Morningstar Corporate Credit Research Highlights
It's Not Thanksgiving Yet, but Everyone's Talking Turkey

Morningstar Credit Ratings, LLC
13 August 2018

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Credit Market Insights

It's Not Thanksgiving Yet, but Everyone's Talking Turkey

Tailwinds from strong economic growth and robust second-quarter earnings reports helped drive corporate credit spreads tighter during the first half of last week. However, credit spreads reversed course and gave up those gains and more by the end of the week.

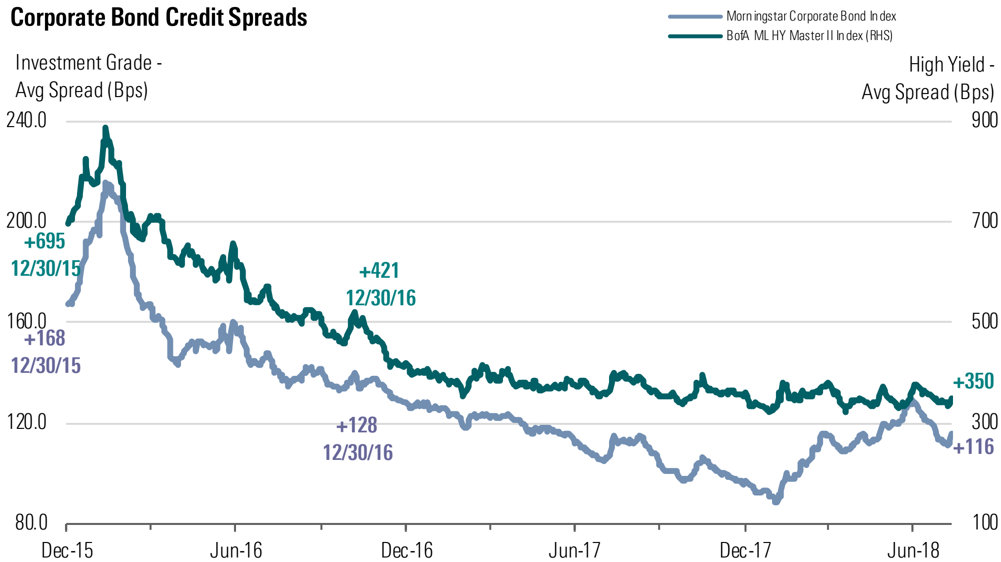
Over the past few months, investors have become increasingly concerned about Turkey's economic strength, stability, and progressively tense relations with the United States. Those concerns turned into a full-scale currency crisis Friday after President Donald Trump announced that he would double the tariffs paid on Turkish steel and aluminum imports. The Turkish lira plunged approximately 18% against the dollar on Friday before clawing its way back to a 13% loss for the day. This rout adds to the loss of confidence that the lira has suffered this year. Year to date, the lira has declined 40% against the dollar.

With the value of the lira plunging, it will become increasingly difficult for Turkey to support and repay its sovereign debt, especially notes denominated in dollars. As a result, the yield on Turkey's 10-year bond soared to close at 8.50% on Friday from 5.30% at the beginning of the year. The crisis continued early Monday morning as the price on the Turkish bond continued to drop, with the resulting yield rising to 9.31%, a spread of +634 basis points over U.S. Treasuries.

As the lira plummets and yields skyrocket on Turkish sovereign bonds, investors are concerned that many Turkish corporations with dollar- or euro-denominated debt may find access to international capital markets constrained, potentially leading to financial distress from illiquidity or insolvency. While the direct impact on the global economy from a decline in economic output from Turkey would be very limited, contagion from this currency and debt crisis has begun to spread to other emerging markets, especially those that rely heavily on foreign investment. In addition, the equity of European banks with significant direct exposure to Turkey, as well as Turkish corporations, slid at the end of last week.

The average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade market) widened 4 basis points to +116 last week. In the high-yield market, the BofA Merrill Lynch High Yield Master Index widened 7 basis points to +350. While risk assets were under pressure at the end of the week, heightened volatility in the emerging markets drove investors to the safety of U.S. Treasuries. By the end of the week, the yield on the 2-year Treasury had tightened 4 basis points to 2.60%, the 5-year Treasury note tightened 7 basis points to 2.74%, the 10-year declined 8 basis points to 2.87%, and the 30-year dropped 6 basis points to 3.03%.

Although the corporate bond market experienced a slight pullback last week, quarter to date, risk assets have continued to perform well, as strong economic growth and robust corporate earnings have buoyed investor sentiment. Over the past few weeks, among the economically sensitive companies that Morningstar Credit Ratings rates, we have published numerous credit notes highlighting the double-digit increases in top-line growth this past quarter and the resulting surge in earnings. Even after accounting for last week's pullback, since the end of June, the investment-grade index is 12 basis points tighter and the high-yield index is 21 basis points tighter.

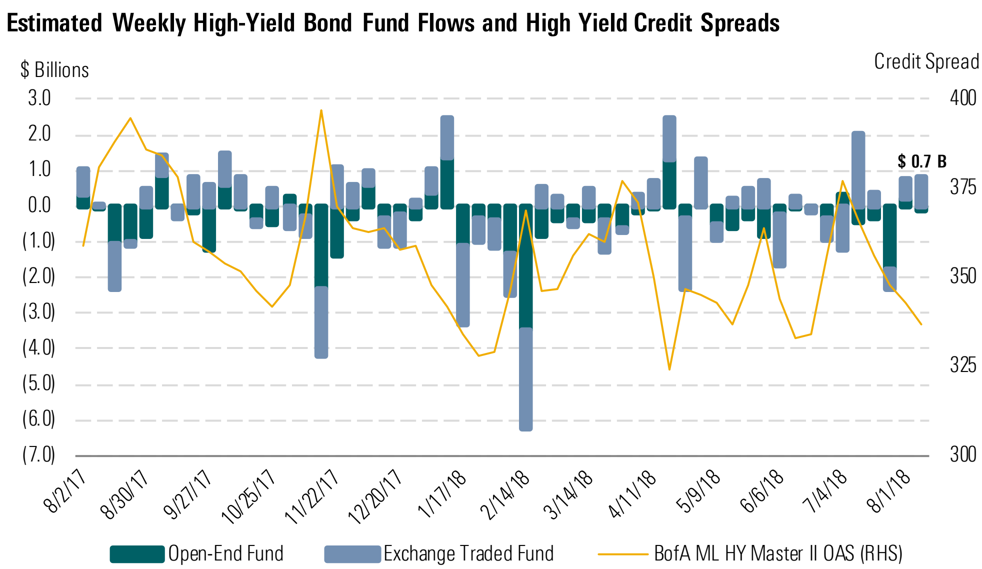


Source: Morningstar,Inc., BofA Merrill Lynch Global Indexes. Data as of 8/10/2018.

Morningstar Credit Ratings issues credit ratings on over 250 corporate and financial institutions. For detailed analysis and research, please see our credit notes published under the Research tab at: www.morningstarcreditratings.com.

Weekly High-Yield Fund Flows

Although open-end high-yield mutual funds experienced an outflow of $0.1 billion last week, the $0.8 billion of net new unit creation among high-yield exchange-traded funds overwhelmed the slight outflows. Total high-yield fund flows for the week were a net inflow of $0.8 billion. Year to date, fund flows have registered a total outflow of $15.2 billion, consisting of $3.1 billion of net unit redemptions across ETFs and $12.1 billion of redemptions among open-end funds.



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

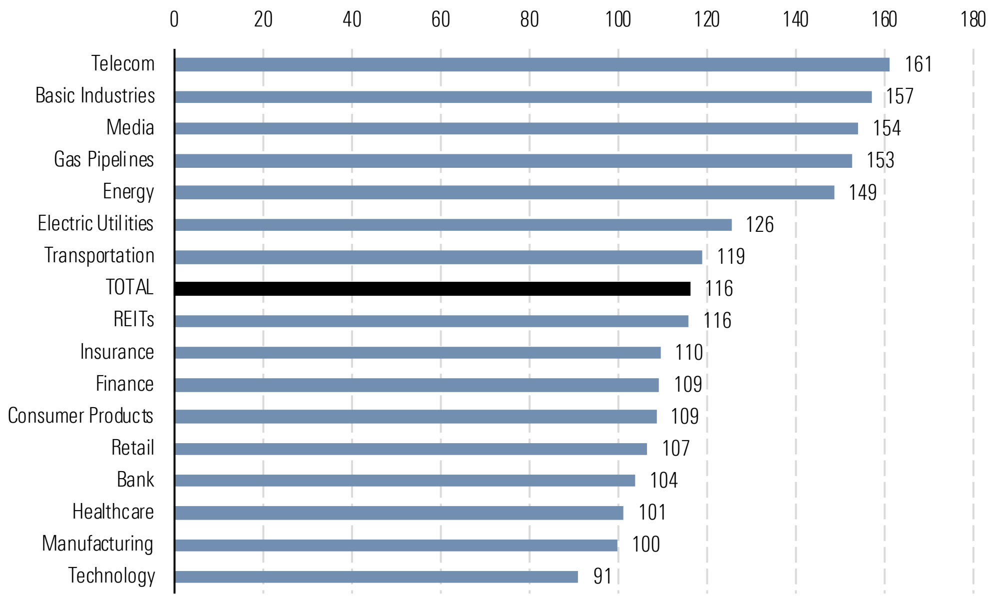
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

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-**	**5,099**	**6.9**	**116**	**3**	**20**	**0.27**	**(2.07)**
FINANCIAL	**A-**	**1,491**	**5.3**	**106**	**2**	**23**	**0.38**	**(1.64)**
Bank	A-	912	4.8	104	2	23	0.34	(1.46)
Finance	A-	268	5.6	109	3	22	0.33	(1.90)
Insurance	A	216	8.1	110	1	23	0.62	(2.47)
REITs	BBB+	86	5.8	116	(2)	11	0.76	(1.31)
INDUSTRIAL	**A-**	**2,955**	**7.5**	**120**	**5**	**19**	**0.17**	**(2.29)**
Basic Industries	BBB	241	7.6	157	8	28	0.18	(2.72)
Consumer Products	BBB+	351	7.4	109	4	25	0.18	(2.91)
Energy	A-	403	7.3	149	8	27	0.04	(2.18)
Healthcare	A-	416	7.7	101	4	13	0.20	(2.45)
Manufacturing	A-	458	5.9	100	1	19	0.37	(1.91)
Media	BBB+	169	8.5	154	5	25	0.14	(2.90)
Retail	A-	168	7.8	107	4	20	0.17	(2.43)
Technology	A+	354	7.3	91	5	14	0.23	(1.83)
Telecom	BBB+	168	9.0	161	6	18	(0.03)	(1.74)
Transportation	BBB+	169	8.9	119	5	21	0.10	(3.05)
UTILITY	**BBB+**	**600**	**8.7**	**137**	**2**	**18**	**0.49**	**(2.40)**
Electric Utilities	A-	346	9.2	126	3	22	0.48	(3.20)
Gas Pipelines	BBB	239	7.8	153	1	9	0.48	(1.20)
Rating Bucket								
AAA Bucket		124	7.6	51	1	3	0.20	(2.00)
AA Bucket		510	5.6	67	0	8	0.38	(1.20)
A Bucket		1,931	6.8	93	3	20	0.34	(2.18)
BBB Bucket		2,534	7.1	150	5	23	0.19	(2.16)
Term Bucket								
1-4	A-	1,672	2.3	68	(0)	11	0.31	0.29
4-7	A-	1,182	4.7	106	4	27	0.46	(1.00)
7-10	A-	891	7.0	132	6	26	0.35	(2.37)
10PLUS	A-	1,354	13.6	170	7	25	0.02	(5.21)

Data as of 08/10/2018

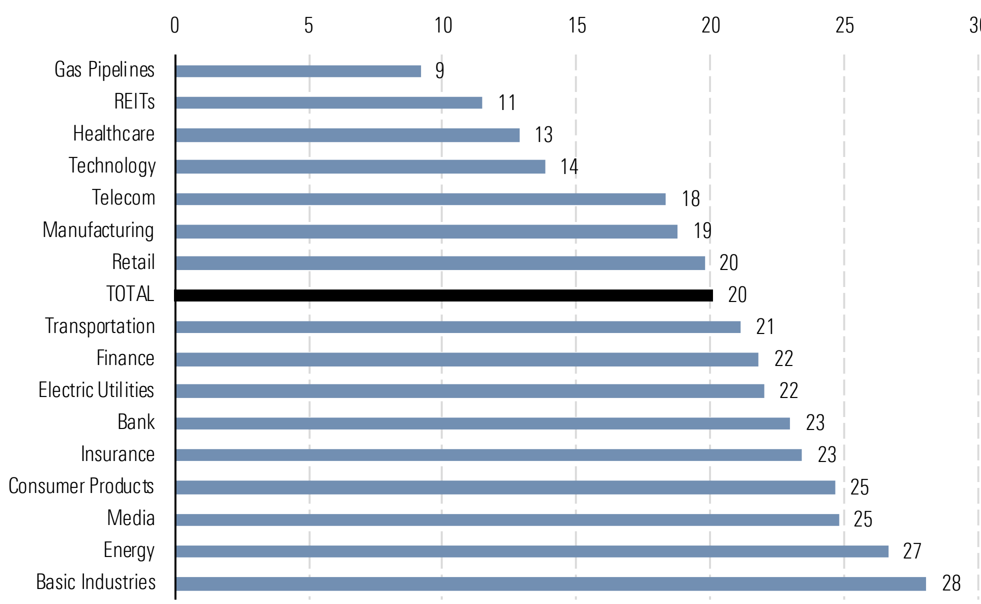
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



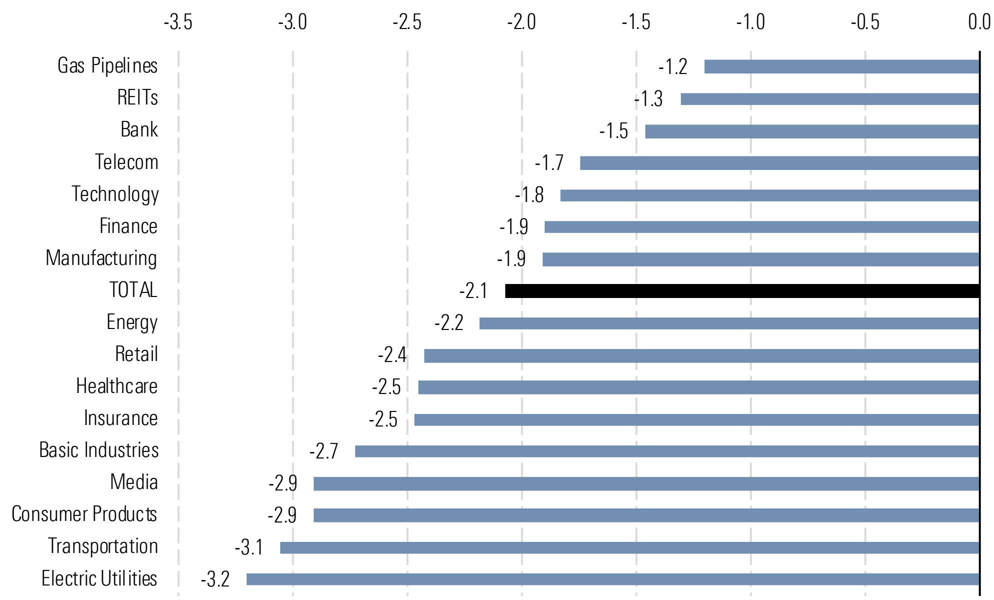
Source: Morningstar, Inc.

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

Cardinal Health (A-, Stable) Beats Consensus in 4Q, Gives Neutral 2019 Outlook in Face of Challenges

MCR Credit Risk Assessment

Cardinal Health Inc (A-, stable) reported fiscal fourth-quarter operating results Aug. 6 that beat consensus expectations. However, its outlook for fiscal 2019 remains in the neutral zone, and in the longer term, uncertainty surrounds the pharmaceutical pricing environment, which could negatively influence Cardinal's future results. Considering those factors and the likelihood for shareholder-friendly capital allocation activities, our credit outlook for Cardinal remains stable for now, despite better-than-expected results in the quarter.

Cardinal's operating results beat previously lowered expectations primarily due to a lower-than-expected tax rate. In the quarter, revenue grew 7% to $35.3 billion, or above consensus of $34.4 billion, and adjusted earnings per share declined 23% to $1.01 (or above consensus of $0.93). The profit decline reflected a variety of headwinds, such as the recent divestiture of Cardinal's distribution business in China, the PharMerica contract expiration, and ongoing problems with Cordis in its medical segment. These factors are reflected in profit declines in both operating segments, and those trends will probably pressure results in fiscal 2019 as well. From an earnings perspective, a lower tax rate (25%-28% versus 29% in fiscal 2018) and ongoing share repurchases may not fully offset those pressures. In fiscal 2019, Cardinal expects only low-single-digit top-line growth and relatively neutral earnings per share growth ($4.90-$5.15 from $5.00 in fiscal 2018).

During the quarter, the pharmaceutical segment's operating profits ($416 million) contracted 18% year over year despite 6% revenue ($31.4 billion) growth. These results reflect the recent divestiture of Cardinal's distribution business in China and the PharMerica contract expiration. Also, the generic deflationary environment remains a headwind, despite the positive influence of the Red Oak generic drug sourcing partnership with CVS Health (BBB+/UR-). The company also recently extended its contract with UnitedHealth's Optum division to 2024, which was a positive development for a relationship that began in 2015 but reflects a squeeze on profitability through some pricing concessions and increased investments to better serve the client. Positively, the specialty distribution business continues to grow in double digits, and the branded pharmaceutical business turned in better-than-expected results in the quarter too. Considering all of these factors, Cardinal anticipates this segment's top line will grow in the low single digits, but profits are expected to decline in the high single to low double digits in fiscal 2019.

In the longer term, it's uncertain how the branded pharmaceutical pricing environment might change, particularly around rebating. Positively, Cardinal's management team reiterated a similar message as the other major drug distributors. For Cardinal, less than 10% of this business is contingent on branded drug inflation, and while it currently expects mid-single-digit growth of branded drug prices in its fiscal 2019 guidance, it can absorb about 300 basis points of lower branded inflation within that outlook. For the longer term, the team believes that its manufacturer partners recognize the value that Cardinal provides through its distribution operations, and it believes Cardinal would be able to renegotiate for higher rates in inflation-contingent contracts if the branded pricing environment changes substantially, which was an assertion made by the other top-tier distributors on their quarterly calls as well.

Cardinal's medical segment continues to benefit from the acquisition of the patient recovery business from Medtronic (A+, stable), but those positives aren't offsetting the problems in its Cordis division. In the quarter, this segment's revenue ($3.9 billion) grew 14% while segment profit ($114 million) declined 17%. Last quarter, management highlighted a multiquarter effort to fix an inventory management problem in the Cordis division, which will probably constrain this segment's results going forward. Management expects segment growth of only low single digits on the top line and mid- to high single digits on the bottom line in fiscal 2019.

Management did not give a specific update on its leverage target during the call, and we suspect nothing has changed much on that front, which informs our stable outlook on its rating. At the end of June, Cardinal owed $9.0 billion (down from $9.6 billion in March) and cash stood at $1.8 billion (down from $2.2 billion in March). On a pro forma basis, leverage did not change much, as gross leverage remained in the mid-2s and net leverage remained in the low 2s. With the company only targeting gross leverage of 2.0 times by the end of fiscal 2020 (calendar mid-2020), we would not be surprised to see significant returns to shareholders and tuck-in acquisitions between now and then, which may be necessary to appease shareholders, considering Cardinal's anemic near-term outlook and potential changes to its operating landscape. For comparison, Cardinal's gross and net leverage remain roughly in line with key peer McKesson (A-, stable) but higher than AmerisourceBergen (A, stable) on a gross (by half a turn) and net (by roughly a turn) basis.

Market Data

We use Cardinal's distribution peers as its credit comparables, given their similar credit profiles and exposure to industry trends. Cardinal's bonds recently traded at wider spreads than its key peers. Also, in the 10-year maturity bucket, all of these issuers traded wider than the Morningstar Corporate Bond Index in their respective ratings. The following bond data is sourced from Interactive Data.

In the approximate 10-year maturity bucket, bonds recently traded as follows over the nearest Treasury:
Cardinal's 3.25% notes due in 2027 at +154 basis points.
AmerisourceBergen's 3.45% notes due in 2027 at +142 basis points.
McKesson's 3.95% notes due 2028 at +146 basis points.

For comparison with the 10-year maturity bucket, the Morningstar Corporate Bond Index is at +90 basis points in the A category, +103 basis points in the A- category, and +134 basis points in the BBB+ category.

Tenet's (B-, Positive) Profitability Continues to Improve, but Net Leverage Rises Slightly in 2Q

MCR Credit Risk Assessment

On Aug. 6, Tenet Healthcare Corp.'s (B-, positive) reported solid operating results for the second quarter. Net leverage rose slightly during the quarter on a continued investment in the USPI joint venture, but

Tenet is 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 to 5 times or less, 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.

During the quarter, Tenet's operating results improved enough for the company to boost its earnings guidance for 2018, despite a relatively weak top line. In the second quarter, Tenet's net revenue of $4.5 billion represented a decline of 6% after recent divestiture activities, and it was on the low end of management's guidance for the period ($4.475 billion-$4.675 billion), or slightly below consensus of $4.6 billion. However, adjusted EBITDA of $634 million in the second quarter grew 11% year over year on an apples-to-apples basis and slightly beat management's outlook of $575 million-$625 million. The company's restructuring activities, particularly in the Conifer business, continue to produce positive results on the bottom line. As a result, the company generated adjusted earnings per share of $0.49 (above consensus of $0.25,) and management increased its earnings outlook for 2018 to $1.54-$1.88 (from $1.36-$1.70 previously and consensus of $1.56). It kept the rest of its financial guidance the same. Management still expects revenue of $17.9 billion-$18.3 billion, adjusted EBITDA of $2.55 billion-$2.65 billion, and adjusted free cash flow of $725 million-$925 million in 2018.

The Conifer segment accounted for most of the 2018 guidance increase, but all of Tenet's segments performed well on the bottom line during the quarter. In the second quarter, the hospital and other segment ($3.7 billion of net revenue) declined 9% on the top line, including recent divestitures. On a same-hospital basis, net patient revenue grew 3.2% on a 0.2% decline in adjusted admissions and 3.5% uptick in revenue per admission. Compared with last year, adjusted EBITDA in this segment grew 0.6% to $345 million, despite recent divestitures and uncompensated care increasing to 23.5% compared with 22.3% in the prior-year period. Positively, Tenet's ambulatory segment accelerated in the quarter too, with net revenue growing 12.5% to $531 million (6.9% on same-facility basis) and adjusted EBITDA growing 20.7% year over year to $198 million. This segment's continued expansion above company growth rates is helping Tenet's profit margins rise. The Conifer segment, which is being considered for sale by the company, declined 3.5% on the top line to $386 million, but its adjusted EBITDA grew 51.7% year over year to $91 million on a cost structure improvement.

From a credit perspective, Tenet's pro forma net leverage rose slightly in the quarter on cash outflows to invest further in the USPI joint venture, but prior and potential leverage improvements are reflected in our positive outlook. Management revealed that net leverage stood at 5.8 times as of June, or slightly higher than the 5.5 times it hit in March. Tenet still aims to hit its net leverage goal of 5 times or less by the end of 2019, though. For comparison, HCA Healthcare's (BB+, stable) net leverage stood at 4 times as of June.

Market 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 100.39, yield to worst (2022 call date) of 6.89%, and spread to maturity of +410 basis points.
HCA's 5.88% notes due 2026 at 103.75, yield to worst (2025 call date) of 5.23%, and spread to worst of +233 basis points.

For comparison, BofA Merrill Lynch's U.S. High Yield B Index was recently indicated at 6.45% and a spread of +362 basis points.

Starbucks (A-, Stable) Offering 7-Year, 10-Year, and 30-Year Notes

Market News and Data

According to a recent regulatory filing, Starbucks Corporation (A-, stable) is in the market with a 7-year, 10-year, and 30-year notes issuance. Proceeds are expected to be used for general corporate purposes, including share repurchases, business expansion, payment of cash dividends, or the financing of possible acquisitions. We compare Starbucks with McDonald's (A-, stable). Bonds from these issuers recently traded over the nearest Treasury according to Interactive Data as follows.

In the near 7-year area, comparables are as follows:
Starbucks' 2.45% notes due 2026 at 96 basis points.
McDonald's 3.125% notes due 2025 recently at 106 basis points.

In the near 10-year, comparable issues were indicated as follows:
Starbucks' 3.5% notes due 2028 recently at 98 basis points.
McDonald's 3.8% notes due 2028 at 78 basis points.

According to data from Morningstar, Inc., the A- tranche of the Morningstar Corporate Bond Index was recently at +102 basis points.

MCR Credit Risk Assessment

Starbucks' A- corporate credit rating reflects the balance between the company's aggressive capital-allocation policy and its successful operational and financial performances. MCR downgraded Starbucks' rating to A- from A in June following an increase in its fiscal 2018-20 cash return to shareholders program to $25 billion from $20 billion. Starbucks previously increased the program to $20 billion in May from $15.0 billion in November following its announcement of a global coffee alliance with Nestlé (the largest food and beverage company in the world), for which it will receive a pretax up-front payment of $7.15 billion. The additional net increase in the company's cash return to shareholders will be debt-financed, which is expected to weaken the company's credit pillars.

Starbuck's core operations are strong and its namesake brand's growing ubiquity in the beverage industry still supports our low Business Risk assessment. Starbucks' has been highly successful in menu innovation, channel expansion, and cross-branding. The company consumer engagement has been best in class in its digital, mobile, and loyalty programs. However, the company's increased debt and greater reliance on capital markets weaken its strong Solvency Score and moderate Cash Flow Cushion. Still, Starbucks has solid brand intangible assets that command premium pricing and, combined with its scale advantages, has resulted in Morningstar's Equity Research Group assigning the company a wide economic moat.

Starbucks' lease-adjusted leverage throughout MCR's five-year forecast is just under 3.0 times and in line with management's commitment. Its lease-adjusted interest coverage is forecast at high single digits to low double digits. Free cash flow after dividends is forecast to average in excess of $1.0 billion. These measures are adequate for the rating category.

For comparison purposes, Starbucks' lease-adjusted leverage for the latest 12-month period ended April 1 is 3.2 times. Similar-rated McDonald's is experiencing a full-fledged turnaround with mid-single-digit same-store sales growth on a global basis and higher operating margins, earnings, and free cash flow. However, McDonald's carries higher leverage with lease-adjusted leverage almost 1 turn higher than Starbucks at 4.0 times for the latest 12-month period ended March 31.

CVS (BBB+/UR-) Boosts 2018 Outlook After Strong 2Q, Reveals Small Impact of Rebates on Bottom Line

MCR Credit Risk Assessment

On Aug. 8, CVS Health Corp. (BBB+/UR-) reported second-quarter results that beat consensus and raised its earnings per share guidance for the full year. The company also revealed that pharmaceutical rebates account for only 3% of its bottom line, so we believe any change to that practice would be easily manageable for CVS. Importantly for creditors, the Aetna acquisition remains on track for closure later this year. Related to this deal, the company's long-term leverage target is higher than its previous target, and our credit rating for CVS remains under review with negative implications.

In the quarter, net revenue grew 2% to $46.7 billion (above consensus of $46.3 billion), and adjusted EPS grew 27% to $1.69 (above consensus of $1.61). These better-than-expected results reflected share gains in the company's retail pharmacy and a lower tax rate. They also excluded the costs of the debt taken on to close the Aetna deal, which is expected later in the third quarter or early in the fourth quarter, according to management. Because of these better-than-expected results, management increased the adjusted earnings per share guidance for 2018 to $6.98-$7.09 (above consensus of $6.97).

CVS' team addressed the debate surrounding pharmaceutical pricing and rebates in the drug supply chain. Specifically, CVS highlighted that only 3% of its earnings power is influenced by retaining pharmaceutical rebates in its pharmacy benefit management operations. Also, whether the PBM retains the rebate is determined solely by its payer clients, and approximately 98% of the rebates are passed through to CVS' clients and do not directly affect CVS' bottom line. Additionally, rather than rebates causing faster pharmaceutical price growth, CVS' analysis suggests that list prices grow faster on pharmaceuticals with smaller rebates than for drugs with substantial rebates. This dynamic makes economic sense to us and probably relates to the competitive landscape for each drug. Basically, if there is less competition for a particular therapeutic due to patent protection or other advantages, the faster that manufacturer can raise prices and the smaller a rebate the PBM can obtain from the manufacturer.

But if generic drugs or cheaper branded drugs with similar safety and efficacy are available to compete with a particular product, the manufacturer has an incentive to offer pricing concessions through slower price growth and a larger rebate on that product. We note that drug price growth for CVS's client base was 0.2% on a per capita basis last year versus 10% growth in average wholesale prices, which suggests that the PBM helps constrain realized pricing growth relative to manufacturer list pricing growth.

From a credit perspective, post-Aetna leverage goals remain higher than CVS' previous target as a stand-alone entity. After the $40 billion bond issuance in March to prefund the combination, CVS owed $65 billion in debt as of June, and management expects pro forma gross leverage of 4.6 times once the deal closes in late 2018. After that, the company aims to reach 3.5 times gross leverage within two years of the deal's closure and around 3 times in the long run. That long-term leverage target appears higher than the company's previous long-term goal, which was lease-adjusted leverage of 2.7 times. CVS' willingness to boost and keep leverage above its previous target continues to reinforce our under review negative status.

Market Data

We compare CVS' bonds with key pharmaceutical supply chain peers Express Scripts Holding (A-/UR-) and Walgreens Boots Alliance (BBB, stable). CVS' bonds due 2028 recently traded roughly in line with the BBB+ category of the Morningstar Corporate Bond Index. All of the following bond data is sourced from Interactive Data.

In the approximate 10-year maturity bucket, spreads over the nearest Treasury from recent trades were as follows:
CVS' 4.30% notes due 2028 at +135 basis points.
Express Scripts' 3.40% notes due 2027 at +146 basis points.
Walgreens' 3.45% notes due 2026 at +128 basis points.

For comparison with the roughly 10-year maturities, the Morningstar Corporate Bond Index is at +133 basis points at BBB+ and +144 basis points at BBB.

HCA (BB+, Stable) Issuing New Notes to Refinance 2019 Maturity

Market News and Data

HCA Healthcare Inc (BB+, stable) is in the market issuing $2 billion of new bonds. Proceeds from the issuance are intended to redeem its 3.75% senior secured notes due 2019 ($1.5 billion of principal) with the balance earmarked for general corporate purposes, including acquisitions. HCA is only one of two hospital operators in our coverage universe, so we compare it with Tenet Healthcare (B-, positive). Given their very different ratings, though, we expand HCA's comparables to the broader healthcare market with notes from Teva Pharmaceutical Industries (BB, stable). All of the following bond data is sourced from Interactive Data.

HCA's 5.88% notes due 2026 at 103.94, yield to worst (2025 call date) of 5.20%, and spread to worst of +228 basis points.
Teva's 3.15% notes due 2026 at 83.67, yield to maturity of 5.68%, and spread to maturity of +274 basis points.
Tenet's 7.00% notes due in 2025 at 101.00, yield to worst (2022 call date) of 6.71%, and spread to worst of +391 basis points.
For comparison, BofA Merrill Lynch's U.S. High Yield BB Index was recently indicated at 5.11% and a spread of +225 basis points.

MCR Credit Risk Assessment
Our BB+ rating for HCA reflects its competitive advantages in local hospital markets and substantial debt obligations. HCA's returns on invested capital exceed its capital costs, and given those economic profits combined with HCA's substantial local market share, Morningstar's Equity Research Group recognizes HCA's competitive advantages with a narrow moat assessment. This assessment combined with the company's size and relatively stable operations contribute to a moderate Business Risk pillar. HCA's other pillars (Cash Flow Cushion, Solvency Score, and Distance to Default) remain influenced by its substantial debt obligations and ongoing outflows to stakeholders. With gross debt/adjusted EBITDA around 4 times as of June, HCA operates in the middle of its leverage target range of 3.5-4.5 times debt/adjusted EBITDA. Given that debt leverage compared with historical norms and its target range, HCA's obligations remain manageable, albeit large. HCA owes $33 billion in debt, and we are not surprised to see the company seeking to refinance its upcoming obligations, as its cash balance in June ($868 million) was significantly lower than its current debt obligations ($1.7 billion). HCA may need to regularly refinance its obligations as they come due, given its acquisition activities and ongoing outflows to stakeholders that include share repurchases, distributions to noncontrolling interests, and a recently initiated dividend.

Kilroy Realty (BBB, Stable) to Issue Up to 5 Million Common Shares
MCR Credit Risk Assessment
On Aug. 8, Kilroy Realty Corporation (BBB, stable) announced that it will offer 5 million shares of its common stock, subject to forward sale agreements, in a program with its several investment banks as joint book-running managers. At Aug. 7's market closing price of $73.52, Kilroy could eventually receive proceeds of up to roughly $360 million after fees and commissions, according to a prospectus supplement dated Aug. 8. Proceeds are to be used for general corporate purposes, including the funding of property development and acquisitions and repayment of outstanding indebtedness.

We view the potential equity issuance as credit positive and expect that it will have a moderate deleveraging effect. On a net debt/gross assets basis, net debt will decrease to about 39% pro forma from 44.3% at June 30. The impact to net debt/last 12 months EBITDA is also clear, as the June 30 ratio of 6.7 times would improve to 5.9 times if the stock issuance proceeds were to be counted as an offset to debt. Overall, the use of equity rather than debt favors creditors.

Kilroy's 13.9 million-square-foot Pacific Coast-based portfolio of office properties is concentrated in the San Francisco Bay Area, which generates almost half of the company's net operating income. Los Angeles contributes roughly 20%, and San Diego and Seattle each contribute about 15%. The company's tenant base is highly concentrated in technology, which accounts for 43% of rent. Media, financial services, and life science each contribute low-double-digit percentages of rent. The high-quality nature of Kilroy's assets and tenant base contributes to our moderate assessment for Business Risk.

Portfolio performance continued to be solid in the second quarter, with 1.3 million square feet of new and renewing leases signed at an average cash-basis rent increase of 9.8%. Same-store net operating income increased 5.1% on a cash basis over the prior-year quarter. The portfolio was 94.0% occupied and 96.8% leased as of June 30. In the key San Francisco Bay market, 5.3 million square feet was 93.8% occupied and 98.2% leased as of June 30. With no more than 12% of rents expiring in any single year through 2022, the portfolio is well positioned to maintain occupancy. Tenant concentration is moderate, as the 15 largest tenants account for 39.2% of in-place rent, and no one tenant exceeds 5% of rent. Our rating assumes that Kilroy will maintain leverage at current levels over time and a transparent and flexible capital structure. We may consider an upgrade if Kilroy can make a meaningful reduction in leverage and improve its interest coverage while continuing to increase rents.

Market Data

Kilroy's rated office peers are Alexandria Real Estate Equities (BBB+, stable) and Highwoods Properties (BBB, stable). The following data is from Interactive Data as of Aug. 8. In the 10-year area, spreads over the nearest Treasury from these issuers were:

Kilroy's $400 million 4.25% bonds due 2029 at +158 basis points.
Alexandria's $425 million 3.95% bonds due 2028 at +152 basis points.
Highwoods' $350 million 4.13% bonds due 2028 at +148 basis points.

The BBB Morningstar Corporate Bond Index is currently priced at +140 basis points.

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