Morningstar Credit Research Highlights

Limited supply and ongoing demand push credit spreads tighter.

Morningstar Credit Ratings, LLC
26 August 2016

This Week	1
Credit Market Insights	2
Corporate Index Spreads	5
Credit Rating Actions	9
Recent Notes Published by Credit Analysts	19
Credit Contacts	23

Credit Market Insights

- Limited supply and ongoing demand push credit spreads tighter.

Credit Rating Actions

- Rating Changes

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Delphi Automotive DLPH	BBB+	BBB
Southwest Airlines LUV	BBB+	BBB
United Continental Holdings UAL	BB-	B+
Boston Scientific BSX	BBB	BBB-

- Rating Affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Tenneco TEN	BB+	BB+
Lear LEA	BBB-	BBB-
BorgWarner BWA	BBB+	BBB+
Merck KGaA MKGAY	BBB+	BBB+
Celgene CELG	A-	A-
C.R. Bard BCR	A+	A+
Edwards Lifesciences EW	A-	A-

Recent Notes Published by Credit Analysts

- **Pfizer** filling oncology medicine cabinet with Medivation.
- **Gap** remains weakly positioned in its BB+ rating category following 2Q results.
- **Best Buy**'s 2Q results reflect ongoing profit improvements; strongly positioned in the BB category.

Credit Market Insights

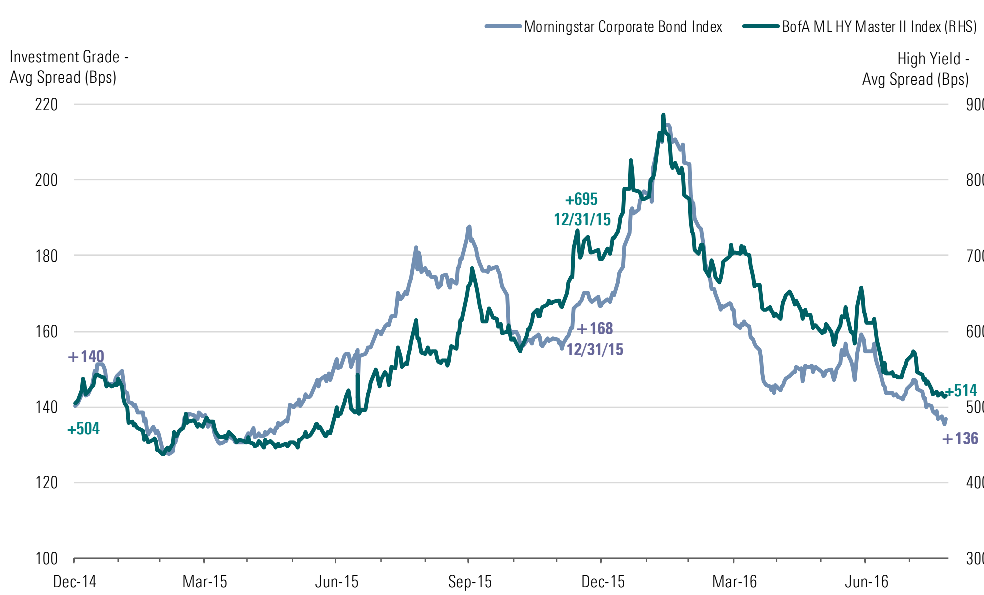
Limited Supply and Ongoing Demand Push Credit Spreads Tighter

David Sekera, CFA

The seasonal August slowdown is in full swing as a significant portion of portfolio managers, senior bond traders, and investment bankers are taking vacation time before Labor Day. In the past week, trading volume slowed to some of its lowest levels of the year, and the new issue market ground to a halt; however, cash continued to pour into corporate bond mutual funds and exchange-traded funds, and portfolio managers sought out assets to put this money to work. As the thinly staffed trading desks fought over the few trades that took place, traders bid prices up in order to source bonds. On a week-over-week basis through Aug. 25, the average spread of the Morningstar Corporate Bond Index (our proxy for the investment-grade market) tightened 2 basis points to +137 and the average spread of the Bank of America Merrill Lynch High Yield Master Index tightened 6 basis points to +514.

After gapping wider earlier this year in the face of deteriorating expectations for global economic outlook and the plunge in oil prices, the corporate credit markets have not only recovered those losses but posted very strong returns year to date. These returns have been driven by a combination of tightening corporate credit spreads and falling interest rates. For example, through Aug. 25, the Morningstar Corporate Bond Index has risen 9.07% and the Bank of America Merrill Lynch High Yield Master Index has increased 14.40%. Over this period, the average spread of the Morningstar Corporate Bond Index tightened 32 basis points and the average spread of the Bank of America Merrill Lynch High Yield Master Index tightened 181 basis points.

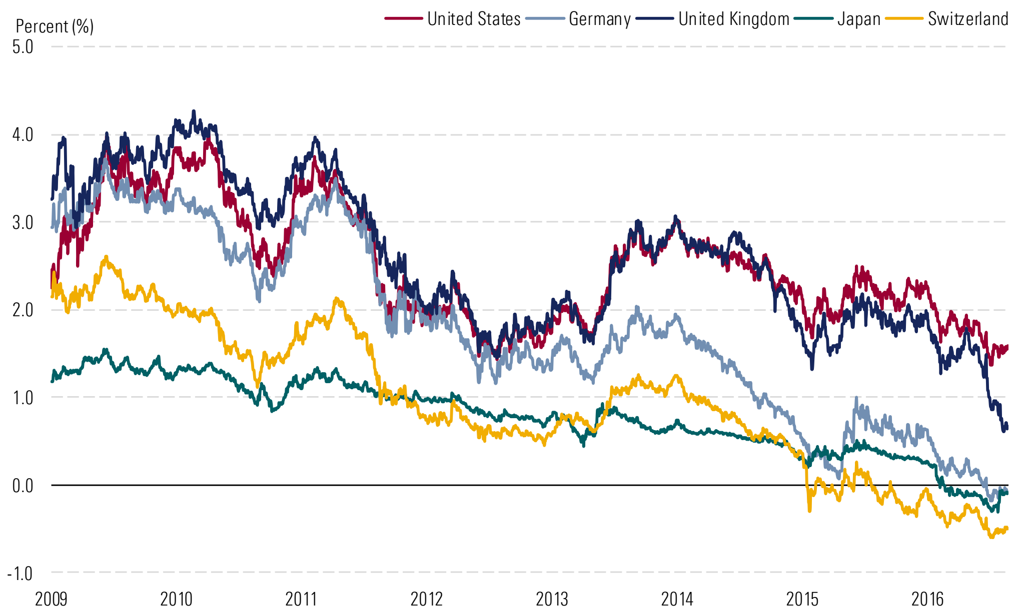
Corporate Bond Credit Spreads



Source: Morningstar, Inc., Bank of America Merrill Lynch Global Indexes. Data as of 8/25/2016.

As some of the last sovereign bonds in the developed markets to trade at a positive yield, Treasury bonds have risen sharply as global fixed-income investors clamor for yield. Year to date, the yield on the 5-year Treasury has tightened 59 basis points to 1.17%, the 10-year Treasury has decreased 70 basis points to 1.57%, and the 30-year Treasury has fallen 78 basis points to 2.24%. While these yields may seem low to U.S. investors, they appear quite attractive to global investors who not only are able to invest in a higher yield, but also benefit from investing in the safety of the U.S. dollar. For example, the yield on 10-year German bonds is negative 0.08%, Japanese 10-year bonds yield a negative 0.07%, and Swiss 10-year bonds yield a negative 0.52%. According to industry reports, over $12 trillion worth of debt is currently trading at prices so high that if investors purchase those bonds and hold them until maturity, they will lock in a loss. The only way an investor could earn a positive return would be to sell those bonds at an even higher price to another investor, which means the second investor would be willing to lock in an even greater loss. Even through there were significant concerns about the credit quality and economic trajectory of Italy and Spain in 2011-12 during the European sovereign debt and banking crisis, the yields on those countries' bonds are currently below those of U.S. Treasury bonds. Italian 10-year bonds are yielding 1.13% and Spanish 10-years are yielding 0.94%, a far cry from the over 7%-plus yields they were trading at in early 2012.

World Interest Rates, 10-Year Treasury Yields

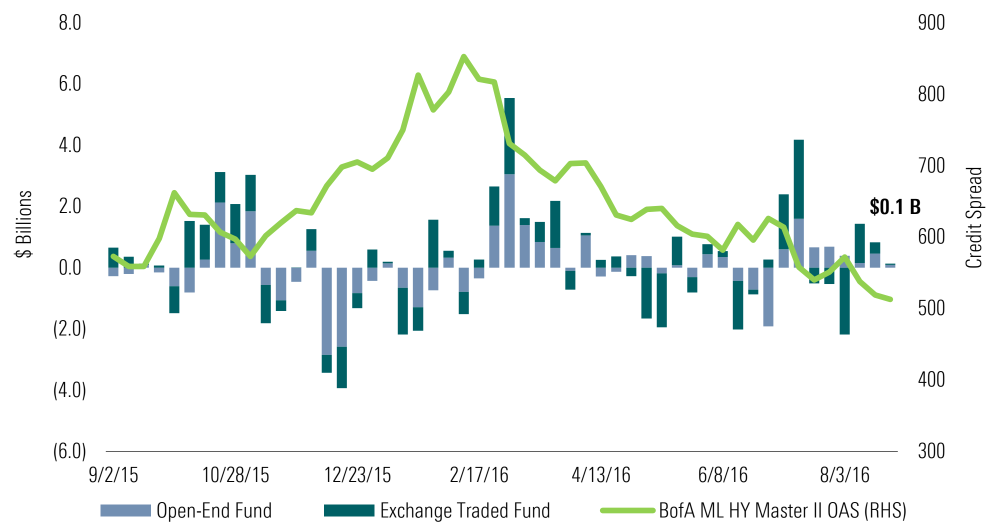


Source: Macrobond Financial AB. Data as of 8/25/2016.

Barring any unforeseen events, next week will similarly quiet as well, as the new issue market will remain effectively closed and secondary trading volume will be kept to a minimum until after Labor Day. In the United States, investors will be focused on the speeches and presentations at the Federal Reserve's annual confab at Jackson Hole on Aug. 25-27 to garner a better understanding of what data the Fed is focused on and decipher when the Fed may raise interest rates next. Fed watchers will parse every word of Fed Chair Janet Yellen's speech over the weekend to try to divine her monetary outlook. Currently, the market-implied probability of a hike in interest rates at the September meeting is only 24%; for the December meeting, the probability has increased to 57%.

While the Federal Reserve made its first foray into normalizing monetary policy by raising the federal funds rate a quarter point in December 2015, the ultra-easy monetary policies that exist among global central banks are unabated. In fact, based on recent reports, the European Central Bank and Bank of Japan are considering loosening their already historically easy monetary policy by increasing their asset-purchase programs and/or lowering interest even further into negative territory. This easy monetary policy will continue to support the corporate bond market over the near term. With interest rates negative in the European Union and Japan, and with rates on U.K. bonds hitting all-time lows, the U.S. dollar may continue to appreciate against other developed-market currencies. As global interest rates remain near their lowest historical levels, corporate bonds have become increasingly more attractive on a relative value basis. With underlying interest rates as low as they are, the extra return provided by the credit spread on corporate bonds above the underlying benchmark bond has become an increasingly larger portion of total return.

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. 26, 2016
(000,000s $ unless otherwise noted)

Issuer Name	Ticker	Morningstar Corporate Rating	Issue Size	Coupon	Description	Maturity	Approx Spread to US Treasuries
Crown Castle International	CCI	BBB-	$700	2.25%	Senior Notes	2021	+112

(*) Morningstar's estimate of relative fair value as of the date of issuance.

Exhibit 2 Morningstar, Inc. Corporate Bond Index Spreads

The following exhibits depict spread and return data for bonds in the Morningstar Corporate Bond Index. Rating buckets are determined by each issue's NRSRO rating. Data as of Aug. 26, 2016.

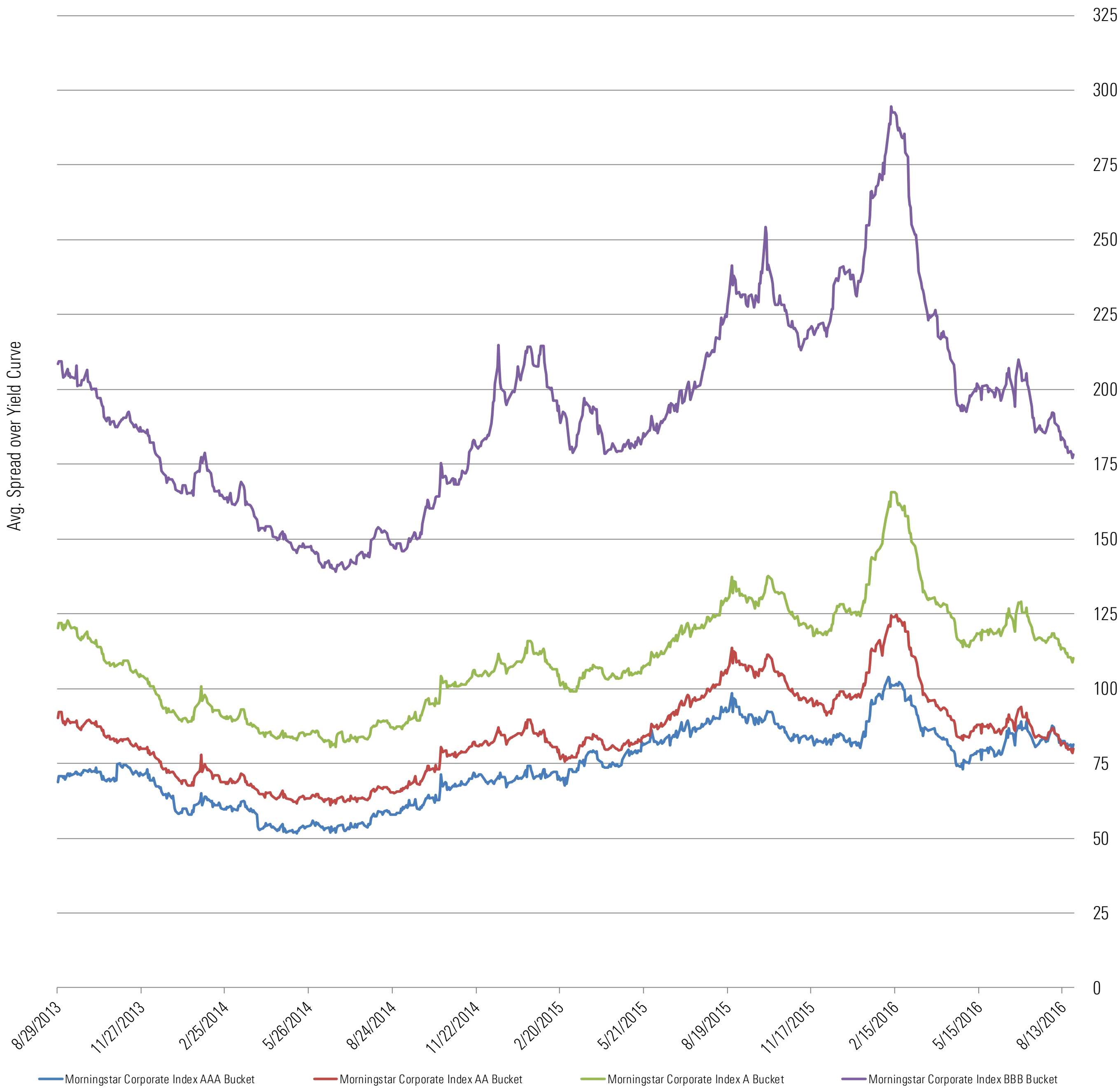


Exhibit 3 Morningstar, Inc. Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	OAS (bps)	WTD OAS Spread Chg (bps)	MTD OAS Spread Chg (bps)	YTD OAS Spread Chg (bps)	MTD Excess Return (%)	YTD Excess Return (%)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	**A-**	**3,961**	**7.0**	**142**	**(0)**	**(8)**	**(30)**	**0.81**	**3.30**	**0.16**	**9.07**
FINANCIAL	**A-**	**1,222**	**5.6**	**133**	**(1)**	**(9)**	**(4)**	**0.76**	**1.70**	**0.20**	**6.17**
Bank	A-	760	5.2	132	(2)	(10)	(2)	0.80	1.66	0.26	5.66
Finance	A	215	5.6	121	(1)	(2)	(12)	0.58	2.01	0.02	6.86
Insurance	A	189	8.1	153	(1)	(7)	(2)	0.78	1.30	0.07	8.16
REITs	BBB+	54	6.3	145	0	(7)	(10)	0.63	2.19	(0.03)	7.39
INDUSTRIAL	**A-**	**2,306**	**7.6**	**142**	**0**	**(7)**	**(41)**	**0.77**	**3.83**	**0.09**	**10.22**
Basic Industries	BBB+	188	7.4	201	1	(12)	(170)	1.00	10.40	0.32	16.96
Consumer Products	A-	253	7.8	113	(0)	(4)	(21)	0.38	3.16	(0.32)	9.61
Energy	A-	355	7.2	174	1	(18)	(75)	1.77	4.97	1.11	10.94
Healthcare	A-	359	7.9	118	1	(1)	(16)	0.39	2.50	(0.32)	9.11
Manufacturing	A-	327	6.1	112	(0)	(1)	(22)	0.34	2.65	(0.23)	7.54
Media	BBB+	161	8.7	175	(1)	(7)	(39)	0.76	4.93	0.02	12.55
Retail	A-	147	8.4	119	1	(2)	(21)	0.29	2.97	(0.44)	10.18
Technology	A+	242	6.9	129	(0)	(6)	(7)	0.84	2.46	0.19	8.26
Telecom	BBB+	137	8.8	165	1	(10)	(29)	1.01	4.60	0.27	12.18
Transportation	BBB+	94	9.2	141	0	(4)	(25)	0.31	3.90	(0.47)	11.73
UTILITY	**BBB+**	**430**	**8.6**	**183**	**(1)**	**(16)**	**(69)**	**1.31**	**6.91**	**0.59**	**14.48**
Electric Utilities	A-	256	8.9	149	(0)	(8)	(24)	0.65	3.01	(0.08)	10.75
Gas Pipelines	BBB+	165	7.9	239	(3)	(29)	(144)	2.41	13.34	1.70	20.61
Rating Bucket											
AAA Bucket		71	8.9	86	1	(3)	1	0.40	1.22	(0.36)	8.27
AA Bucket		425	6.0	83	0	(6)	(16)	0.53	1.63	(0.04)	6.44
A Bucket		1,577	6.9	115	(0)	(7)	(14)	0.56	2.29	(0.07)	7.90
BBB Bucket		1,888	7.2	185	(1)	(12)	(59)	1.13	4.86	0.46	11.01
Term Bucket											
1-4	A-	1,253	2.3	86	(1)	(6)	(27)	0.30	1.54	0.05	3.04
4-7	A-	986	4.7	118	0	(8)	(38)	0.66	2.96	0.10	6.78
7-10	A-	710	7.2	157	(0)	(11)	(30)	1.04	3.83	0.17	9.96
10PLUS	A-	1,012	14.0	213	(0)	(9)	(31)	1.35	5.19	0.35	18.01

Data as of 08/25/2016

Exhibit 4 Morningstar, Inc. Corporate Bond Index Option-Adjusted Spread by Sector

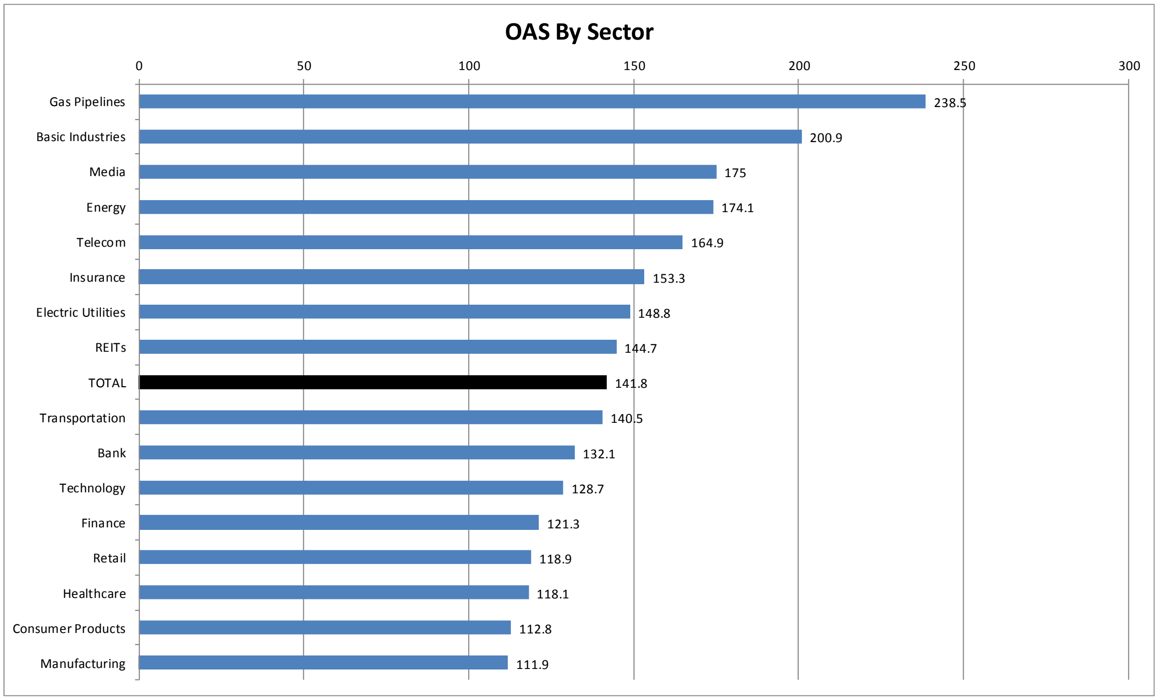


Exhibit 5 Morningstar, Inc. Corporate Bond Index 1-Week OAS Change

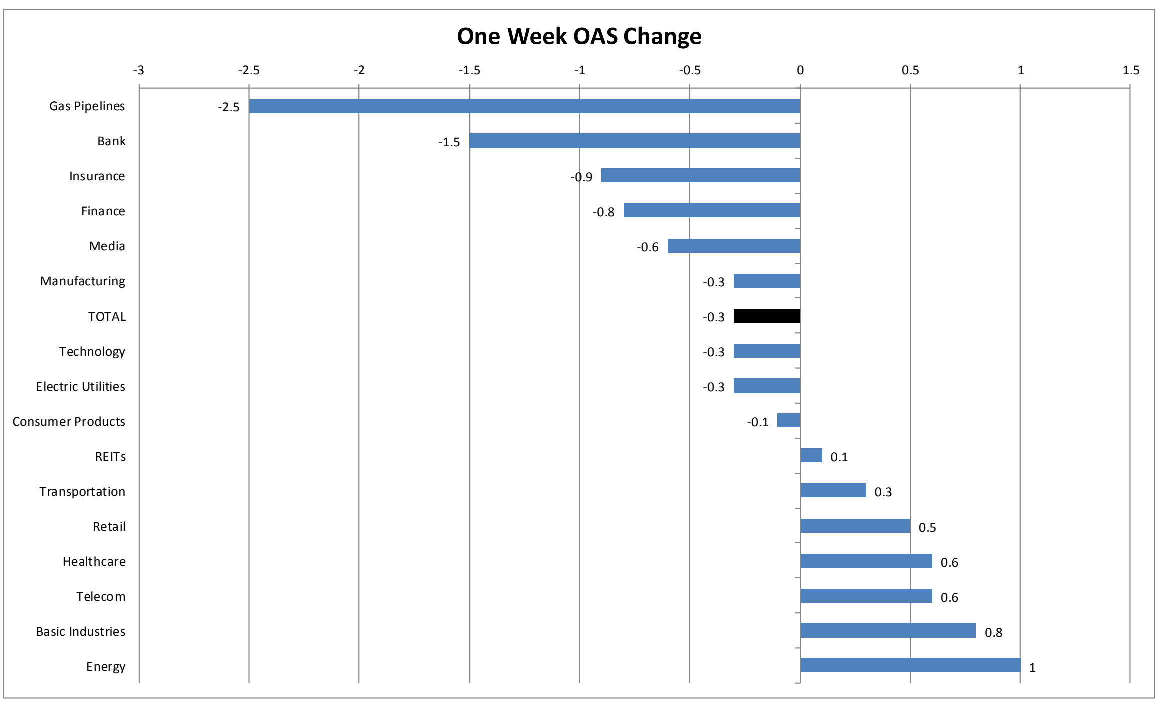


Exhibit 6 Morningstar, Inc. Corporate Bond Index Year-to-Date OAS Change

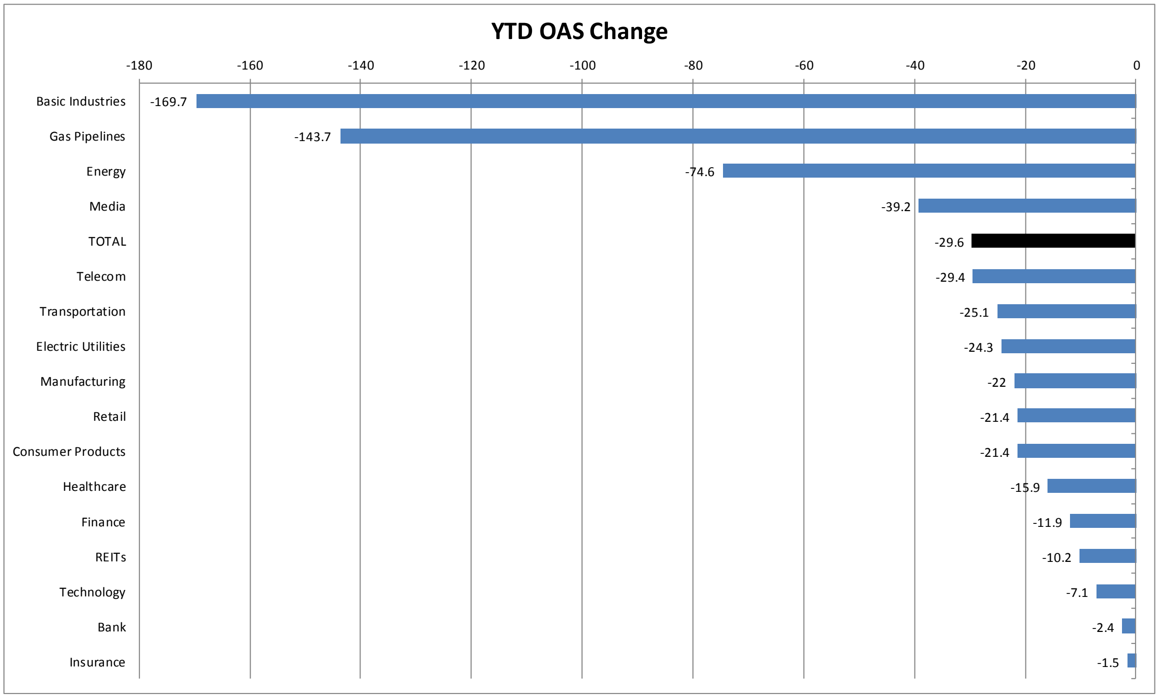
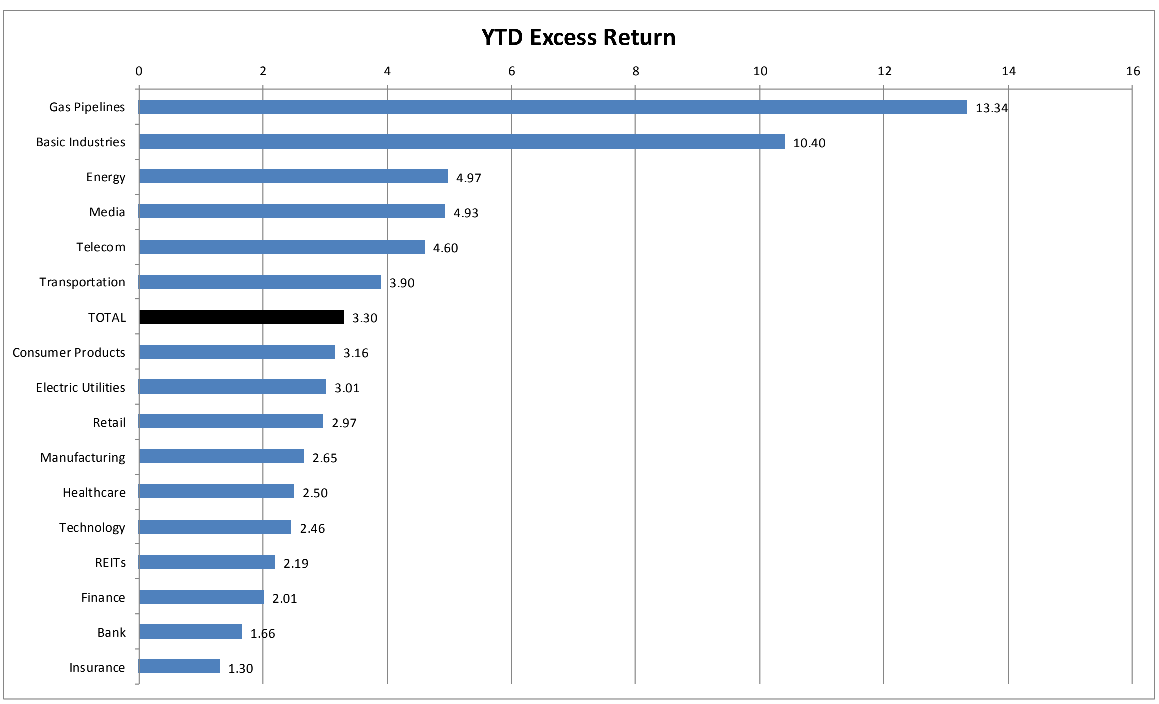


Exhibit 7 Morningstar, Inc. Corporate Bond Index YTD Excess Return



Credit Rating Actions

► Rating Changes

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Delphi Automotive DLPH	BBB+	BBB
Southwest Airlines LUV	BBB+	BBB
United Continental Holdings UAL	BB-	B+
Boston Scientific BSX	BBB	BBB-

► Rating Affirmations

Issuer/Ticker	Current Issuer Credit Rating	Previous Issuer Credit Rating
Tenneco TEN	BB+	BB+
Lear LEA	BBB-	BBB-
BorgWarner BWA	BBB+	BBB+
Merck KGaA MKGAY	BBB+	BBB+
Celgene CELG	A-	A-
C.R. Bard BCR	A+	A+
Edwards Lifesciences EW	A-	A-

Credit Rating Upgrade: Delphi Automotive

Rick Tauber, CFA, CPA

We are increasing our credit rating on Delphi DLPH (rating: BBB+, narrow moat) one notch to BBB+ and establishing a stable outlook. Our rating action is driven by Delphi's proven sustainable business model, steady free cash flow, and committed capital-allocation policy.

Delphi's much leaner cost structure and focus on healthier parts of the auto-supply industry since exiting bankruptcy in 2009 have led to higher profitability. With recent portfolio reshaping (including acquisitions and divestitures), the firm's operating margins are now among the best in our auto supplier coverage universe and have expanded about 200 basis points since 2013. Delphi operates with only one small U.S. defined-benefit pension plan, no U.S. other postemployment benefits, and no United Auto Workers employees. The firm has redeployed much of its cost base out of the U.S. to lower-cost countries. Further, we view Delphi as being well positioned in the auto-supply chain. The firm provides products that are in high demand by consumers and supported by government legislation. As such, we believe Delphi is positioned to enjoy growth in excess of global vehicle production. Our Business Risk assessment considers our narrow moat assessment but also the deep cyclicality of the industry and historically cutthroat nature of the business. Our rating takes into consideration Delphi's recent acquisitions, including HellermannTyton, which have increased leverage to the mid-1 times area from about 1 times. The company's portfolio continues to evolve around electronic content supporting connectivity and safety. We expect leverage to stabilize or decline slightly on EBITDA growth as the company pursues a balanced capital-allocation policy around acquisitions and share repurchases. Delphi has historically invested substantially in its business through research and development, which has allowed it to retain its technological edge. The company's Cash Flow Cushion is supported by annual free cash flow exceeding $1 billion and only modest maturities, although dividends are a modest negative.

Any additional rating upgrades would be driven by continued steady top-line growth, expanding operating margins, and steady deleveraging. Delphi's success at navigating the next downcycle would also be a credit positive. Ratings could be negatively affected if the firm makes additional debt-funded acquisitions that push leverage back above 2 times on a sustained basis. Evidence of meaningful margin contraction in the next downcycle--which we do not expect, given the firm's variable cost structure--could also pressure the rating.

Credit Rating Upgrade: Southwest Airlines

Basili Alukos, CFA, CPA

We are increasing Southwest Airlines' LUV (rating: BBB+, no moat) credit rating one notch to BBB+ from BBB to reflect an improvement in the firm's credit metrics and Cash Flow Cushion since our last update. Thus far in 2016, the company has delivered record profitability and its free cash flow of $1.8 billion already exceeds 2015's generation, suggesting that its aircraft refresh is bolstering results. We are initiating a stable outlook for the firm because the improved credit metrics are slightly offset by the firm's plans to return incremental cash to shareholders, which will limit further deleveraging.

Southwest's Business Risk benefits from its large revenue base and generally creditor-friendly management, but is offset by the firm's lack of economic moat. Southwest arguably has a lower-cost structure compared with its peers, but we view the airline sector as being plagued by challenging operating characteristics such that no company can reliable sustain returns above invested capital for an extend period. Still, the recent industry consolidation and resurgent pricing power enabled Southwest and the industry to benefit from strong profitability gains during the past few years, with Southwest delivering impressive profitability metrics and interest coverage ratios--two things that bolster its Solvency Score. The resounding profitability helps the firm's Cash Flow Cushion, but the score is weakened by the new $2 billion share-repurchase authorization and a one-third increase in the dividend, in addition to average maturities of $538 million due annually over the next five years. The firm is operating with rent-adjusted leverage of 1.6 times as of June 30, and we forecast this metric to remain mostly stable over the next five years. Liquidity remains adequate, with cash of $2 billion, a credit facility of $1 billion, and an estimated $8 billion of unencumbered assets to tap for capital.

We foresee our rating will remain at BBB+, given our stable outlook, but a meaningful increase in profitability from the firm's international expansion coupled with a plan to reduce debt could result in a possible rating upgrade, as it would boost the Cash Flow Cushion and the Solvency Score. Moreover, an improvement in the firm's Business Risk based on a renewed analysis of its competitive position could also result in an upgrade. Alternatively, our credit rating could come under pressure if Southwest abandons its cost discipline to capture further market share in a prolonged fare war that could result in margin degradation and a resultant increase in leverage that would hurt the firm's Solvency Score. We could also see rating pressure should Southwest decide to add incremental debt to return more cash to shareholders, which would also hurt its Cash Flow Cushion.

Credit Rating Upgrade: United Continental Holdings

Basili Alukos, CFA, CPA

We are upgrading United Continental Holdings' UAL (rating: BB-, no moat) credit rating one notch to BB- from B+ to reflect an enhanced view of the firm's credit profile. United has seen a steady improvement in its credit metrics over the past few years. Modest cost containment and industry pricing power have enabled operating margins and free cash flow to ascend skyward, helping rent-adjusted leverage improve to 3.6 times as of June 30 from 6.0 in 2013. We have assigned United a positive outlook because continued EBITDAR growth coupled with delivering on its investment-grade rating aspirations by reducing leverage could result in another positive rating action.

Our rating for United Continental takes into account the large revenue size and average product concentration, offset by the lack of an economic moat. Moreover, consolidation added some much-needed discipline in the industry, although the low barriers to entry may keep any sustained profitability at bay. United has encountered its own challenges in its integration with Continental, including the abrupt departure of former CEO Jeff Smisek and the health issues of current CEO Oscar Munoz. As a result, two investors have won 2 of the 15 board seats, and we suspect this will have modestly negative ramifications for creditors. Already, the firm is on pace to repurchase $3 billion in shares in 2016.

Profitability has improved mightily since 2012, with EBITDAR margins increasing from 7.7% to 26.1% through June 30, enabling United to retire $1.8 billion in debt since 2013 and nearly halving rent-adjusted leverage to a manageable 3.6 times as of June 30. The company operates with a solid liquidity position, with cash and short-term investments of $4.7 billion and access to a $1.35 billion revolver. Still, United's Cash Flow Cushion score is affected by meaningful capital expenditures ($3.6 billion per year over the next five years) as the company upgrades its fleet, debt maturities of $1.2 billion per year through 2020, and the aforementioned share-repurchase program.

We assigned United a positive outlook because on its current trajectory, we foresee further debt reduction and EBITDAR growth related to the firm's earnings initiatives, which it forecasts will extract $3.1 billion of incremental savings by 2018. Should the firm exceed its costs estimates and recapture a portion of the domestic market share it has lost, then this would bolster the firm's Solvency Score and Cash Flow Cushion scores, resulting in a potential upgrade. Conversely, our credit rating could come under pressure if the firm's turnaround efforts prove unsuccessful and the company is forced to return more cash to shareholders to appease its activist investors. In this case, we expect a worsening of the Solvency Score and a deterioration in the Cash Flow Cushion.

Credit Rating Upgrade: Boston Scientific

Julie Utterback, CFA

We are upgrading our credit rating for Boston Scientific BSX (rating: BBB, narrow moat) to BBB from BBB- to reflect recent deleveraging and are initiating a stable outlook.

Boston Scientific has deleveraged substantially in 2016 on profit growth and debt repayment, which has caused a marked improvement in the firm's Cash Flow Cushion, Solvency Score, and Distance to Default pillars. At the end of June, the company owed $5.4 billion in total debt (down from $5.7 billion at the end of 2015), and gross debt/adjusted EBITDA stood at 2.6 times by our estimates (down from 3.0 times at the end of 2015). With cash of $438 million, its net debt/EBITDA stands at 2.4 times (down from 2.8 times at the end of 2015). This deleveraging is the primary cause of the upgrade. With the firm now close to its gross and net leverage goals of 2.5 times and the low 2s, respectively, management now aims to use about two thirds of the roughly $6 billion of the adjusted free cash flow it expects from 2017 to 2019 on share repurchases and acquisitions. We think the rest of that free cash flow may be necessary to fund its mesh liabilities ($2 billion in reserves) and tax settlements (agreed to a $275 million settlement for the tax years 2001 to 2007 with the remaining years through 2015 yet to be determined). With those expected outflows, leverage may remain roughly stagnant for the next few years, and the firm may need to refinance its obligations as they come due, which informs our stable rating outlook.

Our view of Boston's credit profile also reflects its solid Business Risk pillar, which is supported by its narrow-moat medical device business. Boston primarily develops, manufactures, and markets devices for interventional cardiology, endoscopy, peripheral interventions, urology/women's health, neuromodulation, and electrophysiology indications. In contrast with key cardiac device rivals Medtronic and St. Jude, which enjoy wide moats, Boston only sports a narrow moat, reflecting how the firm has fallen behind on technological innovation in recent years after the expensive Guidant acquisition. Nonetheless, the company still typically operates in oligopolies where it faces roughly two other rational competitors. Even though Boston is no longer in a pioneering role in some niches, the medical device industry is structured in such a way that makes it highly unlikely that a new market entrant could push out Boston.

While our rating outlook is stable, we see the potential for both positive and negative changes in our rating. With only a narrow moat in a device sector where the top players sport wide moats, we could see the potential for our Business Risk pillar and credit rating to improve if the company's competitive position strengthens from its recent laggard status. Also, if the firm decides to spend significantly less on repurchases and acquisitions than currently expected, it could build more cash on its balance sheet and manage its obligations through internal means, which would probably have a positive effect on its other rating pillars and provide a potential upgrade catalyst. Negatively, if acquisitions and repurchases are significantly larger than expected, requiring debt financing, or if legal and tax liabilities significantly exceed expectations, the Cash Flow Cushion, Solvency Score, and Distance to Default pillars could weaken substantially, necessitating a downgrade. Based on foreseeable scenarios, we think any rating change would be limited to one notch.

Credit Rating Affirmation: Tenneco

Rick Tauber, CFA, CPA

We are affirming our BB+ corporate credit rating on Tenneco TEN (rating: BB+, narrow moat) and establishing a positive outlook.

Our rating reflects the firm's solid product positioning in the auto-supply universe, including the number-one or -two share in its markets, supporting our narrow economic moat rating. Tenneco is a leader in supplying emission- and ride-control systems that meet the regulatory requirements of customers around the globe. As developing countries suffer greater vehicle congestion and pollution, Tenneco's emission-control products are likely to benefit from clean air legislation. The firm also is diversifying away from autos by providing products to the commercial truck market as well as off-road vehicles. Significant aftermarket sales provide further diversification. These factors support the firm's Business Risk pillar, although the inherent cyclicality in the industry and comparatively narrow product line and modest size offset those positive factors somewhat. Tenneco's geographic and customer diversity have improved over the years, with North America at half of revenue and light vehicles representing 73% of sales. Tenneco navigated the recent downturn in impressive fashion by taking costs out of the business and generating free cash flow. Adjusted debt/EBITDA peaked in 2008 at 4.3 times at the cyclical bottom and has since recovered to below 2 times. We expect the firm to generate annual free cash flow averaging over $200 million on mid-single-digit average top-line growth during the next five years. This should allow the firm to continue to deleverage as EBITDA grows. That said, the firm is near its net debt/EBITDA target of about 1 times, and thus we expect any excess cash to be reinvested in the business or returned to shareholders. The Cash Flow Cushion benefits from a modest maturity schedule. Liquidity remains strong at over $1 billion, and the firm's Solvency Score reflects healthy and improving interest coverage and solid returns on invested capital along with its decent balance sheet.

Our rating could move higher if Tenneco continues to grow and expand its operating margins at a healthy clip. In addition, if adjusted gross leverage trends below 1.5 times and management commits to investment-grade ratings, the rating could be increased. Alternatively, a sharp downturn in the auto OEM environment leading to margin compression and increased leverage could cause the rating to be lowered.

Credit Rating Affirmation: Lear

Rick Tauber, CFA, CPA

We are affirming our BBB- credit rating on Lear LEA (rating: BBB-, narrow moat) and establishing a positive outlook.

Our 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 factors lead to Lear's narrow moat rating 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. Also, 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 growth over the past few years.

Offsetting Lear's size and business position drawbacks is its light leverage, which has been increasing modestly over the past couple of years. Debt/EBITDA was below 1 times before 2014 but has ramped up to 1.3 times through the first half of 2016 and including the impact of a recent acquisition. We expect leverage to remain at 1.5 times or less in support of our rating. We also expect Lear to take a measured approach to conclude the remaining $765 million of its $1 billion share-repurchase program through 2017. Solid free cash flow generation should support this and the modest dividend, and our Cash Flow Cushion score also benefits from minimal debt maturities ahead of the 2020 term loan maturity. Lear's

Solvency Score benefits from healthy interest coverage and strong returns on invested capital driven by low capital intensity.

Our rating could increase by a notch if the company maintains strong margin performance combined with existing leverage metrics over the near term, with acquisitions limited to a bolt-on nature. Our rating could come under pressure if Lear makes a large acquisition or more aggressively repurchases shares, pushing leverage meaningfully higher. A split of the seating and electronics businesses could also hurt the rating.

Credit Rating Affirmation: BorgWarner

Rick Tauber, CFA, CPA

We are affirming our BBB+ rating on BorgWarner BWA (rating: BBB+, narrow moat) and establishing a stable outlook.

Our credit rating reflects BorgWarner's strong positioning as a global supplier of automotive equipment along with modest financial leverage. BorgWarner has produced steady profitability and positive free cash flow every year since its 1993 initial public offering despite the inherent cyclicality and cutthroat nature of the auto-supply industry. BorgWarner's long-term customer relationships and product positioning benefit from the continued secular trend toward improved fuel efficiency, supporting its moat. In its engine segment, BorgWarner is a global leader in the fast-growing turbocharger market, which benefits from an increase in global fuel economy standards and emissions legislation. In its drivetrain segment, products such as dual clutch transmissions have similar industry drivers. The Business Risk assessment also considers the company's good customer and geographic diversity, both of which have improved meaningfully over the past several years.

BorgWarner has become more aggressive with its capital-allocation policy, including ongoing share repurchases along with the $1.2 billion acquisition of Remy last year. These factors pushed debt/EBITDA up to 2 times from historically around 1 times and caused us to lower our rating a notch in 2015. We expect high-single-digit revenue and EBITDA growth over our forecast horizon, driven by the firm's healthy backlog, and this profit growth could result in leverage falling back to the low- to mid-1 times range over the next few years. However, further large acquisitions or more aggressive share repurchases could keep leverage elevated. Our Cash Flow Cushion reflects our expectation of annual free cash flow well above $300 million but significant dividend payouts and modest debt maturities. The Solvency Score is supported by strong interest coverage, modest leverage, and healthy ROICs.

Our rating is unlikely to increase for the foreseeable future, given that it is weakly positioned in the category and management remains focused on returning excess cash to shareholders or using it on acquisitions. Our rating could be lowered if the company gets more aggressive on debt-financed acquisitions or share repurchases, causing leverage to increase toward the 2 times area. If a cyclical downturn occurs and margins compress, leading to lower EBITDA and cash flow and higher leverage, the rating could be lowered.

Credit Rating Affirmation: Merck KGaA

Michael Zbinovec

We have affirmed Merck KGaA's MKGAY (rating: BBB+, narrow moat) BBB+ rating and assigned a stable outlook, reflecting its strengths in life sciences and pharmaceuticals, along with its ability to deleverage after the $17 billion Sigma-Aldrich acquisition.

In conjunction with the acquisition, the company's debt load jumped to EUR 13.7 billion at the end of 2015 from EUR 5.6 billion in 2014. While pro forma net leverage of just below 3.0 times as of June weakly positions Merck KGaA in the BBB+ rating category, the company has made strides on its top priority of reducing net leverage to below 2 times in 2018 by paying down EUR 400 million of debt in the first half of 2016 (gross debt of EUR 13.3 billion as of June). We think the firm's net leverage target of below 2 times can be achieved through debt reduction and solid operational performance while the firm holds tight on large business-development transactions and significant repurchases in the near term. In our view, Merck KGaA's roughly EUR 2 billion in annual free cash flow could grow to exceed EUR 3 billion by 2020, which can easily satisfy annual dividend payments of greater than EUR 500 million while providing flexibility to quickly wind down leverage. Long-term debt maturities of approximately EUR 1.4 billion through 2018 and short-term debt around EUR 4 billion offer the firm an opportunity to chip away at the outstanding debt load to meet its deleveraging goal.

Merck KGaA has dug a narrow moat with a stable moat trend primarily with its life sciences and pharmaceutical businesses, each of which warrants a narrow moat, owing to competitive advantages in their respective markets. The Sigma-Aldrich acquisition doubled the size of the firm's life operations by bringing in a broad portfolio of well-respected research products to better contend with large-scale competitors such as Thermo Fisher. The acquisition also helped ease reliance on a pharmaceutical unit struggling with declining demand for its top product Rebif (around 12% of sales) from new branded multiple sclerosis treatments. While the firm is trying to accelerate its entrance into the promising immuno-oncology space, a nascent therapeutic area for Merck KGaA, on the whole we view its research pipeline as relatively weak. We see the life sciences unit (now 38% of company revenue) becoming Merck KGaA's largest segment by 2019, overtaking the healthcare division (45% of total revenue) as the pharmaceutical business experiences dwindling demand for its top three drugs: Rebif, Erbitux, and Gonal-f. After the acquisition in late 2015, Merck KGaA generated solid organic sales and adjusted EBITDA growth of 5% and 28%, respectively, in the first half of 2016, despite still digesting Sigma-Aldrich. This reinforces our conviction that revenue and adjusted EBITDA may increase around the midsingle digits and high single digits, respectively, through 2020, compounded annually.

While we currently have a stable outlook on Merck KGaA's rating, we may upgrade our rating if net leverage declines to management's target of below 2 times on a consistent basis. That deleveraging will probably require a combination of debt repayment and steady earnings growth. Conversely, Merck KGaA is presently weak within the BBB+ rating category, so any difficulty in the integration of Sigma-Aldrich could damp earnings potential, delay deleveraging, and cut into our rating. Also, additional leveraging transactions that further stress the balance sheet, such that net leverage stays above 2.5 times on a sustainable basis, could lead to a downgrade of the rating.

Credit Rating Affirmation: Celgene

Michael Zbinovec

We have affirmed Celgene's CELG (rating: A-, narrow moat) A- rating and assigned a stable outlook, reflecting a balance between strong growth prospects for the firm's pharmaceutical portfolio versus high product concentration exposure and presently elevated leverage.

Celgene has earned its narrow moat with its pharmaceutical offering that includes the standard of care in multiple myeloma treatment, Revlimid. Our main credit concern is the firm's heavy reliance on best-seller Revlimid, given that the drug represents about 63% of total sales and faces tough brand name competition and a potential generic version of a key competitor Velcade in 2017. Celgene has tried to diversify its portfolio, but we still see sales of the blood cancer medicine surpassing $10 billion and accounting for the majority of revenue in 2020. We see revenue and EBITDA increasing by double digits compounded annually over the next five years, propelled by Revlimid. Celgene has some time to expand its medicine bag as direct generic competition is anticipated on a limited basis in March 2022 and fully in January 2026 per a patent settlement with Allergan's generic business, which was recently acquired by Teva. Celgene's research pipeline contains several promising therapeutics, notably the potential blockbuster ozanimod (from Receptos) for treatment of ulcerative colitis and multiple sclerosis. However, the expected contribution from Celgene's current research portfolio may not entirely compensate for losses expected, as Revlimid patent protection lapses in the next decade.

Celgene's debt balance increased significantly to $14 billion at the end of June from $7 billion in 2014 in conjunction with an $8 billion debt issuance needed to fund the acquisition of Receptos ($7 billion) and share repurchases (around $3 billion). Taken together with cash and investments of $6 billion, the firm's net leverage was 1.8 times for the 12 months ended in June compared with a net neutral position in 2014. Considering our estimate for EBITDA growth, we expect leverage to unwind naturally to preacquisition levels over the long term solely through sustained operational strength. Even though it has financial flexibility provided by estimated annual free cash flow over $6 billion on average through 2020, to accelerate deleveraging the balance sheet, we anticipate the firm will focus its capital allocation on diversifying its product portfolio through pipeline acquisitions and on repurchasing shares, which keeps us somewhat cautious with our outlook.

While our stable outlook suggests that our rating is unlikely to change in the near term, to improve the current rating, the firm would need to unwind presently high leverage toward preacquisition levels. Also, an easing of concentration exposure to Revlimid could lead to a positive movement in the rating. On the other hand, damped operational performance, likely tied to subdued growth of Revlimid from new competition, would delay deleveraging and could pressure our current rating. Additional leveraging transactions, such as aggressive asset buys or share repurchases that significantly push up net leverage for the long run, also could lead to a downgrade of the rating.

Credit Rating Affirmation: C.R. Bard

Julie Utterback, CFA

We are affirming our A+ credit rating on C.R. Bard BCR (rating: A+, narrow moat), which reflects the firm's leadership in vascular, surgical, urology, and oncology devices combined with its solid financial position. We are also initiating a negative outlook on the firm. Bard is weakly positioned in its A+ rating category, and we may downgrade our rating if the firm doesn't meet our cash flow expectations or if its liabilities, especially its legal obligations, prove higher than our current estimate.

Our A+ rating reflects its solid Business Risk pillar combined with light leverage relative to available resources. In our Business Risk pillar, the company's narrow moat partially offsets an average size and concentration risk. We anticipate that Bard can sustain mid-single-digit annual top-line growth during the next five years, thanks to its robust new product set, and we think it can generate over $800 million in adjusted free cash flow annually during the next five years. In particular, we have been impressed by its Lutonix drug-coated balloon product in peripheral arterial disease, which is expanding through both additional sizes and new indications. Aside from advances like that, Bard often positions its products to save hospitals money by avoiding costly procedural complications, which are increasingly valued by customers in an evolving reimbursement climate. Bard scores well in our other rating pillars (Cash Flow Cushion, Solvency Score, and Distance to Default) primarily because of its light debt leverage. At the end of June, Bard owed $1.65 billion in debt (1.5 times EBITDA) and held enough cash on its balance sheet to shave off a turn of leverage on a net basis, although much of that cash may be needed to settle legal cases.

Overall, Bard is weakly positioned as an A+ credit, and we have a negative outlook on its rating. If the firm doesn't meet our cash flow expectations or if leverage rises moderately, our rating could prove too high. Also, we see significant uncertainty around the magnitude and timing of potential legal liabilities, particularly its mesh cases. If liabilities are higher than the roughly $900 million we expect net of expected recoveries from suppliers (Medtronic in the mesh cases), we may downgrade our rating. If the firm's liabilities (legal or otherwise) are lower than expected or new products outperform expectations enough to improve the firm's size, diversity, or moat, our rating could rise. However, given our negative outlook, we see an upgrade scenario as unlikely in the near future.

Credit Rating Affirmation: Edwards Lifesciences

Julie Utterback, CFA

We are affirming our A- credit rating on Edwards Lifesciences EW (rating: A-, narrow moat), which reflects its solid position in the cardiac device industry and its low debt leverage. We are also initiating a stable outlook on the firm. While Edwards operates on the strong end of its A- rating category, in our opinion, we do not think an upgrade is likely within the next couple of years. To upgrade, we would probably need to see a significantly improved Business Risk profile, which could be a multiyear endeavor. Also, with its notes coming due in 2018, management's leverage plans remain unclear. We would not be surprised to see the firm refinance that maturity and even increase its gross debt outstanding, given its very low leverage relative to ongoing profits. An increase in debt leverage could constrain any positive rating momentum.

With its very light leverage, our credit rating on Edwards is pressured primarily by our view of its Business Risk. As a medical device developer and manufacturer, Edwards' operations are highly concentrated in heart valves, which also keep its size and diversity relatively low. Despite those drawbacks, we recognize Edwards' dominance and ongoing innovation in the heart valve market in this pillar primarily through our narrow economic moat rating. The company has a long history of pioneering new heart valves and is still highly regarded by cardiac surgeons for its technological advances. Most recently, Edwards pioneered minimally invasive transcatheter aortic valves, which were launched in Europe in 2007 and in the U.S. in 2011. Despite increasing competition, these products continue to drive robust growth for Edwards, as they steal share from traditional valves that require invasive surgical procedures. Many elderly patients are too frail and high risk to undergo surgical valve replacement, leaving a large untreated target market for transcatheter valves. Since 2010, free cash flow has grown from just under $200 million to $475 million in the 12 months ended in June. We project annual free cash flow will grow to roughly $800 million by 2020 primarily on continued expansion of the firm’s aortic transcatheter valves. That growing free cash flow should be plenty to meet its financial obligations. In the long run, Edwards also aims for success with a minimally invasive mitral valve, which looks like a big opportunity if its multiyear development program succeeds. With its light debt leverage, Edwards scores very well in our Cash Flow Cushion, Solvency Score, and Distance to Default pillars. As of June, Edwards’ gross debt/EBITDA stood at only 0.8 times. With cash and investments significantly exceeding debt, the firm should not have any trouble repaying its debt. However, most of its cash remains overseas, which could create incentive for the company to refinance and even increase its leverage while also meeting its other capital-allocation priorities.

Edwards’ rating is constrained by its fair Business Risk ranking. To improve that pillar, it would probably need to grow in size and diversity, which could also affect its moat. Edwards prefers internal innovation and tuck-in acquisitions, though, so improvement in these factors could take some time, which is reflected in our stable rating outlook. Additionally, the firm currently operates with an extremely conservative balance sheet. If it increases leverage substantially or pushes more cash out to shareholders, our rating could decline.

Recent Notes Published by Credit Analysts

Pfizer Filling Oncology Medicine Cabinet With Medivation

Michael Zbinovec

We see no significant impact to Pfizer's PFE (AA- rating, wide moat) credit profile from its plan to acquire Medivation (not rated) for $81.50 per share in cash, representing an enterprise value of approximately $14 billion. Pfizer has substantial liquidity from its cash and investments balance ($34 billion as of June) to easily fund the transaction, which is expected to close by the end of 2016 subject to shareholder and regulatory approvals. However, we continue to see material event risk at Pfizer, given its potential split into two organizations with one focused on branded pharmaceuticals and the second marketing established pharmaceuticals. Management plans to decide on a separation by the end of 2016. As we've seen in other healthcare separations, corporate restructurings like these usually cut into size and diversity in our Business Risk pillar, and the capital structures of the separating entities can also change significantly. If Pfizer ultimately pursues such action, our current AA- credit rating may prove too high.

We see the addition of Medivation's prostate cancer drug, Xtandi, and an advancing research portfolio consisting of the oncology projects talazoparib (PARP inhibitor for breast cancer) and pidilizumab (for blood cancers) as positive for Pfizer, although we do not expect it to significantly change the firm's Business Risk profile or strong credit rating. For Pfizer, we expect solid uptake of newer medicines Xeljanz (diabetes) and Ibrance (cancer) plus incremental revenue from Medivation to help fully offset patent lapses, leading to compound annual sales growth to the end of the decade in the midsingle digits. Pfizer faces operational hurdles arising in 2017 and 2018, when U.S. patent protection falls for Viagra (4% of revenues) and Lyrica (10% of sales), respectively. Pfizer's total debt was $44 billion at the end of June, rising from $39 billion at the end of the first quarter due to the $5 billion purchase of Anacor in June. Pfizer had substantial liquidity from cash and investments of $34 billion at the end of June to easily fund the proposed purchase of Medivation. In addition, the company generated free cash flow of $13 billion for the 12 months ended in June. Overall, we estimate slight improvement over the next few years to current total debt and net debt leverage of 2.0 times and 0.5 times, respectively, for the 12 months ended in June, mainly by EBITDA generation (including contribution from Medivation) outpacing revenue growth.

Pfizer's 2.75% notes due 2026 are indicated at +80 basis points over the nearest comparable Treasury, on par with Roche's RHHBY (rating: AA-, wide moat) 2.625% bonds due 2026. However, given the event risk related to a potential split of Pfizer, bond investors may want to use lower-rated pharmaceutical firms as key comparables. For example, Gilead's GILD (rating: A+, wide moat) 3.625% bonds due 2026 recently traded around +115 basis points, or 35 basis points wider than Pfizer's 2026s. Investors should also note that Pfizer's downgrade potential in a separation scenario could be more than one notch. Therefore, other comparables, such as Biogen's BIIB (rating: A, wide moat) 4.05% bonds due 2025 that recently traded around +140 basis points, represent a potential high-risk separation scenario for Pfizer.

Gap Remains Weakly Positioned in BB+ Rating Category Following 2Q Results

Wayne Stefurak, CFA

Gap's GPS (rating: BB+, no moat) recently reported second-quarter results highlight continuing competitive challenges despite stabilizing operating performance. We continue to believe the company is weakly positioned in its BB+ rating category.

Results for the second quarter (ended July 30) showed some progress. Gap reported a same-store sales decline of 2%, an improvement from the 5% decline in the first quarter. In addition, merchandise margins increased 90 basis points over last year (excluding foreign exchange) and gross margins remained relatively flat at 37.3%. Adjusted EBITDAR, including $150 million in restructuring costs related to store closures and streamlined operations, fell 2% to $896 million while margins held relatively steady at 23.3%. For the last 12 months, EBITDAR was $3.3 billion with a margin of 21.3%. Free cash flow was $991 million after capital spending of $695 million. While share-repurchase activity has been halted in 2016, annual dividends approximate $368 million. Management has stated that 2016 repurchases will be meaningfully lower than its historical average of just over $1 billion annually due to its $400 million term loan maturity. Gap's adjusted debt totals $12.2 billion, including $10.5 billion related to liabilities for operating leases. Adjusted debt/EBITDAR has risen over the past couple of years and stood at 3.7 times at the end of the second quarter.

For fiscal 2016, Gap expects net closures of about 50 company-operated stores and forecasts it can attain operating margins of 8.5%, which would represent a slight improvement from 8.2% for the last 12-month period. We continue to believe Gap will be challenged to arrest comparable store declines and demonstrate meaningful margin improvement. For 2016, we project a 4% revenue decline, and longer term we forecast a low-single-digit average annual revenue decline with operating margins around current levels. As such, leverage may remain elevated for an extended period.

Recently, we revised our moat rating to none from narrow on the belief that Gap's brand strength can no longer deliver pricing power. Customers appear to be favoring price and performance over brand labels, as evidenced by off-price retailers TJX Companies TJX (rating: A, narrow moat) and Ross Stores ROST (NR, narrow moat) which have increased revenue in the midsingle digits on average annually over the past three years. To better compete, Gap has worked to create a responsive supply chain over the past couple of years that would allow it to quickly adjust volume to current demand, respond to immediate fashion trends, and increase inventory turns. However, inventory turns remain flat and gross margins continue to decline, most recently to 35.6% for the last 12 months ended in the second quarter from a peak of 39.4% in 2012. Gap's credit rating was recently lowered one notch to BB+ and assigned a negative outlook. Our negative outlook reflects the current lack of demand visibility, cash requirements for charges and higher investments, and challenges to reduce currently high leverage.

We continue to believe Gap is weakly positioned in its BB+ rating category. Gap's $1.25 billion 5.95% senior unsecured notes issue due in 2021 recently traded at a yield of 4.03% and a spread of +286 basis points. Two similar-rated peers in apparel retailing are L Brands LB (rating: BB+, wide moat) and Hanesbrands HBI (rating: BBB-, narrow moat), both of which have been awarded an economic moat and carry lower leverage. We believe L Brands is positioned strongly in the BB+ rating category. L Brands' outstanding $500 million 5.625% senior notes issue due in 2023 recently traded at a yield of 3.76% and a spread of +234 basis points over the nearest Treasury. Hanesbrands' $900 million 4.625% senior unsecured notes issue due in 2024 are indicated at a yield of 3.87% and a spread of +246 basis points. The senior unsecured notes are subordinated to about $2.3 billion of secured credit facilities, while net adjusted leverage of 3.1 times is at the high end of management's target of 2-3 times.

Best Buy's 2Q Results Reflect Ongoing Profit Improvements; Strongly Positioned in BB Category

Wayne Stefurak, CFA

Best Buy BBY (rating: BB, no moat) reported second-quarter results for fiscal 2017 ended July 30 that accelerated its multiyear trend of higher EBITDAR and margins, as well as gradually improving leverage. Given continued profit improvements, we believe that Best Buy is strongly positioned in its BB rating category.

Best Buy reported second-quarter same-store sales and profitability ahead of its guidance. The company's domestic business reported comparable sales growth of 0.8%, which was on top of comparable sales growth of 3.8% last year. Results were supported by online same-store sales growth of nearly 24% due to increased traffic, higher average order values, and higher conversion rates. Online revenue now represents 10.6% of total domestic revenue. Second-quarter EBITDAR increased 1% to $658 million while margins remained flat at 7.7%. Margins reflected 40 basis points in gross margin erosion offset by a 30-basis-point reduction in cost savings. Best Buy achieved another $50 million of cost reduction under its Renew Blue program, bringing total savings to date of $250 million out of a target of $400 million. EBITDAR for the past 12 months increased 1.5% to $3.06 billion and margins increased 10 basis points to 7.8%. Over the past two-and-a-half years, margins have steadily expanded by over 120 basis points. Free cash flow is also near recent highs and was $1.7 billion for the past 12 months ended in the second quarter. After spending $1.4 billion on dividends and share repurchases, debt balances were reduced by over $200 million compared with one year ago. Leverage has steadily declined over the past couple of years, and adjusted debt/EBITDAR now stands at 2.5 times. Best Buy's cash and investments total $3.5 billion, and net leverage is one turn lower.

For fiscal 2017, management continues to expect revenue declines in the first half followed by growth in the back half. While full-year revenue guidance was maintained for flat growth, the company raised expectations for operating income to grow in the low single digits versus previous expectations of zero growth. Given Best Buy's commitment to share repurchases, we do not anticipate leverage to materially decline from current levels.

Best Buy's credit rating continues to reflect its competitive position as one of the largest consumer electronics retailer in the U.S., with a midteens share of the industry. Competitive advantages include a well-known brand intangible asset, high-traffic retail locations, store base shipment capabilities, a growing online platform, and store-within-store partnerships. Still, electronics retailing is characterized by intense price competition, minimal customer switching costs, and reliance on continuous product innovation. The threat from online retailers is only increasing, mass merchants are ever willing to provide price discounts, and consumer product vendors are increasingly selling direct to the customer.

We believe Best Buy is strongly positioned in its BB rating category. Best Buy's notes due in 2021 are indicated at +186 basis points over the nearest Treasury. As a comparison, Royal Caribbean Cruises' RCL (rating: BB+, narrow moat) senior unsecured notes due in 2022 are indicated at +239 basis points. We view Royal as strongly positioned in the BB+ rating category, given its positive credit rating outlook and improving credit fundamentals. Meanwhile, Norwegian Cruise Line Holdings' NCLH (rating: BB, narrow moat) senior unsecured notes due in 2020 recently traded at +318 basis points. Norwegian's bonds (issued by NCL) reflect the subordination to an estimated $4.8 billion of secured debt somewhat offset by an improving credit profile. Finally, L Brands' (rating: BB+, wide moat) senior unsecured notes due in 2023 are indicated at +244 basis points. L Brands' bonds reflect consistent EBITDA growth offset by a leveraged balance sheet.

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