

# Morningstar Corporate Credit Research Highlights

Credit Spreads Largely Unchanged Last Week,  
but Falling Oil Prices Have Pressured Corporates Over Past Month

## Morningstar Credit Ratings, LLC

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### Contents

2	Credit Market Insights
9	Credit Rating Actions
12	Recent Notes Published by Credit Analysts
18	Credit Contacts

### Credit Market Insights

- ▶ Weekly Corporate Bond Market Highlights
- ▶ Recent Morningstar Credit Ratings Research
- ▶ Weekly High-Yield Fund Flows

### Credit Rating Actions

#### ▶ Rating Initiation

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Americold Realty Trust <b>COLD</b>	BBB	--

#### ▶ Rating Affirmation

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Deere <b>DE</b>	A	A

### Recent Notes Published by Credit Analysts

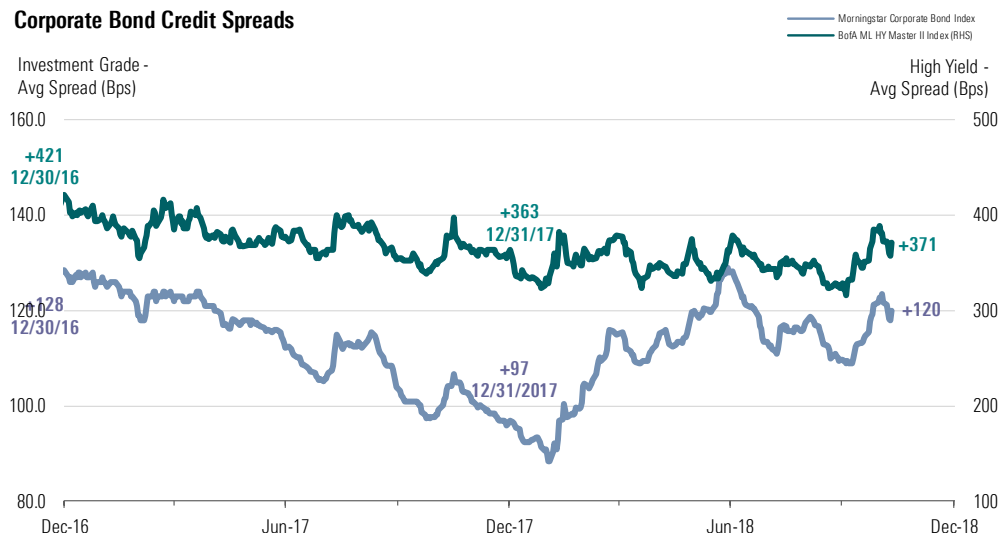
- ▶ **Tenet** (B-, Positive) Trims 2018 Outlook After Weak Hospital Segment Performance in 3Q
- ▶ **AmerisourceBergen's** (A, Stable) PharMEDium Still a Problem in 4Q; Company Boosts Share-Repurchase Authorization
- ▶ **Eli Lilly's** (AA, Stable) Strong 3Q Results Driven by New Products; Debt Leverage Steady After Elanco IPO
- ▶ **Bausch Health** (B-, Negative) May Be Nearing Bottom in 3Q; Debt Leverage Modestly Unwinding

## Credit Market Insights

### Credit Spreads Largely Unchanged Last Week, but Falling Oil Prices Have Pressured Corporates Over Past Month

Corporate bond markets rallied for much of last week, but credit spreads gave back some of the gains in sympathy with the pullback in the equity markets Friday. While the S&P 500 registered a gain of 2.13% for the week even after accounting for the swoon Friday, corporate credit spreads were largely unchanged. The average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade market) tightened 2 basis points to end the week at +120. The BofA Merrill Lynch High Yield Master Index was essentially unchanged, tightening 1 basis point to end the week at +371.

#### Corporate Bond Credit Spreads



Source: Morningstar, Inc., BofA Merrill Lynch Global Indexes. Data as of 11/09/2018.

While there was little movement across the broad corporate bond market indexes last week, they have been under pressure over the past month. The energy component of the indexes has been weakening as oil prices have fallen 22% from their recent highs at the beginning of October to below \$60 per barrel last Friday. Oil prices peaked Oct. 3 at \$76.40 and have fallen to below \$60 as of Friday, while the average spread of the Morningstar Corporate Bond Index has widened 11 basis points to +120 from +109. Over this period, the energy component of the index has widened 22 basis points. The high-yield index has widened 55 basis points to +371 from +316 as the average spread of the energy component of the index has widened 98 basis points to +455 from +357.

In 2014 and 2015, the free-fall in oil prices had an outsized impact on the high-yield market as the energy sector represents 16% of the overall index. As a comparison, the next-largest sector weighting represents only 11% of the index. In the following chart, we have inverted the price of oil compared with the average credit spread of the overall index. Thus far this year, the strength of the economy and robust earnings have driven credit spreads tighter in other sectors, which has offset much of the widening in the energy sector.

**WTI Crude Oil Spot Price v.s. BAML HY Master II Index OAS**

Sources: Bank of America Merrill Lynch, Federal Reserve Bank of St. Louis, Bloomberg. Data as of 11/09/2018.

In the U.S. Treasury bond market, the shape of the yield curve flattened last week. Short-term rates rose as investors concluded that the Federal Reserve remained on course to hike the federal-funds rate at its December meeting, while long-term interest rates declined as concerns regarding the sustainability of global economic growth re-emerged. The yield on the 2-year U.S. Treasury bond rose 2 basis points to 2.92%, and the yield on the 5-year increased 1 basis point to 3.04%. In the longer end of the curve, the 10-year declined 3 basis points to 3.18%, and the 30-year decreased 7 basis points to 3.38%. The result was that the spread between the 2-year and the 10-year has compressed to 26 basis points.

**10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity**

Source: Federal Reserve Bank of St. Louis as of 11/09/2018.

Investors keep a close eye on the shape of the yield curve, as historically an inverted yield curve has been an indication of an impending recession. However, while recent economic indicators and forecasts may show a slowing in the rate of economic growth, they are not signifying a contraction. For example, the Atlanta Fed's GDPNow forecast for fourth-quarter GDP growth is 2.9%, which is still a strong growth rate, especially considering the growth rate has averaged 4% for the past two quarters. The shape of the yield curve has been affected by the monetary policies of the major global central banks. After a decade of 0% interest rates, the Fed has embarked on normalizing the federal-funds rate, which has had a significant impact on the short end of the curve. From the first hike in December 2015 through the three rate hikes thus far this year, the federal-funds rate has risen about 200 basis points. Currently, the futures market is pricing in a 76% probability that the Fed will raise the rate another quarter point next month.

In the long end of the curve, several forces have helped drive up interest rates this year. First, inflation has risen to the Fed's targeted rate of 2%. Second, more supply has come on the market as the U.S. government is increasingly selling more debt to fund the deficit and the Fed is selling some of the assets in its portfolio that had been bought as part of its quantitative easing programs. Finally, although supply is increasing, demand for fixed-income securities by the other global central banks is decreasing. The European Central Bank's quantitative easing program is coming to an end in December, and the Bank of Japan's asset-purchase program is expected to dwindle next year as well.

### **Recent Morningstar Credit Ratings Research**

Last week, Morningstar Credit Ratings initiated public rating coverage of Americold Realty Trust (BBB, stable) and published a detailed report outlining our rating rationale. The rating reflects Americold's leadership in the temperature-controlled warehouse business, the experience and sophistication of its management team, and its tenant roster, which is populated with a considerable number of investment-grade tenants that have long working relationships with the real estate investment trust. As well, Americold increasingly demonstrates a sustainable competitive advantage from a number of sources. These considerations are somewhat offset by its relatively small size and its history as a highly leveraged and secured capital structure.

Our telecom, media, and technology team published its Investment-Grade Semiconductor 2019 Credit Outlook. In this report, Michael Dimler, CFA, our senior TMT analyst, highlighted that in his opinion, credit quality for semiconductor firms remains robust. Credit ratings in the semiconductor sector remain buoyed by entrenched competitive advantages that drive strong returns on invested capital and free cash flow. Though he expects growth to slow over the next year or two, he believes conditions remain conducive to further margin expansion. With the less burdensome tax rules governing cash repatriation, companies now have additional flexibility to utilize cash on hand to fund capital needs, reducing the need for external funding.

Our real estate investment trust team published a Corporate Credit Spread Chartbook. In this report, Chris Wimmer, CFA, our senior REIT analyst, opined that REITs specializing in industrial warehouse properties continue to enjoy strong demand in excess of new supply; otherwise, most other sectors are

experiencing conditions that suggest the commercial real estate cycle is near the top of the cycle. In his view, investment-grade REITs are not raising any warning signs with respect to their balance sheets. Currently, MCR is not anticipating negative rating pressure in the coming year or two.

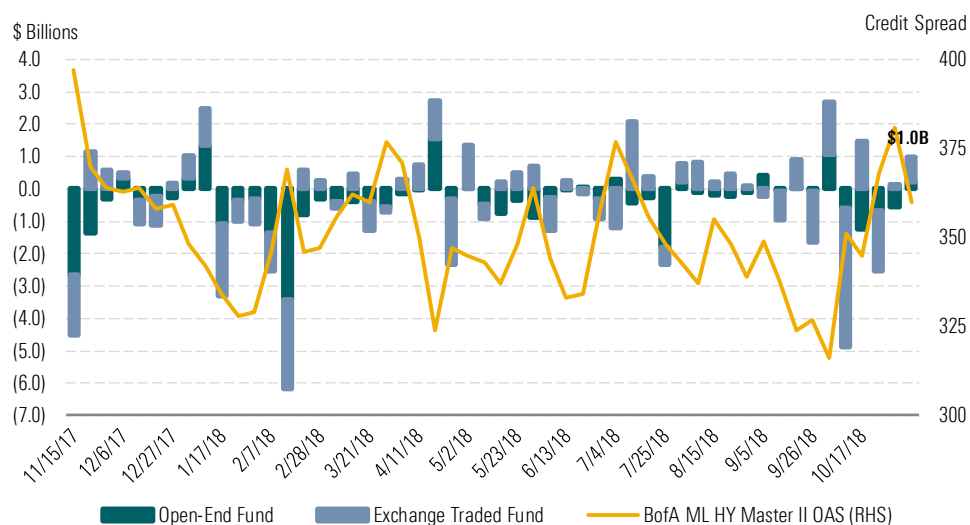
As third-quarter earnings season winds down, we published credit notes on Bausch Health (B-, negative), Eli Lilly & Co (AA, stable), AmerisourceBergen (A, stable), and Tenet Healthcare (B-, positive).

For greater detail regarding our credit ratings as well as for access to our corporate credit research and notes, please visit [www.morningstarcreditratings.com](http://www.morningstarcreditratings.com).

### Weekly High-Yield Fund Flows

Investors reversed course and returned to the high-yield asset class last week. Net fund inflows were \$1.0 billion, consisting of \$0.8 billion of net unit creation across high-yield exchange-traded funds and \$0.2 billion of inflows among open-end funds. Year to date, total outflows across the high-yield sector have been decidedly negative; investors have pulled \$19.5 billion out of the junk bond market. Outflows among open-end funds is \$13.6 billion and net unit redemptions in ETFs is \$5.8 billion.

### 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 (%)
<b>TOTAL</b>	<b>A-</b>	<b>5,157</b>	<b>6.7</b>	<b>120</b>	<b>(2)</b>	<b>24</b>	<b>0.19</b>	<b>(3.35)</b>
<b>FINANCIAL</b>	<b>A-</b>	<b>1,481</b>	<b>5.2</b>	<b>110</b>	<b>(0)</b>	<b>27</b>	<b>0.00</b>	<b>(2.51)</b>
Bank	A-	909	4.7	106	(2)	25	0.11	(1.93)
Finance	A	256	5.4	127	8	39	(0.58)	(4.06)
Insurance	A	218	8.0	110	(1)	24	0.16	(4.02)
REITs	BBB+	89	5.9	117	0	12	(0.06)	(2.02)
<b>INDUSTRIAL</b>	<b>A-</b>	<b>2,998</b>	<b>7.4</b>	<b>124</b>	<b>(3)</b>	<b>23</b>	<b>0.30</b>	<b>(3.69)</b>
Basic Industries	BBB	248	7.2	156	(4)	27	0.40	(3.86)
Consumer Products	BBB+	362	7.4	118	(1)	34	0.16	(4.86)
Energy	A-	401	7.1	156	1	34	0.08	(3.87)
Healthcare	A-	427	7.6	105	(3)	16	0.31	(4.06)
Manufacturing	A-	460	5.9	109	(1)	28	0.09	(3.06)
Media	BBB+	178	8.4	141	(11)	12	0.63	(3.68)
Retail	A-	168	7.6	106	(4)	19	0.32	(3.78)
Technology	A+	348	7.1	93	(4)	16	0.39	(3.02)
Telecom	BBB+	164	8.9	154	(7)	11	0.81	(2.49)
Transportation	BBB+	176	8.7	123	(2)	25	0.31	(4.80)
<b>UTILITY</b>	<b>BBB+</b>	<b>627</b>	<b>8.4</b>	<b>143</b>	<b>(1)</b>	<b>24</b>	<b>0.07</b>	<b>(4.52)</b>
Electric Utilities	A-	363	8.9	133	(1)	30	0.02	(5.58)
Gas Pipelines	BBB	246	7.7	158	(2)	14	0.14	(2.98)

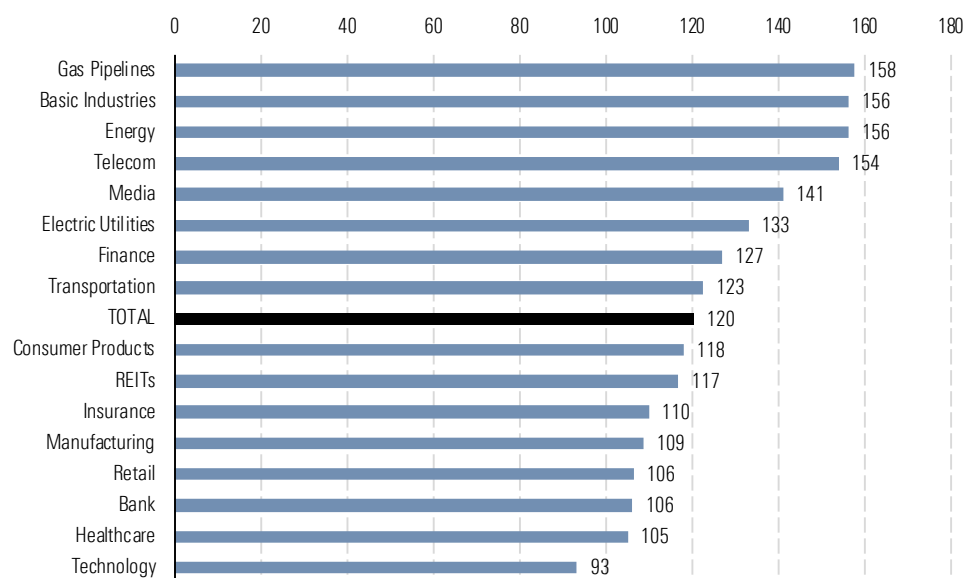
**Rating Bucket**

AAA Bucket		122	7.4	48	(4)	(0)	0.36	(3.16)
AA Bucket		501	5.6	67	(2)	8	0.13	(1.99)
A Bucket		1,939	6.7	97	(1)	23	0.12	(3.54)
BBB Bucket		2,595	7.0	155	(2)	28	0.24	(3.49)

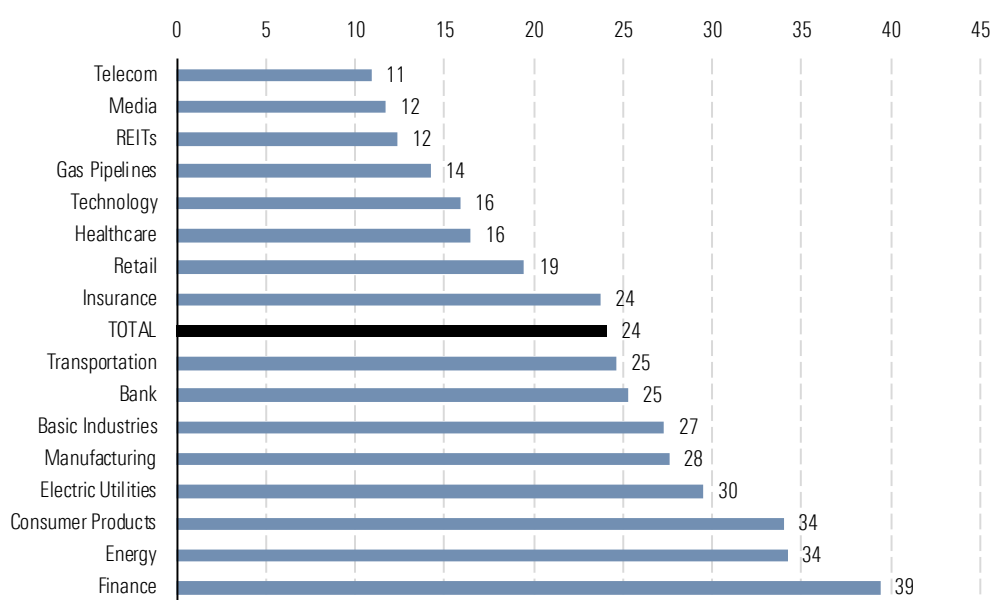
**Term Bucket**

1-4	A-	1,676	2.3	72	0	15	(0.01)	0.42
4-7	A-	1,179	4.7	113	(1)	33	(0.03)	(1.59)
7-10	A-	897	6.9	137	(3)	31	0.07	(3.69)
10PLUS	A-	1,405	13.3	170	(5)	26	0.65	(8.46)

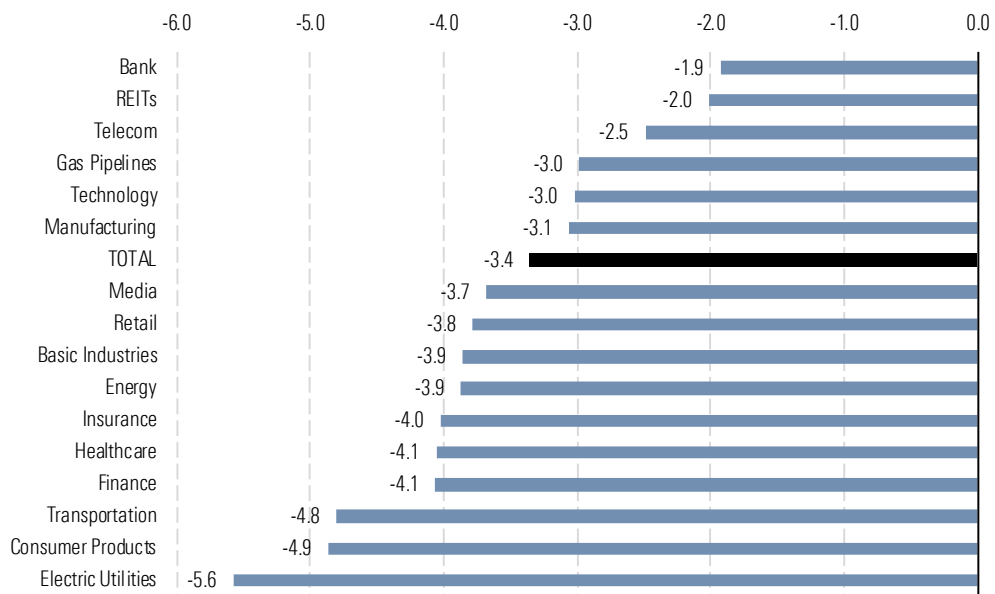
Data as of 11/09/2018

**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.



### Credit Rating Actions

#### ► Rating Initiation

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Americold Realty Trust <b>COLD</b>	BBB	--

#### ► Rating Affirmation

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Deere <b>DE</b>	A	A

### Morningstar Credit Ratings Initiates Credit Coverage, Assigns Ratings for Americold Realty Trust

Morningstar Credit Ratings, LLC is assigning Americold Realty Trust a corporate credit rating of BBB. The outlook is stable. The rating is supported by moderate Business Risk that is driven by the high-quality and well-positioned portfolio of temperature-controlled warehouses, or TCWs, the moderate cyclicity of its business, the diversity of its locations and its tenant roster, and its well-rounded management team. As well, we believe Americold has a moderate sustainable competitive advantage. These attributes are partially offset by its relatively small size and some dependence on the capital markets. The rating is also supported by a moderate Cash Flow Cushion as well as a strong Distance to Default. Its weak, albeit improving, Solvency Score has a negative impact, similar to other real estate investment trusts rated by Morningstar Credit Ratings, given relatively higher leverage and lower interest coverage at a certain rating level when compared with the broader universe of corporate debt issuers.

The temperature-controlled logistics business is an increasingly key component of the food supply chain, wherein consumer demand for healthier and fresher "farm to fork" items continues to grow at steady pace. TCWs provide essential space for food goods that must move through the chain at a constant temperature, where refrigeration and placement in the TCWs, or "racking," are customized based on product and customer needs.

While similar to traditional warehouse properties, in that their primary purpose is storage of commercial goods, many key points of differentiation must be considered. The average area size of a TCW is around 25% larger than that of the average industrial warehouse; however, given that customers lease space denominated in pallet positions, volume is a more relevant measure of capacity (Americold's average facility size is just under 6 million cubic feet; industrywide data is sparse). In terms of barriers to entry from newly constructed TCWs, cost is a constraint, with cold storage requiring meaningfully more investment for refrigeration and other equipment, as are location requirements, customer switching costs, and operator reputation. Food producers and retailers require specific expertise in the presentation and handling of their products, and TCWs need to be located either near points of production or near population concentrations for distribution. Hence, multiple factors limit competition and speculative development.

The top three independent providers of TCWs in the U.S. represent just over 50% of total market space—Americold is the leader at 23%—and no provider outside the top five represents more than 3%. Owners of single assets are abundant. Customers include producers of commodities such as Conagra,

Danone, Kraft Heinz, and Unilever as well as retailers and distributors, including Kroger, Safeway, Sysco, and US Foods. Americold is the only public REIT specializing in the TCW business.

Traditionally, customers have utilized on-demand contracts for space in TCWs based on need. This can lead to mismatches in the demand for and supply of space in the facilities during peak periods, such as harvests and year-end holidays. This in turn can lead to significant cost increases for customers that need to transport goods to alternative facilities, which are often in these scenarios located away from targeted markets and for which on-demand contract rates can be elevated. Working initially with its larger and more sophisticated customers, Americold has transitioned a meaningful portion of its customers' contracts to fixed-storage committed contracts and leases—currently 44% of total warehouse segment revenue, and we anticipate this number to grow. Both Americold and its customers benefit from these arrangements, as the former receives more stable revenue streams and the latter benefit from more predictable and leverageable costs. These leases often have escalators and other features that insulate Americold from potentially costly legislative and regulatory changes, such as those relating to labor or utilities.

Management has demonstrated talent and expertise from a variety of related industries, including real estate, food distribution, and logistics. The team has made substantial investments over the past five years to maintain and expand the TCW business while working to achieve optimal internal efficiency in the portfolio with respect to occupancy and costs, in part by using its customer data to develop detailed customer profitability and standardized underwriting processes, a concept relatively new to this otherwise fragmented sector. Americold has also spent to develop proprietary scalable and customer-facing information technology, which is integrated across the company. In addition, Americold has been successfully introducing contracts and leases that require customers to agree to longer-term commitments for fixed amounts of space, which contrasts with the previous industry standard that had customers paying on an as-utilized basis. Many of these improvements were made possible by not only its size and scale as the number-one provider of TCWs in the U.S., but also its large and diverse base of customers, many of which have been with Americold for more than 30 years.

The current management team has undertaken the multiyear and meticulous task of transforming the balance sheet, which had been entirely encumbered by long-term mortgage debt and therefore exhibited little flexibility. In 2015, Americold commenced refinancing mortgage debt with secured bank debt, which would provide more flexible repayment terms. In 2018, Americold generated nearly \$733 million from its initial public offering and follow-on offerings, \$353 million of which was used to pay down debt, meaningfully reducing leverage. As the next step in its balance sheet transformation, Americold has issued \$600 million senior unsecured private placement seven-year and ten-year notes to further pay down mortgage debt, as well as recast its revolver and term loan as unsecured, while upsizing the revolver to \$800 million. These will dramatically reduce secured debt, lengthen average debt maturity, increase unencumbered assets, and enhance balance sheet flexibility.

To be considered for a higher rating, Americold would need to achieve significant growth, most likely through new and expanded customer relationships as well as construction of new and expanded

facilities. If Americold were to approach \$450 million in EBITDA while maintaining current leverage levels (42.9% debt/gross assets and net debt 5.6 times EBITDA) or lower, we could potentially upgrade the rating. Should Americold reverse its commitment to the unsecured borrowing model, with a meaningful increase in secured debt approaching 25% to gross assets, with a corresponding weakening of the unencumbered asset portfolio that would lower the Cash Flow Cushion, we could lower our rating. In this scenario, we would commensurately lower our assessment of Americold's dependence on capital markets and possibly management, further pressuring the rating.

### **Morningstar Credit Ratings Releases Updated Ratings for Deere**

Morningstar Credit Ratings, LLC is affirming our A corporate credit rating on Deere & Co. Our rating on Deere focuses on the company's manufacturing operations along with a qualitative assessment of risk added by the finance subsidiary, John Deere Capital. Deere's credit profile benefits from its strong competitive position and solid financial ratios. The improving economy has helped Deere's fortunes over the last year, and we think management has done a good job minimizing the credit impact that the debt-financed Wirtgen acquisition had on the balance sheet. Although there seems to be some economic softness emanating from the recent global trade spat, we expect the company's overall credit profile will remain mostly unchanged over the next few years. Therefore, we are affirming our stable outlook.

Deere has amassed dominant share in the North American agricultural equipment market related to its strong brand name and immense dealership network. These factors have helped the firm earn a wide economic moat from Morningstar's Equity Research Group that bolsters its Business Risk pillar. We view the firm's historical focus on farming and its corresponding volatility as slight detractors, although the purchase of Wirtgen slightly lessens our view of the company's cyclicity. Deere has translated its competitive position into impressive high-double-digit returns on invested capital and solid interest coverage ratios, while its high cash balance produces a healthy quick ratio. Deere's Cash Flow Cushion score benefits from its strong operating cash flow generation and limited reinvestment needs. The company also faces a very manageable debt maturity schedule of \$750 million due in 2019 and \$1.1 billion due in 2022, though its two \$2.5 billion revolvers mature in 2021 and 2022. Deere's Cash Flow Cushion score is also constrained modestly by its targeted 25%-35% dividend payout ratio. Although Deere still plans to use its excess cash flow to repurchase shares, we expect that the company's first priority is to preserve its balance sheet through the cycle.

The economic backdrop and addition of Wirtgen have helped propel Deere's results for much of the last year. Although we think the economic outlook may soften somewhat compared with today's robust levels, we still expect Deere's credit profile will stabilize over the coming years and assign the company a stable outlook. However, should the initial effects from tariffs upend the agricultural economy, then we would anticipate strain on Deere's financials. The reduction in revenue and profitability could cause leverage to worsen and may affect the company's ability to reduce the debt from the Wirtgen purchase. In this situation, we would expect a possible rating downgrade, as lower profitability and cash flow could cause the Cash Flow Cushion and Solvency Score pillars to wilt. Alternatively, if the economic environment remains robust, then we could foresee a lift in the Solvency Score and Cash Flow Cushion pillars that causes an upgrade, assuming no change in Deere's leverage profile.

## Recent Notes Published by Credit Analysts

### Tenet (B-, Positive) Trims 2018 Outlook After Weak Hospital Segment Performance in 3Q

#### *MCR Credit Risk Assessment*

On Nov. 5, Tenet Healthcare Corp. (B-, positive) reported decent third-quarter operating results but trimmed its outlook for 2018 on weaker-than-expected hospital segment trends. From a credit perspective, net leverage declined slightly in the quarter, and Tenet remains less than a turn away from meeting its net leverage target of 5 times or less, which it aims to achieve by the end of 2019. As Tenet focuses on deleveraging, an upgrade is possible on improvement in its leverage-sensitive pillars (Cash Flow Cushion, Solvency Score, and Distance to Default), which influences our positive outlook.

In the quarter, Tenet's net revenue of \$4.5 billion declined 2% after recent divestiture activities, but it was on the high end of management's guidance for the period (\$4.3 billion-\$4.5 billion) and slightly above consensus of \$4.4 billion. Also, adjusted EBITDA of \$577 million grew 14% year over year on an apples-to-apples basis and just met management's outlook of \$575 million-\$625 million. Overall, the company performed well in its ambulatory surgery and Conifer segments but did not meet expectations in its hospital segment. Despite that weakness in its core hospital operations, the company generated adjusted earnings per share of \$0.29, which was above consensus of \$0.13. While these results look generally positive relative to consensus, the weak hospital segment results caused management to adjust its outlook on the bottom line for 2018. Specifically, the company has trimmed its adjusted EBITDA guidance to \$2.525 billion-\$2.575 billion from \$2.55 billion-\$2.65 billion on the challenges in the hospital segment offset somewhat by better-than-expected results in the ambulatory segment. On these weaker expectations, the company has reduced its adjusted earnings per share outlook to \$1.44-\$1.83 from \$1.54-\$1.88. The company also now expects just \$600 million-\$800 million in adjusted free cash flow, too, down from \$725 million-\$925 million.

By segment, the hospital and other segment's net revenue declined 3% to \$3.8 billion and adjusted EBITDA declined 3% to \$312 million, reflecting risk-based weakness in a Southern California contract, higher-than-expected malpractice-related costs, recent divestitures, and uncompensated care increasing to 24.7% compared with 22.9% in the prior-year period. More positively, Tenet's ambulatory segment performed well with net revenue growing 7% to \$502 million (primarily on growth on a same-facility basis) and adjusted EBITDA less facility-level noncontrolling interest expense growing 12% year over year to \$116 million. This segment's continued expansion above company growth rates is helping Tenet's profitability rise. The Conifer segment, which is being considered for sale and other strategic options by Tenet, declined 7% on the top line to \$371 million, but its adjusted EBITDA grew 3% to \$81 million with margins growing 210 basis points year over year.

From a credit perspective, Tenet's pro forma net leverage declined slightly on debt redemption, although expected cash outflows to invest further in the ambulatory surgery segment (\$95 million-\$120 million possible still in 2018) could keep net leverage stagnant through the rest of 2018. Management revealed that net leverage stood at 5.7 times as of September, or slightly lower than 5.8 times as of June. Tenet still aims to hit its net leverage goal of 5 times or less by the end of 2019, though, which contributes to

our positive outlook on Tenet's rating. For comparison, HCA Healthcare Inc.'s (BB+, stable) net leverage stood at 3.7 times by our estimates as of September.

#### *Market News and Data*

In our coverage universe, Tenet is rated much lower than its key hospital peer, HCA, so we use index data as a comparison as well. Recent bond data is sourced from Interactive Data as follows:

- ▶ Tenet's 7.00% notes due in 2025 at 98.50, yield to maturity of 7.28%, and spread to maturity of +417 basis points.
- ▶ HCA's 5.88% notes due 2026 at 99.00, yield to maturity of 5.53%, and spread to maturity of +239 basis points.

For comparison, BofA Merrill Lynch's U.S. High Yield B Index, was recently indicated at 7.02% and a spread of +398 basis points.

### **AmerisourceBergen's (A, Stable) PharMEDium Still a Problem in 4Q; Company Boosts Share-Repurchase Authorization**

#### *MCR Credit Risk Assessment*

On Nov. 6, AmerisourceBergen Corp. (A, stable) turned in fiscal fourth-quarter operating results generally in line with consensus. However, problems with a PharMEDium facility remain a headwind and led to a weaker-than-expected outlook for fiscal 2019. Positively from a credit perspective, the firm's balance sheet remains lightly leveraged relative to its peers, and we maintain a stable view of AmerisourceBergen's credit profile.

In the quarter, revenue grew 11% to \$43.3 billion (in line with consensus), adjusted operating income declined 8% on higher costs after recent acquisitions and ongoing PharMEDium problems, and adjusted earnings per share increased 9% to \$1.45 (or just above consensus of \$1.44) on tax-reform-related benefits. In its core distribution business, adjusted operating income declined 11% related primarily to ongoing problems with PharMEDium, despite continued strength in its anchor clients and specialty business. Specifically, the Walgreens Boots Alliance Inc. (BBB, stable) relationship remains strong, and the distributor is benefiting from the onboarding of Walgreens' recently acquired Rite Aid stores. Also, AmerisourceBergen recognized its 19th consecutive quarter of double-digit growth in its specialty distribution business, which offers oncology and physician-administered therapies. Negatively, though, PharMEDium's Memphis facility, which represents about half of that business' sterile compounding production capacity, is still not shipping commercially due to regulatory concerns. On the last call, management anticipated that this problem would be resolved by the end of fiscal 2018. AmerisourceBergen now remains uncertain of when regulators will allow that facility to return to commercial operations, so this issue remains a key operational headwind for the firm.

In fiscal 2019, the company intends to increase its top line in the midsingle digits and its adjusted operating income in the low to mid-single digits, which includes low-single-digit headwinds from the PharMEDium problems, as management would expect mid-single-digit adjusted operating income growth absent those problems. AmerisourceBergen also expects adjusted free cash flow of \$1.4 billion-

\$1.6 billion (up from \$1.1 billion in free cash flow in fiscal 2018) and adjusted earnings per share of \$6.65-\$6.95 in fiscal 2019 (up 2%-7% from \$6.49 in fiscal 2018 but below consensus of \$7.11), including help from share repurchases. The board just authorized a new \$1.0 billion share-repurchase program, which should help the company offset PharMEDium-related concerns for shareholders.

From a credit perspective, AmerisourceBergen maintains a conservative balance sheet relative to its key distribution peers, Cardinal Health Inc. (A-, stable) and McKesson Corp. (A-, stable), supporting our one-notch-higher rating for the company. As of September, AmerisourceBergen owed \$4.2 billion of debt and held \$2.5 billion in cash, contributing to lease-adjusted and net leverage of 2 times and less than 1 times, respectively, which both remain roughly a turn lower than its key distribution peers, by our estimates. These leverage differences reinforce our higher credit rating on AmerisourceBergen than its peers, and our outlook on the company's rating remains stable.

#### *Market News and Data*

We use AmerisourceBergen's drug distribution peers as its credit comparables. AmerisourceBergen's bonds recently traded at the tightest spreads in this peer group, but in the 10-year maturity bucket, its bonds traded between the A- and BBB+ categories of the Morningstar Corporate Bond Index. We sourced all of the following bond data from Interactive Data.

In the 10-year area, bonds recently traded as follows over the nearest Treasury:

- ▶ AmerisourceBergen's 3.45% notes due in 2027 at +132 basis points.
- ▶ Cardinal's 3.25% notes due in 2027 at +161 basis points.
- ▶ McKesson's 3.95% notes due 2028 at +138 basis points.

For comparison to the 10-year maturity bucket, the Morningstar Corporate Bond Index is at +98 basis points in the A category, +113 basis points in the A- category, and +146 basis points in the BBB+ category.

In the 30-year area, bonds recently traded as follows over the nearest Treasury:

- ▶ AmerisourceBergen's 4.30% notes due in 2047 at +179 basis points.
- ▶ Cardinal's 4.34% notes due in 2047 at +213 basis points.
- ▶ McKesson's 4.88% notes due in 2044 at +190 basis points.

#### **Eli Lilly's (AA, Stable) Strong 3Q Results Driven by New Products; Debt Leverage Steady After Elanco IPO**

##### *MCR Credit Risk Assessment*

As announced Nov. 6, Eli Lilly & Co (AA, stable) continued to leverage its leaner operating expense base in the third quarter, as top-line growth of 7% drove adjusted net income up 29%. These strong results contribute to an 8% rise in revenue and a 32% jump in adjusted net income for the first nine months of 2018. This strong performance, bolstered by solid uptake of a refreshed medicine portfolio, reinforces our expectation that Eli Lilly can achieve sales growth in the mid-single-digit sales compounded annually over the next five years, which supports our stable credit outlook for Eli Lilly's rating.

Eli Lilly's solid operational performance is indicative of the firm's success in overcoming patent expirations of once top-selling pharmaceuticals, such as erectile dysfunction drug Cialis, with new medicines launched since 2014. These products are Trulicity, Jardiance, and Basaglar in diabetes; Cyramza, Lartruvo, Portrazza, and Verzenio in cancer; and Taltz and Olumiant in immunology. Collectively, sales of these newer medicines represent about 31% of overall revenue, and continued uptake of these drugs should more than offset generic competition to Cialis that began in the U.S. at the end of September (already faces generics in Europe). In addition, the firm contends with generic versions of cancer medicine Alimta outside the U.S. and may contend with generics to osteoporosis drug Forteo in the next year or so. Together these three drugs generated about 23% of total sales in the third quarter. Despite facing these patent challenges, the firm now expects sales of \$24.3 billion to \$24.5 billion in 2018 (slightly increased from \$24.0 billion to \$24.5 billion) and adjusted EPS of \$5.55-\$5.60 (from \$5.40-\$5.50) thanks to higher revenue and tax savings from U.S. tax reform. In September, Eli Lilly's animal health business was separated in an initial public offering as Elanco Animal Health with Eli Lilly owning around 80% of the new company. Management expects to divest this ownership stake within one year of the IPO. Excluding Elanco, our forecast of mid-single-digit sales growth coupled with operating leverage from successful cost controls bolster our expectation for low-double-digit EBITDA growth compounded annually through 2022.

From a credit perspective, Eli Lilly's total debt leverage held steady at around 1.7 times EBITDA for the latest 12-month period ending Sept. 30, even as the debt load rose slightly to \$12.7 billion at the end of the third quarter from \$12.2 billion at the end of the second quarter and \$11.7 billion at the end of the first quarter. With cash and investments of \$11.0 billion on Sept. 30, net leverage was 0.2 times for the latest 12 months. We are cautious that leverage may increase following the divestment if the firm's stake in Elanco as management previously indicated that it does not expect to reduce its debt level to offset the loss of EBITDA from Elanco. Helping to potentially offset this, the firm has financial flexibility to easily manage its debt obligations totaling \$2.1 billion over the next five years with its cash and investments balance and free cash flow that we see averaging \$5 billion annually through 2022. Eli Lilly's long-term debt maturities over the next five years are \$600 million of 1.95% unsecured notes in March 2019 and around \$1.5 billion of unsecured debt in 2022. Repayment of these notes along with continued solid operational performance driven by strong demand for new medicines may decrease gross leverage to the mid-1s by 2020, in our estimation, and helps inform our stable outlook. Eli Lilly prioritizes capital deployment for supplementing its highly productive research program with external projects and increasing returns to shareholders. Throughout 2018, Eli Lilly paid dividends of around \$1.7 billion and repurchased approximately \$3.1 billion in shares.

#### *Market News and Data*

For closest comparisons to Eli Lilly's notes, we look to similar-rated Merck & Co. Inc (AA, stable) and Novartis AG (AA, stable). We also look for comparison with lower-rated peer Pfizer Inc (AA-, stable). Adjusted for bond maturities, Eli Lilly's bonds due in 2027 recently traded tighter than those in this peer group. In addition, the firm's bonds traded tight to the Morningstar Corporate Bond Index in the AA category, according to Interactive Data.

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

- ▶ Eli Lilly's 2.35% notes due 2022 at +37 basis points.
- ▶ Merck's 2.35% notes due 2022 at +41 basis points.
- ▶ Novartis' 2.40% notes due 2022 at +45 basis points.
- ▶ Pfizer's 3.00% notes due 2023 at +45 basis points.

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

- ▶ Eli Lilly's 3.10% notes due 2027 at +61 basis points.
- ▶ Merck's 2.75% notes due 2025 at +64 basis points.
- ▶ Novartis' 3.10% notes due 2027 at +68 basis points.
- ▶ Pfizer's 1.00% notes due 2027 at +88 basis points

For comparison to the approximate 10-year maturities, the Morningstar Corporate Bond Index is at +68 basis points in the AA category.

#### **Bausch Health (B-, Negative) May Be Nearing Bottom in 3Q; Debt Leverage Modestly Unwinding** *MCR Credit Risk Assessment*

On Nov. 6, Bausch Health (B-, negative) reported a revenue decline of 4% on a reported basis but a 3% organic increase when excluding foreign exchange effects and dislocations resulting from divestment (including Dendreon, iNova, and Obagi during 2017). As a result, the firm has maintained its revenue outlook for 2018 of \$8.15 billion-\$8.35 billion, a decrease of more than 5% from 2017. Our negative outlook reflects our view that the firm is still reaching for a floor as it repairs its operations from a prior roll-up strategy, which may stress already elevated debt leverage in the next year or so.

Bausch Health touted its organic growth in the third quarter, which included organic increases from each of its segments: Bausch & Lomb/International (up 3%), Salix (grew 2%), Ortho Dermatologics (rose 1%), and Diversified Products (up 4%). Some of this organic growth may reverse in the fourth quarter as the firm looks to realign its supply chain with actual demand as part of its ongoing efficiency initiatives (Project CORE). Positively, management held its sales guidance for 2018 despite an expected hit to revenue of \$100 million from the program. Bausch Health increased its expectation for adjusted EBITDA to \$3.30 billion-\$3.45 billion (from \$3.20 billion-\$3.35 billion, previously) even after including an \$85 million impact from the inventory changes. With the launch of seven key products over 2016-19, we see the firm directing increased investment to ensure success of these new medicines and vision care offerings that may hold EBITDA generation relatively flat over the next five years. Bausch Health anticipates that its significant seven products—Relistor (opioid-induced constipation), Siliq (psoriasis), Vyzulta (glaucoma drops), Lumify (eye redness drops), SiHy contact lens, Bryhali (plaque psoriasis), and potentially Duobrii (plaque psoriasis)—will peak at over \$1 billion in sales over the next five years.

Bausch Health continues to diligently utilize internal cash flow generation to ease its heavy debt burden, and as a result of these efforts, debt was \$24.7 billion on Sept. 30, or total debt/adjusted EBITDA of 7.4



times for the trailing 12 months. This compares with total debt of \$25.5 billion at the end of 2017 or gross leverage of 7.6 times. The firm further chipped away at the debt load in the fourth quarter, having repaid \$125 million of 7.5% unsecured notes due in 2021. With a cash balance at \$973 million on Sept. 30, net debt leverage was 7.1 times for the latest 12-month period. We favorably view Valeant's commitment to deleveraging, but operational pressure through 2018 may overwhelm debt repayment such that leverage stays elevated, which informs our negative outlook. However, recapitalization efforts have pushed out the next significant tower of debt maturities (totaling \$2.6 billion) into 2021, granting Bausch Health more time to repair its businesses over the next few years.

#### *Market News and Data*

We compare Bausch Health's bonds with key peers that are rated in the general B category in the healthcare industry, which includes specialty pharmaceutical firm Mallinckrodt PLC (B+, stable) and healthcare provider Tenet Healthcare Corp (B-, positive). In the approximate 10-year area, Bausch Health's bonds recently traded close to those at Tenet and much tighter than Mallinckrodt's bonds. All bond data is sourced from Interactive Data, which can be seen as follows:

- ▶ Bausch Health's 6.13% notes due in 2025 at 94.03, yield to maturity of 7.30%, and spread to maturity of +421 basis points.
- ▶ Mallinckrodt's 5.50% notes due in 2025 at 81.00, yield to maturity of 9.51%, and spread to maturity of +642 basis points.
- ▶ Tenet's 7.00% notes due in 2025 at 98.50, yield to maturity of 7.28%, and spread to maturity of +417 basis points.

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