Corporate Credit Spread Chartbook
Industrials Sector

Morningstar Credit Ratings, LLC
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Contents

Basili Alukos, CFA, CPA
Assistant Vice President
+1 312 384-4984
basili.alukos@morningstar.com

Rick Tauber, CFA, CPA
Senior Vice President
+1 312 384-5431
rick.tauber@morningstar.com

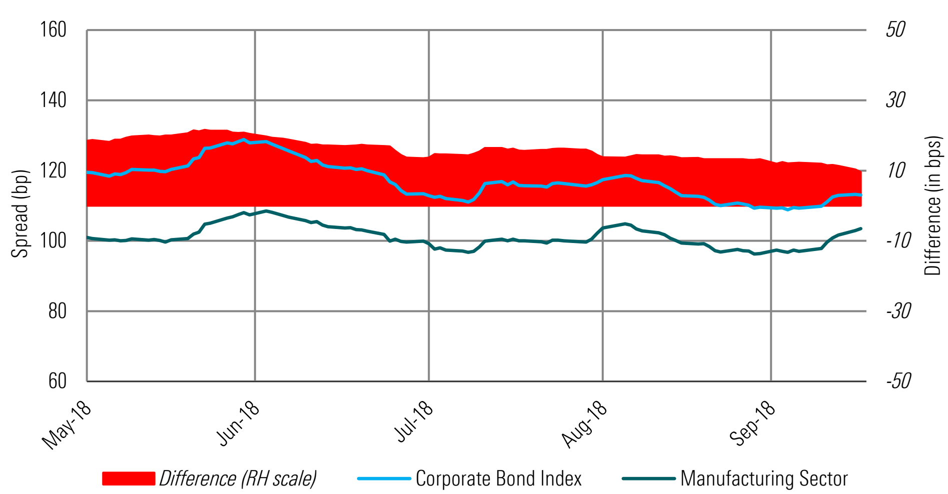
Executive Summary

We experienced a handful of rating activity in the industrials landscape since our previous publication in June. In total, we upgraded three companies on improvements in credit profiles, while one company's rating declined one notch because of its decision to enhance shareholder value through debt-funded repurchases and acquisitions, which we expect may continue in the sector. We shifted one automotive supplier's outlook to positive from stable on improving cash flow and moved one auto OEM to negative from stable on industry and company headwinds. We also upgraded our outlook to stable for one industrial credit on an improved assessment of its Business Risk. Spreads across the board widened during the quarter, coming off recent post-recession tights in both the manufacturing sector and the index as a whole.

Historical Sector Spreads

The credit spreads of the Morningstar, Inc. Corporate Bond Index tightened, while the Manufacturing Sector Index widened out since our June Industrials Chartbook. Specifically, the CBI tightened 7 basis points to +113, while the MSI widened 2 basis points to +103. The MSI ended the period +10 basis points inside of the CBI versus +18 basis points at the start of the period. The ending differential of +10 basis points was essentially the low differential during the period, inside of both the average of +16 basis points and the high of +22 basis points.

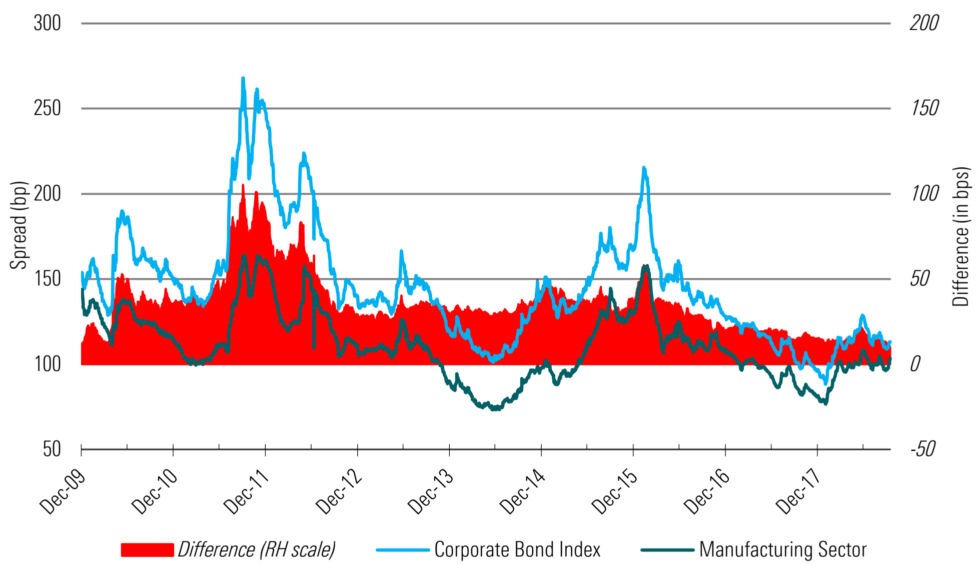
Exhibit 1 Morningstar, Inc. Corporate Bond Index Versus Manufacturing Sector (Since May 30, 2018)



Source: Morningstar, Inc. Data as of Oct. 17, 2018.

At the beginning of the current economic expansion, the Manufacturing Sector Index experienced the same fluctuations as the overall Morningstar, Inc. Corporate Bond Index, but maintained its characteristic of trading inside of the CBI. The latter widened during summer 2011, which coincided with the downgrading of the United States' credit rating as well as the sovereign debt crises and contagion of Iceland, Ireland, and Greece. The index widened, related to global growth worries leading into the end of 2015 and into 2016, which coincided with falling energy prices and the impending default risk. We think President Donald Trump's stance on global trade policies may have contributed to market spread widening. Still, the MSI ended the period at the low of +10 basis points inside of the CBI, tight to the +36 basis points inside the CBI it averaged during this span.

Exhibit 2 Morningstar, Inc. Corporate Bond Index Versus Manufacturing Sector (2010–present)



Source: Morningstar, Inc. Data as of Oct. 17, 2018.

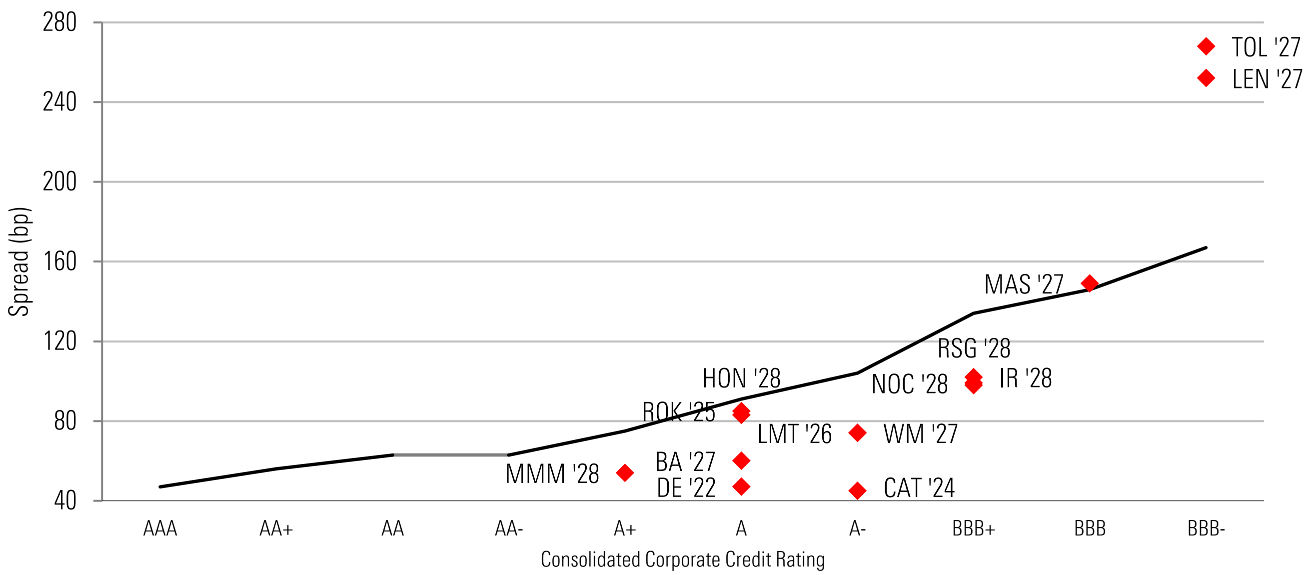
Our optimistic view for the industrials sector has ebbed slightly as of late. Although we still think that the economic furor over the president's enacted tariffs on steel and aluminum and resulting trade war concerns are likely overblown, we may have seen an early, disconcerting warning from our most influential leading indicator, the Institute for Supply Management Purchasing Managers' Index, a diffusion index. Although September's reading of 59.8 remained strongly in positive territory, the index was down 150 basis points sequentially from August's level. Moreover, the new orders component contracted 330 basis points sequentially, and we think it could indicate further softening. We will look to future movements in both the new order and inventory component of the PMI for further direction, but given the large exposure to energy, as long as the price of oil remains robust, we would expect the diversified industrial economy to motor along.

Spread Charts by Subsector

In the pages that follow, we discuss credit trends and the major headlines since our last publication.

Capital Goods

Exhibit 3 Capital Goods Versus Morningstar, Inc. Industrials Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of Oct. 17, 2018.
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends

On average, bond spreads in this subsector widened +6 basis points since our last publication versus the CBI, which tightened 7 basis points. In addition, we are introducing Toll Brothers Inc. (BBB-, stable) and Lennar Corporation (BBB-, stable) to the chart, which adds to Masco (BBB, stable) as part of our homebuilding and building materials coverage. Both Toll and Lennar are crossover credits operating in a sector that carries negative sentiment, thus partially explaining their much wider spreads versus the index.

Many companies produced solid calendar second-quarter earnings, although a handful noted increased input costs. Industrial companies reported strong mid- to high-single-digit quarterly organic growth rates, with the continued resurgence in the energy patch further fueling top-line growth in housing, consumer, and aerospace end markets. Mergers and acquisitions were again front and center, although no large deal was consummated. Still, many management teams of large industrials have said that tax reform could create a catalyst to use their overseas cash for acquisitions.

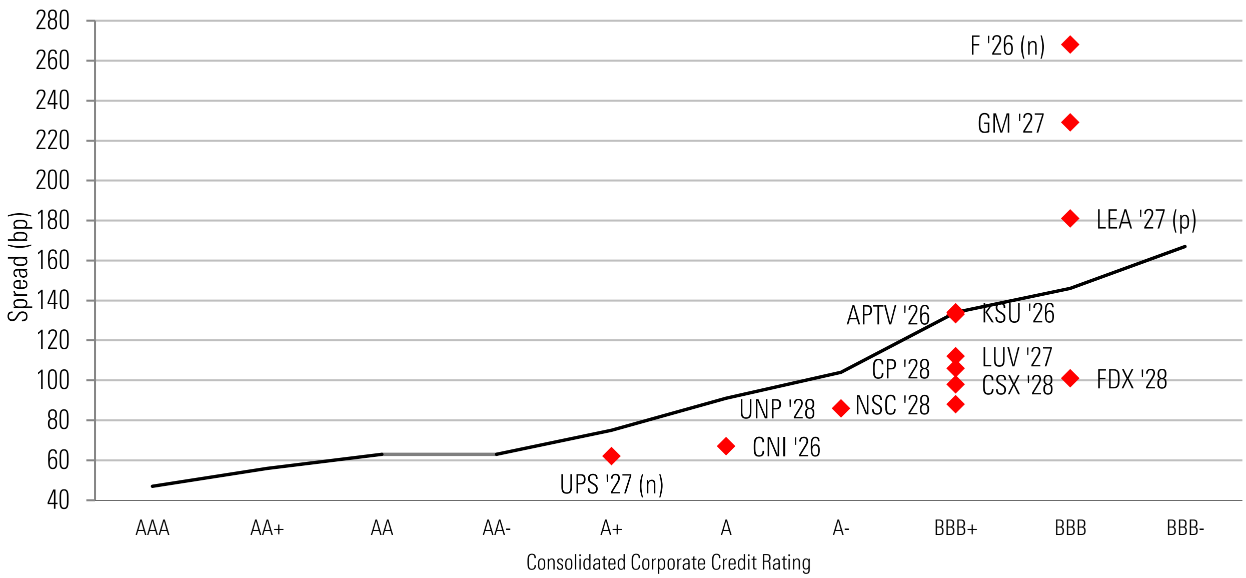
The homebuilding sector has cooled off somewhat, as higher input costs to build homes, including land, labor, and materials, has limited new supply and pushed prices solidly higher. This, along with mortgage rates approaching 5%, has affected affordability and hindered transactions. We continue to see significant pent-up demand from millennials coming out of the Great Recession, but this may manifest itself in the low end of the entry-level market or perhaps in rental units. Nonetheless, we have maintained our rating and outlook on Toll for several years, and this credit, along with Lennar, has produced strong top-line performance recently and healthy operating results. We expect these trends to continue, albeit perhaps at a lower pace of growth, driven by ongoing job and wage growth and a healthy economy.

Issuer Highlights

- In July, we dug Lennar (BBB-, stable) out of the junk pile by raising its BB+ rating one notch. Lennar completed its $10 billion acquisition of CalAtlantic in February and became the largest domestic homebuilder by sales. While leverage increased, with net debt/capital rising to 42.5% in February from the 30% range before the deal, Lennar remains committed to free cash generation and leverage already declined to 40% by the May quarter. We expect further reductions back into the 30% range by year-end. Importantly, we see lower Business Risk as a result of the deal. Lennar's number-one position in 20 markets and market share of 21%-43% give it heft among local contractors and developers of land. This should also give the firm an edge in a market slowdown, which we do not foresee in the near term.
- We downgraded our corporate credit rating on 3M Co (A+, stable) one notch to A+ in August. In 2016, management laid out its plan to increase shareholder value. With gross leverage hovering around 2.0 times, leverage increased enough to warrant the ratings action. We still think 3M has a strong credit profile, and we are assigning a stable outlook, as we expect our rating to remain at the current level over the next few years.
- In August, we upgraded Waste Management Inc (A-, stable) one notch to A- from BBB+. The upgrade incorporates improved profitability, manageable leverage, and a more favorable view of Waste Management's competitive position as the undisputed leader in the North American waste services industry.
- In August, we also affirmed our BBB+ rating on Republic Services Inc but moved our outlook to stable from negative. Although we believe that Republic Services' meaningful leverage constrains its credit profile, we have evolved our thinking around it competitive position such that it has enhanced the company's Business Risk to protect it from an imminent downgrade.

Transports & Automotive

Exhibit 4 Transports & Automotive Versus Morningstar, Inc. Industrials Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of Oct. 17, 2018.
(UR) = rating under review/(p) = positive outlook/(n) = negative outlook

Credit Trends

On average, bond spreads in this subsector widened +18 basis points since our last publication versus the CBI, which tightened 7 basis points. The driving force behind the overall widening was the auto sector, with the four credits we cover widening an average of +74 basis points. Ford, which announced weak second-quarter results and a major restructuring charge, widened about +125 basis points. Excluding autos, the subsector tightened 7 basis points, in line with the overall index.

The auto sector is under pressure on a number of fronts. Both Ford and GM highlighted that global tariffs on commodity inputs are having a material impact on their profitability. Additional risk of trade wars, particularly with China, provide another headwind. Demand in China has been weaker than in recent years, and competition greater, making that market more challenging. Finally, as we have noted many times in the past, North American sales peaked in 2016 and look likely to continue their steady decline, even in a robust economy, driven by poorer affordability on higher interest rates and higher pricing, increases in off-lease nearly new supply coming into the market, and fewer drivers given the increase in car-sharing or ride-hailing as alternative primary modes of transportation. The latter trends, along with the emergence of autonomous and electrified vehicles, are further pressuring the OEMs, although some suppliers may benefit.

Looking to the transportation sector, the early indication for earnings season for the Class I rails is encouraging, as CSX Corp (BBB+, stable) reported impressive results and raised its 2018 revenue guidance. As long as the manufacturing economy continues to run on high gear, we expect the rails to keep chugging along.

Issuer Highlights

- In September, we upgraded our corporate credit rating on Kansas City Southern (BBB+, stable) one notch to BBB+. Previously, we had believed that the rail's smaller revenue base and large Mexican exposure essentially capped its ultimate rating despite credit metrics that were at least consistent with, if not superior to, its higher-rated peers. That said, and despite the political tumult, the rail has bolstered its profitability enough over the last year that further strengthened its credit profile. We now believe that the company's credit profile is sufficient enough to outweigh these risks.
- Our rating on Lear (BBB, positive) was affirmed, but the outlook changed to positive from stable as the company continues to grow cash flow, which drove our Cash Flow Cushion higher. Lear continues to produce impressive margins in both its seating and electrical businesses. The company's strong liquidity and modest leverage provide good defense against some of the headwinds facing the industry, including potential global trade issues and increased commodity costs. Still, the firm is also well-positioned to capture growth as the industry shifts to more electronic content per car as well as autonomous vehicles.
- Contrary to narrow-moat Lear (as provided by Morningstar's Equity Research Group), we affirmed our BBB rating on no-moat Ford but moved the outlook to negative. Ford announced very weak international results for its second quarter and also revealed plans for $11 billion in restructuring charges ($7 billion of which will be cash) although many specifics around the plans to get fiscally fit were left out. The firm also canceled an analyst meeting. With this restructuring and potentially further investments needed in its autonomous and mobility units, we expect Ford's ample cash position to get tapped. This should negatively affect our Solvency Score and could drive the rating lower should these efforts not be offset elsewhere, such as with a dividend cut.

Recent Headlines

- Labor issues continued to remain at the forefront this quarter. United Parcel Service Inc (A+, negative), which had been notified by the union representing 260,000 of UPS' 454,000 workers that its members had given the go-ahead to call a strike should the two sides fail to renew the contract that expires July 31, 2018, recently ratified a new five-year contract despite a "no" vote by the majority of the employees who actually voted on the contract.

Morningstar® Credit Research

For More Information
Greg Hiltebrand
+1 312 244-7353
Greg.hiltebrand@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA