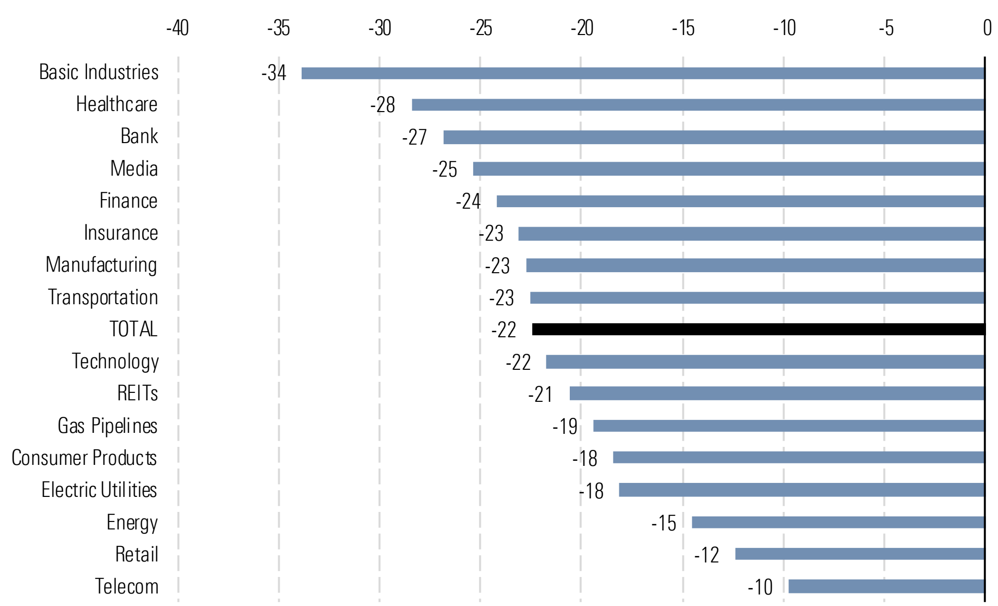
Source: Morningstar, Inc.

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



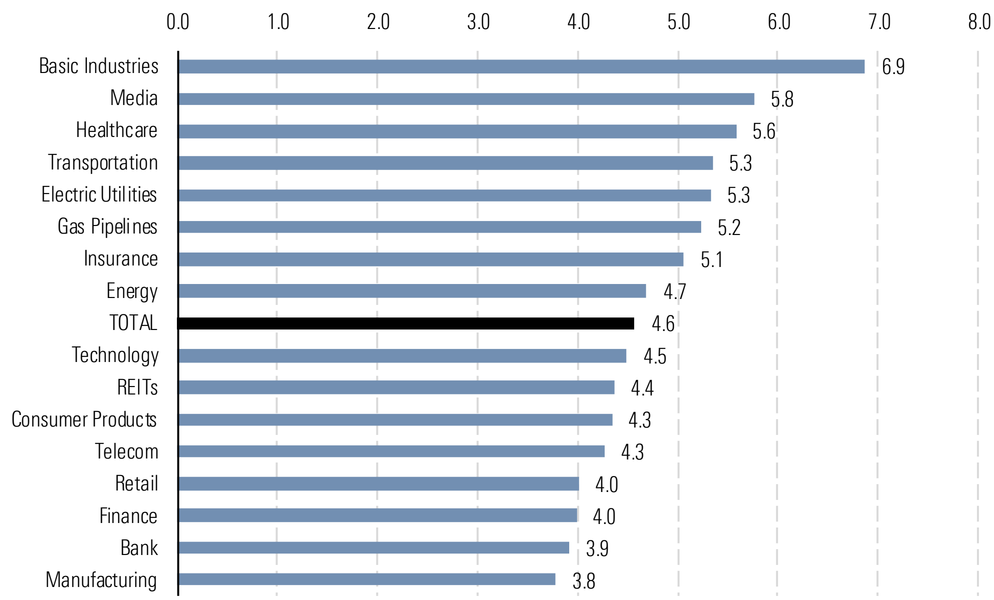
Source: Morningstar, Inc.

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



Source: Morningstar, Inc.

Exhibit 5 Morningstar, Inc. Corporate Bond Index YTD Return



Source: Morningstar, Inc.

Credit Rating Actions

► Rating changes

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Ingersoll-Rand **IR**	BBB+	BBB

► Rating affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Waste Management **WM**	BBB+	BBB+
Republic Services **RSG**	BBB+	BBB+
3M **MMM**	AA-	AA-

Ingersoll-Rand's Rating Upgraded One Notch to BBB+ on a Stronger Solvency Score; Stable Outlook

Morningstar Credit Ratings, LLC, is upgrading its corporate credit rating on Ingersoll-Rand PLC one notch to BBB+. The upgrade represents the culmination of Ingersoll-Rand’s profitability improvements over the past few years and improved capital efficiency lifting returns on invested capital. The stronger results have helped boost its Solvency Score pillar. In the absence of a concerted effort to operate with lower leverage, we expect that our rating will remain at the current level for the foreseeable future. As such, we are moving our outlook to stable.

Ingersoll-Rand has earned a narrow economic moat rating from Morningstar's Equity Research Group due to its collection of brand names such as Trane, difficult-to-replicate distribution in HVAC, and cost advantages in its non-HVAC businesses. These benefits are slightly offset by its exposure to the general industrial economy and the resulting cyclicality, but its 32% service-oriented business softens the blow. Historically, Ingersoll-Rand has struggled to monetize its brand name into strong operating margins and high returns on invested capital. More recently, however, operational improvements have lifted operating margins nearly 300 basis points over the past three years. Improved capital efficiency has also enabled returns on invested capital to expand commensurately, and stronger profitability and modest leverage have strengthened its Solvency Score. During the next five years, we project that Ingersoll-Rand will generate around $1.8 billion in average annual operating cash flow and reinvest a minimal 2% of sales, roughly $280 million, in the business. However, the firm has boosted its dividend payout ratio to 35%-40% from around 23% previously and is likely to increase the payout more quickly than earnings. The firm has allocated the remaining cash flow for repurchases or mergers and acquisitions. Ingersoll-Rand also faces a meaningful maturity schedule during the next five years. Collectively, these factors hinder its Cash Flow Cushion score.

Ingersoll-Rand’s strong operating performance resulted in a ratings upgrade, but we think further upgrades are unlikely and have assigned the firm a stable outlook. Management appears content with its current credit profile, and we expect leverage to remain at current levels over the next few years, as the firm looks to return its remaining free cash flow back to shareholders or through tuck-in acquisitions. Should management decide to permanently reduce leverage, we could consider another upgrade, as lower leverage would boost the Solvency Score and Cash Flow Cushion pillars. Recently, management has de-emphasized large-scale acquisitions and is apt to pursue small tuck-in deals to bolster its product offering. However, should the company recant and pursue a large, debt-funded deal, then we would expect a ratings downgrade, as the added leverage would probably put pressure on the Solvency Score and Cash Flow Cushion.

Waste Management's Rating Affirmed at BBB+ With Stable Outlook

Morningstar Credit Ratings, LLC, is affirming our BBB+ corporate credit rating on Waste Management Inc. Our rating balances Waste Management’s strong competitive position and recent improvement in its profitability offset by its meaningful leverage and large cash outflows. Overall, we expect that Waste Management’s credit profile should remain similar over the next few years, and we are also affirming our stable outlook.

Waste Management is North America’s leading provider of waste management services. Landfills are difficult to replicate, and the costs and regulatory burdens create high barriers to entry that have helped the company garner a narrow economic moat assessment from Morningstar's Equity Research Group that supports its Business Risk pillar. Waste Management benefits from broad customer diversification and general countercyclical trends, further benefiting its Business Risk score. Over the last few years, the firm has improved its profitability by shifting away from recycling and waste-to-energy and refocusing its efforts on its core solid-waste business. The combination of better profitability and a lower capital base has resulted in stronger returns on invested capital that help support its Solvency Score; however, this boost is offset by a high total liabilities/total asset ratio and gross leverage of the mid-2s. Still, Waste Management produces strong operating cash flow close to 20% of sales via its annuitylike collection and disposal contracts, but reinvests approximately 10% of sales back into the business each year. Moreover, the firm pays a sizeable dividend, roughly $740 million or 50% of free cash flow, that will expand with earnings. Management intends to use the remaining cash flow on share repurchases and tuck-in acquisitions, so we expect that debt levels should rise over time. Waste Management faces a meaningful maturity schedule over the next five years, with $610 million due in 2017, $783 million due in 2018, $432 million due in 2019, $746 million due in 2020, and $540 million due in 2021. Collectively, these factors weigh down its Cash Flow Cushion score.

At this point, we expect that our credit rating will remain at the same level for the next few years. We suspect that any earnings improvement will be coupled with incremental debt issuance to prevent leverage from falling. Should management decide to permanently reduce leverage, then we would expect lower debt would benefit both the Solvency Score and Cash Flow Cushion and lead to a possible upgrade. Conversely, if Waste management were to undertake a substantial debt-funded acquisition, then we would expect the additional debt would weigh down the Solvency Score and Cash Flow Cushion pillars, causing a potential downgrade.

Republic Services' Rating Affirmed at BBB+ With Negative Outlook

Morningstar Credit Ratings, LLC is affirming its BBB+ corporate credit rating on Republic Services Inc. Our rating incorporates Republic Services' strong competitive position but is held down by the firm’s substantial leverage and large cash outflows. Given our negative outlook, we contemplated a rating action, but we believe recent trends are headed in the right direction and have staved off a downgrade for now. However, we are retaining our negative outlook, as we believe the firm's credit profile is still perilously close to a downgrade.

Republic Services is the second-largest provider of nonhazardous solid waste collection in the United States, where it operates 191 active landfills. The landfills are difficult to replicate, and the costs and regulatory burdens create high barriers to entry that have helped the firm earn a narrow economic moat rating from Morningstar's Equity Research Group, which supports its Business Risk pillar. Republic also benefits from broad customer diversification and general countercyclical trends. More than 80% of its revenue has an annuity-type profile that buttresses its Business Risk pillar. Republic has converted its competitive advantage into solid returns on invested capital excluding goodwill, but recent trends have turned downward. Moreover, its low quick ratio, high leverage, and resulting modest interest coverage ratio produce a below-average Solvency Score. Republic generates strong operating cash flow but reinvests around 10% of sales in the business. The firm pays out more than half of its free cash flow in a dividend and uses the rest for share repurchases and tuck-in deals. Along with substantial maturities due from 2018 to 2021, these factors contribute to a generally weak Cash Flow Cushion score.

Republic Services' leverage is close to crossing the Rubicon into the BBB category and is the primary reason for our negative outlook. We think the firm's defensive business characteristics provide refuge against a sudden and drastic drop in profitability should economic conditions shift. Still, if the firm uses copious amounts of debt to fund tuck-in acquisitions or share repurchases, then our rating would probably be revised downward. We suspect that the added leverage would overwhelm the ongoing improvement in profitability and cause both the Solvency and Cash Flow Cushion scores to contract from current levels. Should Republic reconsider its leverage profile and adopt a lower threshold, then we could contemplate a rating upgrade. We believe the reduction in leverage would help the total liabilities/total assets and interest coverage components of the Solvency Score, while the lower debt payments would help raise the Cash Flow Cushion score.

3M's Rating Affirmed at AA-, but Negative Outlook Retained

Morningstar Credit Ratings, LLC is affirming our AA- corporate credit rating on 3M Co. Our rating balances 3M's competitive position and enviable returns with its desire to increase leverage to return more cash to shareholders. Over time, we expect that the firm will add incremental debt to boost leverage, which will eventually cause a deterioration in its credit quality and a likely downward revision in its rating. As a result, we are maintaining our negative outlook.

3M benefits from a strong brand name and cost advantages that have helped it garner a wide economic moat assessment from Morningstar's Equity Research Group, supporting its Business Risk score. 3M's name is synonymous with household products like Post-it, Scotch tape, and Command mounting hooks, but it has a vast portfolio of innovation that spreads across healthcare (18% of sales), safety and graphics (19% of sales), industrial (34%), electronics and energy (15% of sales), and the balance consumer, which includes the Nexcare and Ace brands. The Business Risk pillar also benefits from 3M's broad customer base across many sectors and geographies, including 60% of sales outside of the U.S. Approximately 70% of its products are part of a customer's design, specifications, or protected via regulation, and this has enabled the firm to produce gross margins that hover around 50%.

Within our methodology, the firm enjoys a strong Solvency Score, but its plan to increase shareholder returns through debt financing constrains our Cash Flow Cushion. 3M has capitalized on its advantages by producing impressive returns on invested capital and high interest coverage ratios, and despite higher and likely rising leverage levels, 3M still manages to operate with a high quick ratio. These factors help support its strong Solvency Score. The firm is also a prodigious cash flow generator, but management is intent on increasing shareholder value by adding leverage and returning more cash to shareholders. From 2016 through 2020, management expects to return all its free cash flow (approximately $30 billion) and an incremental $10 billion-$15 billion of debt to shareholders through a combination of dividends (which we estimate will total at least $15 billion during the next five years), repurchases, and acquisitions. 3M faces a meaningful debt maturity schedule. Combined, these factors weigh down its Cash Flow Cushion score, despite its solid free cash flow generation.

We have again affirmed our rating since 3M's credit metrics should protect its rating in the near term. Of note, however, was the general pricing weakness it experienced during its fiscal second quarter, which contributed to a 170-basis-point decline in its gross margin. Should the shift to price-competitive e-commerce prove long lasting, then the profitability decline could undermine 3M's Solvency Score, causing a downgrade. Already, we assign the firm a negative outlook since we expect our rating to move downward over time, as we expect incremental debt will increase leverage to 1.7-2.1 times by 2020 from 1.3 times as of June 30, 2017. The added leverage will probably pressure its Solvency Score and Cash Flow Cushion pillars. Moreover, a large debt-funded acquisition could result in a downgrade. Alternatively, our rating could move up a notch if 3M were to reverse its plan and deleverage, although we view this scenario as very unlikely.

Recent Notes Published by Credit Analysts

Lear in the Market With a New 10-Year Offering to Refinance Debt

Market Data

Auto supplier Lear Corporation (rating: BBB-, positive) is in the market with a 10-year investment-grade bond offering. Proceeds are targeted to refinance its $500 million 4.75% senior notes due 2023, which are old high-yield bonds that are callable in January 2018 at a price of 102.375. Additional proceeds may be used to retire outstanding borrowings under its revolver. Peer auto suppliers include BorgWarner Inc. (rating: BBB+, stable) and Delphi Automotive PLC (rating: BBB+, negative). We would also point to Ford Motor Company (rating: BBB, stable) and General Motors Company (rating: BBB, stable) as comps.

The following bond data, including spreads over interpolated Treasuries, is sourced from Interactive Data:
BorgWarner's 3.375% senior notes due 2025 are indicated at +103 basis points.
Delphi's 4.25% senior notes due 2026 are indicated at +114 bps.
Ford's 4.346% senior notes due 2026 are indicated at +186 bps.
GM's 4.00% senior notes due 2025 are indicated at +181 bps.

MCR Credit Risk Assessment

This bond refinancing will extend Lear's debt maturities and lower its interest expense, both credit positives that can be layered onto Lear's current positive outlook driven by an extended period of margin expansion combined with low leverage. Lear's other two bonds—its $325 million 5.375% senior notes due 2024 and its $650 million 5.25% senior notes due 2025—are also legacy high-yield bonds. Both bonds have hard call dates five years ahead of the respective maturities, and we expect them to eventually get called and replaced with lower-coupon investment-grade bonds. Lear retains a conservative capital structure, with total debt at July 1 of $1.9 billion but also $1.2 billion of cash. Total debt/EBITDA is a modest 1 times. Lear also recently renegotiated its credit agreement to establish a $1.5 billion revolver and $250 million term loan due August 2022 (which replaced a $453 million term loan due 2020).

Our BBB- credit rating reflects Lear's strong position in automotive seats and electronics. Lear is the number-two company in the global market for seating and benefits from global engineering, a global manufacturing footprint, and long-term highly integrated customer relationships. These attributes lead to Lear's narrow moat rating ascribed by Morningstar's Equity Research Group and support its Business Risk score. Still, that metric is constrained by the highly competitive nature of the auto-supply business and deep cyclicality. Margins in the seating business are far below those in electronics due in part to labor intensity, while underlying growth is primarily tied to global automobile production trends as opposed to content growth. That said, Lear has a low-cost footprint and has generated steady margin expansion over the past few years. Offsetting Lear's size and business position drawbacks is its light leverage, which has been declining since a recent peak of 1.5 times in 2014. We expect Lear to continue to take a measured approach in balancing share repurchases and acquisitions. Solid free cash flow generation should support this and the modest dividend, and our Cash Flow Cushion score also benefits from minimal debt maturities over our five-year forecast. Lear's Solvency Score benefits from healthy interest coverage and strong returns on invested capital driven by low capital intensity. While our positive outlook suggests a potential ratings increase under current operating conditions, our rating could come under pressure if Lear makes a large acquisition or more aggressively repurchases shares, pushing leverage meaningfully higher.

Philip Morris International Offering 5-year and 10-year Senior Unsecured Notes

Market Data

Philip Morris International (rating: A-, stable) is in the market offering 5-year and 10-year senior notes. We expect that proceeds will be used to refinance maturing debt and for general corporate purposes. For market comparables, we reference Altria Group Inc. (rating: A-, stable) and British American Tobacco PLC (rating: BBB, stable).

The following bond data, including spreads over interpolated Treasuries, is sourced from Interactive Data:

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

Philip Morris International 2. 5% notes due 2022 are indicated at +58 basis points;

Altria Group Inc. 2.85% notes due 2022 are indicated at +69 basis points;

British American Tobacco 3.25% notes due 2022 are indicated at +99 over basis points.

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

Philip Morris International 2.75% notes due 2026 are indicated at +90 basis points;

Altria Group Inc. 2.525% notes due 2026 are indicated at +91 basis points;

British American Tobacco 3.55% notes due 2027 are indicated at +134 basis points.

As additional points of reference, the A- tranche of the Morningstar Corporate Bond Index is at a spread of +103 basis points.

MCR Credit Risk Assessment

Philip Morris' A- rating is supported by its dominant position in the global tobacco market based on brand strength and market share. Philip Morris' portfolio includes the iconic Marlboro brand, several other well-known brands such as Virginia Slims and Parliament, and local niche labels. Brand strength, scale advantages, and demand inelasticity allow the firm to be the price leader in most of its markets, supporting the firm's wide economic moat rating, which was assigned by Morningstar Equity Research Group. In the near term, we expect that global economic stagnation will hinder the firm's performance and that depreciating currencies will negatively affect its cash flow realization and its credit profile. In our projections, we assume that Philip Morris will use free cash flow to support its high dividend payout ratio and use remaining cash flow to repurchase stock.

Philip Morris reported strong revenue growth during the second quarter of 2017, supported by increased pricing across all regions, greater market share in cigarettes and heated tobacco products. For the second quarter of 2017, excluding negative currency affects, net revenue was up 7.0% to $6.9 billion, and operating income was up 5.9% to $2.8 billion. Cigarette volume shipment was down 7.5% for the quarter, while heated tobacco products are beginning to make a meaningful contribution, with volume increasing to 6.3 billion units in the second quarter versus 1.2 billion in the prior year. The significant volume growth in heated tobacco products is attributed to Asia, mainly Japan. Philip Morris' total debt/adjusted EBITDA was 2.8 times and EBITDA/interest expense was 13 times for the latest 12 months ended June 30, 2017. Although credit measures have weakened slightly since year-end due to higher debt levels, they are in line with its rating category and expected to remain stable in the near to intermediate term. Philip Morris has ample liquidity. Its cash balance was $6.1 billion at period-end, and its total debt balance was $31.8 billion. MCR anticipates that volume pressure from negative currency effects and secular trends will continue, yet we expect them to be substantially offset by pricing and market share gains.

For comparison purposes Altria manages its balance sheet more conservatively, with debt/adjusted EBITDA of approximately 1.5 times. Altria sells tobacco products only in the United States, which is a highly regulated and a mature market, and is experiencing mid-single-digit volume declines. Altria has been effective at increasing profitability through cost-saving measures and pricing, generating one of the highest EBITDA margins in the industry. Lower-rated British American Tobacco's pro forma leverage was mid-4 times after its recently completed acquisition of the remaining 57.8% of Reynolds American Inc. for $54 billion and assumed debt of $12 billion.

LabCorp Refinancing Existing Obligations

Market Data

On Aug. 15, Laboratory Corp of America Holdings (rating: BBB+, stable) is in the market issuing new bonds according to regulatory filings. We have not seen specific maturity lengths of the new issues yet, but the company expects to use the proceeds to redeem its bonds coming due in August ($500 million in principal) and borrowings against its revolving credit facility ($309 million as of June). These projected uses suggest that LabCorp may seek other means (potentially bank debt) to finance its $1.2 billion acquisition of contract research organization Chiltern, which is scheduled to close in late 2017.

LabCorp's closest comparable from a business and credit perspective is Quest Diagnostics Inc (rating: BBB+, stable), and LabCorp's bonds recently traded wider than Quest's at similar maturities. All of the following bond data is sourced from Interactive Data.

In the approximate five-year maturity bucket, bonds from these two issuers recently traded over the nearest Treasury as follows:
LabCorp's 3.20% notes due in 2022 at +84 basis points
Quest's 4.70% notes due in 2021 at +77 basis points

In the approximate 10-year maturity bucket, bonds from these two issuers recently traded over the nearest Treasury as follows:
LabCorp's 3.60% notes due in 2025 at +117 basis points
Quest's 3.45% notes due in 2026 at +97 basis points

For comparison with the roughly 10-year maturities, Morningstar Inc.'s Corporate Bond Index was recently at +102 basis points at A- and +135 basis points at BBB+.

In the approximate 30-year maturity bucket, bonds from these two issuers recently traded over the nearest Treasury as follows:
LabCorp's 4.70% notes due in 2045 at +168 basis points
Quest's 4.70%% notes due in 2045 at +153 basis points.

MCR Credit Risk Assessment
Our BBB+ rating reflects LabCorp's solid Business Risk pillar, while the other pillars are constrained by its elevated leverage. Specifically, the Business Risk pillar primarily reflects its top-tier position in the diagnostics lab industry. As a duopoly, LabCorp and Quest so thoroughly dominate the independent diagnostic lab market in the U.S. that it would be difficult for a new entrant to cost-effectively compete as a national network of labs and facilities. With LabCorp's established position and scale in that market, Morningstar's Equity Research Group awards it a narrow moat rating. That assessment and the business' resistance to economic cycles and its diverse customer and service set, including its recently acquired CRO operations, contribute to its solid Business Risk pillar.

LabCorp's Cash Flow Cushion, Solvency Score, and Distance to Default pillars are all constrained by its elevated leverage. In early 2015, LabCorp acquired the CRO Covance, which inflated the combined entity's gross debt/EBITDA by about 1.5 turns to roughly 4 times directly after the transaction. As of June, the company owed $6.1 billion in debt, or 3.2 times adjusted EBITDA. With the planned acquisition of another CRO, Chiltern, management expects gross leverage to tick up to 3.3 times on a pro forma basis if the deal closes as expected in late 2017. This ongoing delay in deleveraging from an elevated level may be disappointing for creditors, who were originally presented with a plan to return to 2.5 times gross debt/EBITDA by year-end 2016 when the Covance transaction was announced. LabCorp aims to deleverage after the Chiltern acquisition, but management views its 2.5 times gross leverage target as a floor. We expect LabCorp to operate with gross leverage between 2.5 times and 3.0 times in the long run, or slightly above where Quest operates with leverage around 2.5 times as of June.

Amazon Issuing New Senior Unsecured Notes to Fund Its Acquisition of Whole Foods Market
Market Data
Amazon.com (rating: A, stable) announced that it is offering to sell senior unsecured notes in a private offering. Net proceeds are expected to fund all or a portion of its proposed $13.7 billion acquisition of Whole Foods Market, Inc. (not rated), which is expected to close in 2017.

Amazon's closest credit comparables we cover are Priceline Group Inc. (rating: A-, positive), eBay Inc. (rating: BBB+, stable), Target Corp (rating: A, negative), Home Depot Inc. (rating: A+, stable), and Lowe's Companies Inc. (rating: A, stable). The following bond data is from Interactive Data.

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

Amazon's 2.50% notes due in 2022 at +42 basis points;
EBay's 2.60% notes due in 2022 at +85 basis points;
Home Depot's 2.63% notes due in 2022 at +46 basis points;
Lowe's 3.12% notes due in 2022 at +44 basis points.

In the approximate 10-year maturity area, bonds from comparable issuers recently traded over the nearest Treasury as follows:
Amazon's 3.80% notes due in 2024 at +63 basis points;
Priceline's 3.60% notes due in 2026 at +122 basis points;
Ebay's 3.45% notes due in 2024 at +112 basis points;
Target's 2.50% notes due in 2026 at +88 basis points;
Home Depot's 3.0% notes due in 2026 at +71 basis points;
Lowe's 2.5% notes due in 2026 at +81 basis points.

In the approximate 30-year maturity area, bonds from comparable issuers recently traded over the nearest Treasury as follows:
Amazon's 4.95% notes due in 2044 at +122 basis points;
Ebay's 4.0% notes due in 2042 at +207 basis points;
Target's 3.63% notes due in 2046 at +114 basis points;
Home Depot's 3.90% notes due in 2047 at +102 basis points;
Lowe's 4.05% notes due in 2047 at +116 basis points.
For further reference, Morningstar's A Corporate Bond Index is at +84 basis points.

MCR Credit Risk Assessment
Amazon's A rating reflects ongoing improvement in its competitive position as evidenced by a multiyear expansion in EBITDA margins and return on investment, along with the maintenance of moderate leverage and excellent liquidity. Amazon's above average Business Risk score reflects a leading competitive position in e-commerce, low-cost operations, a network effect, and excellent customer service. Morningstar's Equity Research Group has assigned Amazon a wide economic moat rating based on these attributes. Amazon's competitive advantages are expected to generate additional market share gains for the next several years. The company's scalable fulfillment and distribution network provides a lower cost structure versus having a large physical retail presence, allowing it to price below these peers. Amazon possesses a network effect as customers are increasingly attracted to the breadth of its products, offered at low prices through an attractive website, which in turn attracts additional merchants, including third-party sellers, wholesalers, and manufacturers that sell direct on Amazon. Over the past five years, active users have grown at nearly a 20% compound annual growth rate to over 300 million. Meanwhile, Amazon Web Services has developed similar competitive advantages, including a cost advantage, an intangible asset, and a network effect.

Amazon announced a definitive merger agreement to acquire Whole Foods Market in a $13.7 billion all-cash transaction. While MCR believes the transaction will have negligible impact on Amazon's credit, the acquisition marks an important milestone in Amazon's grocery business. While Amazon's current grocery offering is largely limited to online shopping, it is testing a fully automated grocery store near its headquarters. MCR anticipates Whole Foods' 460 stores in the United States, Canada, and the United Kingdom will be integrated with AmazonFresh, providing online delivery as well as a location for customer pickup.

The transaction will increase Amazon's lease-adjusted net debt leverage to 1.7 times from 0.8 times, including pro forma net lease-adjusted debt of $35 billion and pro forma EBITDAR of $20 billion. Amazon held $20 billion in cash and short-term investments at the end of the second quarter of 2017 ended June 30, which could fund the entire all-cash transaction. Amazon generates strong and growing free cash flow that could be used to reduce debt leverage quickly. For the last 12 months ended in the second quarter of 2017 Amazon generated $9.3 billion of free cash flow, 25% higher than the same period one year ago. Amazon does not pay cash dividends or repurchase shares. About 50% of Amazon's $23.7 billion of debt, including capital and finance lease obligations, matures within the next five years.

Agilent Boosts Fiscal 2017 Outlook Yet Again on Strong 3Q Results, While Leverage Remains Steady

MCR Credit Risk Assessment

Agilent Technologies Inc (rating: A-, stable) reported strong fiscal third-quarter results on Aug. 15 that beat consensus expectations on both the top and bottom lines, allowing the firm to boost its outlook yet again for fiscal 2017. Agilent's balance sheet also remains solid. Overall, with these positive operating trends and stagnant leverage trends, our rating remains A- with a stable outlook.

Revenue of $1.11 billion (slightly above consensus of $1.1 billion and above previous guidance of $1.06 billion-$1.08 billion) grew 7.5% on a core basis (organic, constant-currency growth). By segment in the third quarter, growth was broad-based, with 8% core growth from both the CrossLab group and the diagnostic and genomics group, offset only slightly by 7% growth in the firm's largest segment, life sciences and applied markets. The company noted that growth remained in the double digits in the chemical and energy end markets at 10% (versus 14% in the second quarter, 3% in the first quarter, and declines for seven quarters prior to that), while the pharmaceutical end market remained strong with 10% growth in the quarter. These solid trends and 90 basis points of operating margin expansion year over year helped the firm boost adjusted earnings per share by 20% in the third quarter to $0.59, which was well above midpoint guidance of $0.50 and consensus of $0.52. After these strong top- and bottom-line results, Agilent increased its outlook again for fiscal 2017. Now, management expects core revenue growth of 6.0% at the midpoint, up from 5.0% previously (and 4.5% prior to that) and adjusted EPS of about $2.29-$2.31 for fiscal 2017, up from $2.15-$2.21 previously (and $2.10-$2.16 prior to that).

From a credit perspective, Agilent still operates with more cash on its balance sheet than it owes in debt, and its light leverage contributes to its strong Cash Flow Cushion, Solvency Score, and Distance to Default pillars. At the end of July, Agilent held $2.6 billion in cash compared with $2.1 billion in debt, or 2.1 times gross debt/adjusted EBITDA. With shareholders clamoring to get their hands on some of that cash and ongoing free cash flow ($665 million expected in fiscal 2017), Agilent continues to make significant dividend payments. However, the company did not purchase any shares in the quarter, which followed a slowdown in the quarter ended in April. Management appears to be prioritizing acquisitions over repurchases currently. Although it has only made $127 million of acquisitions during the first nine months of fiscal 2017, we would not be surprised to see those activities increase.

Market Data

We use several life sciences companies, including Quest Diagnostics Inc (rating: BBB+, stable), Laboratory Corp of America Holdings (rating: BBB+, stable), and Thermo Fisher Scientific Inc (rating: BBB, stable), to compare with Agilent. Despite its higher rating, Agilent's bonds recently traded at wider spreads than bonds from lower-rated Quest and Thermo. All of the following bond data is sourced from Interactive Data.

In the approximate five-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
Agilent's 3.20% notes due 2022 at +101 basis points.
Quest's 4.70% notes due 2021 at +78 basis points.
LabCorp's 3.20% notes due 2022 at +84 basis points.
Thermo Fisher's 3.30% notes due 2022 at +58 basis points.

In the approximate 10-year maturity bucket, bonds from these issuers recently traded over the nearest Treasury as follows:
Agilent's 3.05% notes due 2026 at +117 basis points.
Quest's 3.45% notes due 2026 at +97 basis points.
LabCorp's 3.60% notes due 2025 at +117 basis points.
Thermo Fisher's 3.20% notes due 2027 at +103 basis points.

For comparison with the approximate 10-year maturities, the Morningstar Corporate Bond Index is at +102 basis points in the A- category, +135 basis points in the BBB+ category, and +147 basis points in the BBB category.

NetApp's Focus on Share Repurchases Continues to Constrain Credit Improvement

MCR Credit Risk Assessment

During its fiscal first quarter, NetApp, Inc. (rating: BBB, stable) reported revenue of $1.3 billion, up 2% year over year, led by a 22% growth in strategic storage products, offsetting an 11% decline in legacy products. Legacy businesses still account for 31% of product revenue, though we expect strategic lines to continue to gain traction over the next few years. Meanwhile, EBITDA improved 30% from a year ago, helped by a 2% decline in operating expenses and a 150-basis-point expansion in gross margin. For the fiscal second quarter, management is guiding to revenue up 3.5% year over year at the midpoint of the range and gross margin to face some pressure from a mix shift toward lower-margin product revenue.

With revenue and margin trends improving, free cash flow increased 11% in the quarter relative to a year ago. However, for the most recent 12 months, free cash flow was $833 million. This represents a 9% decline from the comparable period a year ago, weighed down by a weak cash flow in the fiscal third quarter of last year. Meanwhile, NetApp completed $150 million of net share repurchases and paid out $54 million in dividend payments during the quarter. This brings the total shareholder payout to $658 million over the past 12 months, or a payout of 91% of free cash flow, in line with a year ago. Management remains committed to exhausting the remaining $644 million of its share repurchase authorization by the end of May 2018.

Total debt ended the quarter at $2.4 billion, up nearly $900 million from a year ago, which includes an additional $400 million of commercial paper borrowings, which management indicated was to help fund the completion of its share repurchase program over the balance of the fiscal year. Cash and investments were also up $900 million to $5.3 billion as the debt proceeds were held in cash. Total debt now represents 2.5 times trailing 12-month EBITDA, compared with 2.0 times last year, while cash and investments in excess of debt has narrowed to 3.0 times EBITDA from 3.9 times a year ago. Domestic cash declined by $140 million to $430 million at quarter-end, which largely represents the commercial paper proceeds. In our view, the combination of small onshore cash balances and the company's capital allocation policy continue to constrain its financial flexibility and keep it more reliant on access to the capital markets. Over the next 12 months, NetApp faces $1.6 billion of debt maturities, making it likely that the company will look to issue new senior debt later this year.

Notwithstanding the recent improvement in operating performance, driven by increased momentum behind new product launches, our BBB rating reflects a moderately high Business Risk Score and moderate Cash Flow Cushion and Solvency risk. Our rating also incorporates the company's elevated debt level, management's focus on share repurchase activity to compensate for non-U.S. cash flow, and the intense competition the company is likely to face in the coming years from cloud storage providers.

Among key comparable issuers, we reference Juniper Networks Inc. (rating: BBB+, stable) and Hewlett Packard Enterprise Co (rating: BBB, stable). Both companies also face threats from hardware virtualization and the rise of cloud computing. Juniper's total debt was 1.8 times its EBITDA and it held cash in excess of debt equivalent of just under 1.8 times at the end of June. Meanwhile, Hewlett Packard reported total debt at 2.0 times and net debt at 0.8 times EBITDA at the end of its April quarter.

Market Data

According to pricing source Interactive Data as of Aug. 16, BBB rated NetApp's 3.38% notes due 2021 are indicated at +95 basis points over the nearest Treasury, or 5 basis points tighter from May 24, the date of NetApp's last earnings release. For comparison, same-rated Hewlett Packard's 4.40% notes due 2022 are indicated at +125 basis points, 5 basis points wider from late May. Over the same period, BBB+ rated Juniper's 4.60% notes due 2021 are indicated at +94 basis points, 19 basis points tighter. Finally, the Morningstar Industrial Corporate BBB Index, now quoted at +137 basis points, is 6 basis points tighter over the past three months.

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