Corporate Credit Spread Chartbook
Consumer Cyclical Industry

Morningstar Credit Research
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Contents

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Executive Summary

The average credit spread for consumer cyclical investment-grade issuers covered by Morningstar Credit Ratings, LLC tightened 26 basis points to +111 basis points over Treasuries while the Morningstar Corporate Bond Index tightened 18 basis points to +98 basis points since our last consumer cyclical chartbook publication in June.

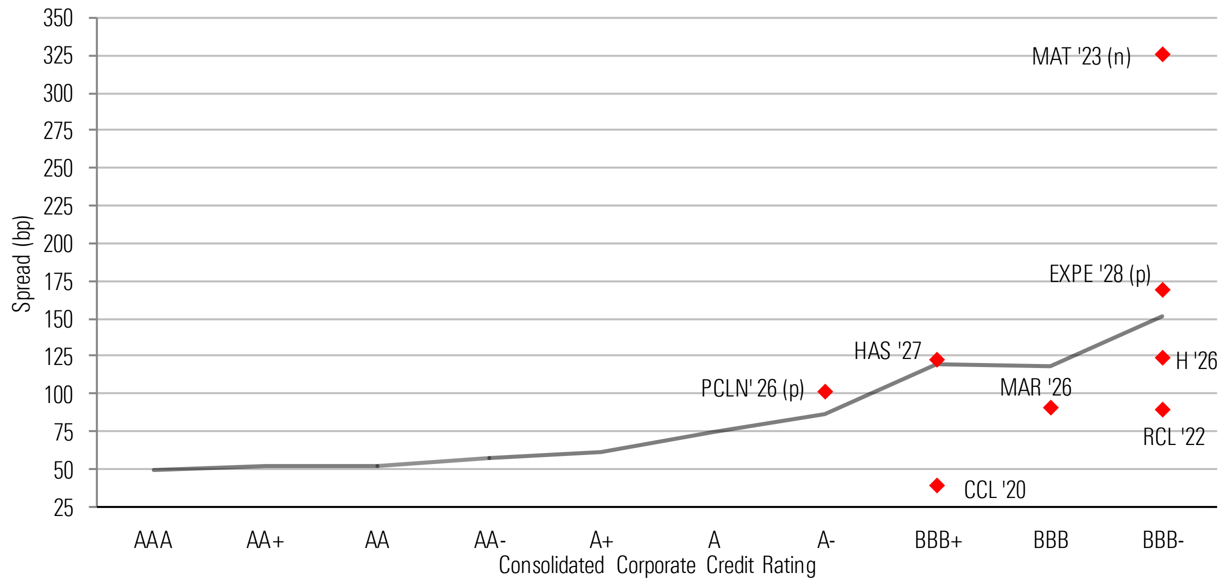
Over this same period Morningstar upgraded one issuer, downgraded two issuers, and affirmed six issuers in the consumer cyclical sector, including high-yield issuers. Credit quality is expected to remain under pressure over the next year as indicated by the predominance of negative rating outlooks. Currently within MCR's consumer cyclical-rated universe, seven issuers have a negative outlook while three issuers have a positive outlook. Credit trends remain negative in the department store, apparel, grocery and discounter, and specialty retail sectors. The gaming, travel, and lodging sectors contain the only issuers with a positive rating outlook.

Overall, the outlook for credit quality in the consumer discretionary sector remains varied. Morningstar expects above-average growth and positive credit trends in the travel and lodging sector that has benefited from improving economic conditions, while the home improvement sector enjoys modest defenses from online competition. Alternately, credit trends in the department store, apparel, and discount and grocery sectors remain negative. Morningstar believes that going forward new competitive threats in the grocery market, greater online investment requirements, an overstored apparel market, and shifts in discretionary spending will pressure credit quality in these sectors.

Spread Charts by Consumer Cyclical Sector

Lodging and Leisure

Exhibit 1 Lodging and Leisure Versus Morningstar Industrials Index



Source: Morningstar Credit Ratings, LLC , Morningstar, Inc., and Interactive Data as of October 31, 2017
(UR) = rating under review / (p) = positive outlook / (n) = negative outlook

Credit Trends and Spreads

Improving credit quality in the gaming, travel, and leisure sector is expected to continue, as evidenced by the positive rating outlook for some issuers. Solid bookings growth has bolstered revenue and margin expansion at online travel agencies, cruise lines, and hotel/casino operators. Online travel agents are expected to grow faster than the overall travel market since online penetration rates of worldwide bookings remains low and online booking growth is about double the total industry.

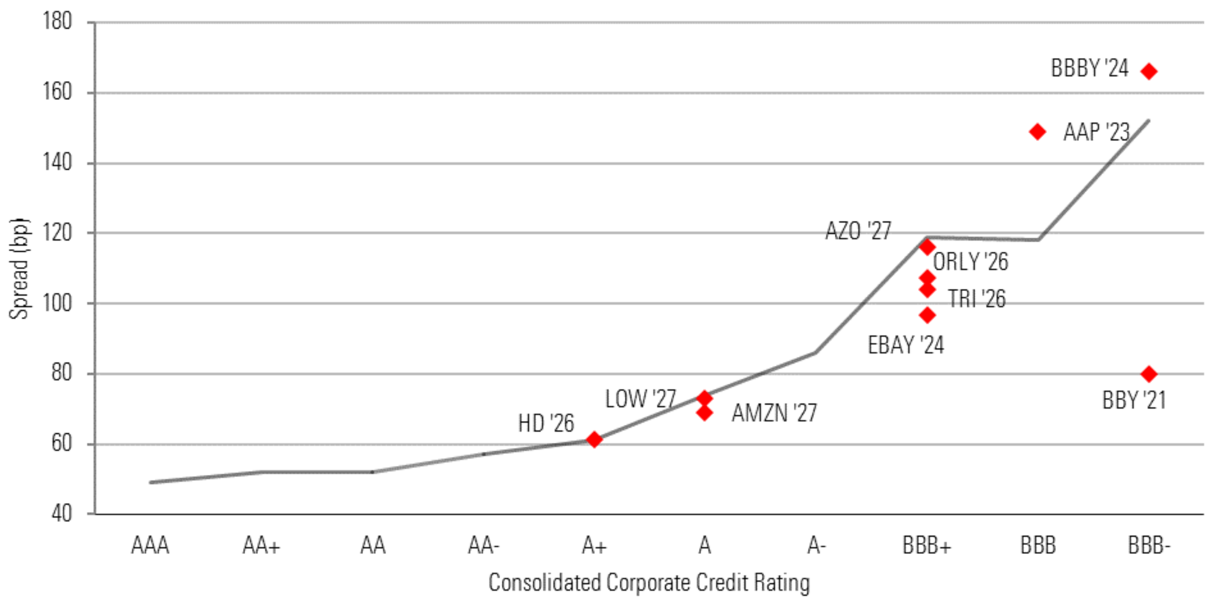
The investment-grade lodging and leisure subsector continues to improve, with most issuers tightening more than the Morningstar Corporate Bond Index. Excluding Mattel (BBB-, Negative), credit spreads tightened 21 basis points on average since our last chartbook publication in June. Expedia (BBB-, Positive) substantially outperformed the sector, as its 2026 bonds tightened 33 basis points since the date of our last chartbook. Hotels continued to outperform, with Hyatt Hotels (BBB-, Stable) and Marriott International (BBB, Stable), bonds tightening by 18 and 28 basis points, respectively. Another travel-related issuer, Priceline Group Inc. (A-, Positive) followed up its strong performance last period with an additional 26 basis points of tightening. Mattel is the only issuer in the sector whose credit spreads widened over this period. Mattel's 2023 bonds widened 179 basis points after it reported weaker-than-expected results for the third quarter of 2017, prompting a downgrade in the company's credit ratings.

Issuer Highlights

- Priceline's (A-, Positive) rating outlook is positive, reflecting the potential for an upgrade if solid growth rates in accommodation reservations and EBITDA continue, building out its competitive advantages. Priceline was assigned a positive outlook in March 2017, following a strong earnings report for 2016. The outlook also incorporates the expectation that management will maintain substantial liquidity and balance sheet strength despite the lack of a defined targeted capital structure. Priceline's rating is based on its leading position in online travel, substantial free cash flow generation, and excellent liquidity.
- Hasbro's (BBB+, Stable) rating was affirmed in October 2017, reflecting its increasingly competitive position in the toy industry, consistent free cash flow generation, and the maintenance of a conservative balance sheet. A stable outlook incorporates the expectation that EBITDA growth and strong free cash flow generation will enable the company to continue to meet its targeted maximum debt/EBITDA ratio of 2.0-2.5 times, along with its stated goal of maintaining a solid investment-grade rating. In September, Hasbro issued $500 million 3.50% 10-year senior unsecured notes at a spread of +145 basis points of Treasuries. Proceeds were used to repay its $350.0 million 6.30% notes due 2017.
- Marriott International's (BBB, Stable) rating was upgraded one notch in August 2017 based on Marriott's leading position in the lodging industry, an attractive business model that provides stable cash flow and moderate leverage. Morningstar also anticipates continued benefits from cost synergies and incremental business from the combination of the Marriott and Starwood loyalty programs. A stable outlook reflects an expectation that Marriott will continue to generate strong free cash flow and returns on invested capital, along with the maintenance of a moderately leveraged capital structure.
- Expedia's (BBB-, Positive) rating outlook is positive, reflecting the potential for an upgrade if the trend of improving profitability and returns continues, resulting in an improvement in Expedia's Solvency Score. Expedia was assigned a positive outlook in March 2017, following a strong earnings report for 2016 and success with the integration of several acquisitions. Expedia's credit rating is based on a leading position in the evolving online travel industry along with excellent liquidity and a moderately leveraged balance sheet. In September, Expedia sold $1.0 billion of 3.8% 10-year senior unsecured notes at a spread of +160 basis points over Treasuries.
- Hyatt's (BBB-, Stable) rating was affirmed in August 2017 based on the company's position as a leading global hotel operator and maintenance of a moderate capital structure, offset by the inherent cyclicality of its cash flows. A stable outlook reflects the expectation that Hyatt will continue to increase cash flow from the more stable managed and franchised segment. In addition, the rating recognizes management's adherence to an investment-grade balance sheet target.
- Mattel's (BBB-, Negative) rating was downgraded in November 2017 for a second time this year due to materially lower profitability and cash flow, resulting in weakened credit protection measures. Mattel's revenue and EBITDA have declined from the loss of a key license agreement, intensified competition due to shorter product life cycles, the increasing use of technology in toys, the growth of online retailers, and heightened competition from its largest retail customers that promote their own private-label toys. Most recently, Mattel's operating results have been negatively impacted by the bankruptcy filing of Toys R Us and Mattel's own efforts to reduce and manage obsolete inventory. We forecast Mattel's adjusted debt to EBITDA will be 5.5 times (4.1 times net) after the upcoming holiday season compared with 3.7 times (2.7 times net) at year-end 2016. A negative outlook reflects the potential for existing lower sales trends to continue, creating difficulty with achieving goals under its restructuring plan.

Specialty Retail and Other

Exhibit 2 Specialty Retail and Other Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of October 31, 2017
(UR) = rating under review / (p) = positive outlook / (n) = negative outlook

Credit Trends and Spreads

Specialty retailers have had mixed success answering challenges related to increasing competition, evolving consumer buying habits, and online growth. Morningstar believes there are certain store-based retailers that possess modest defenses against online threats. These include industries such as auto-parts retailers and home centers, which provide in-store service expertise and low-cost distribution capabilities that can deliver a breadth of inventory within hours.

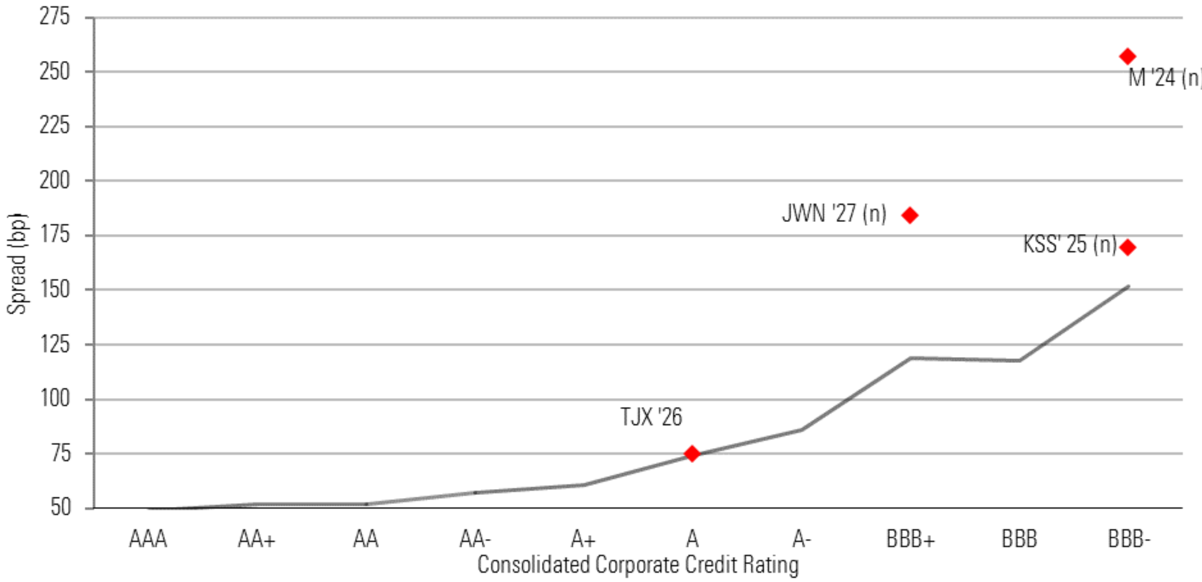
In the specialty retail sector, credit spreads improved, tightening by 20 basis points on average since the last chartbook publication. EBay (BBB+, Stable) and Best Buy (BBB-, Stable) bonds led the sector, tightening by 54 and 46 basis points, respectively. Home Centers continue to perform well, as evidenced by Home Depot (A+, Stable), whose 2026 bond spreads tightened by 17 basis points. Meanwhile, mixed earnings results from the auto parts retailers is evident from the outsized performance of O'Reilly Automotive (BBB+, Stable) bonds that tightened by 23 basis points compared with the underperforming bonds of Advanced Auto Parts (BBB, Stable), which widened by 9 basis points.

Issuer Highlights

- Amazon.com's (A, Stable) acquisition of Whole Foods Market had negligible impact on Amazon's credit rating and outlook despite a slight increase in pro forma leverage. Morningstar believes the acquisition of Whole Foods marks an important milestone in Amazon's grocery business. Morningstar anticipates Whole Foods's 460 store locations in the United States, Canada, and the United Kingdom will be integrated with AmazonFresh, providing online delivery as well as a location for customer pickup. In August, Amazon sold $16 billion of bonds across seven tranches ranging from three years to 40 years. The new issuance included $3.5 billion of 3.15% 10-year senior unsecured notes at a spread of +145 basis points of Treasuries. Net proceeds helped fund the $13.7 billion acquisition of Whole Foods (not rated).
- Home Depot's (A+, Stable) rating was affirmed in July 2017. The rating continues to be supported by its strong competitive position, substantial free cash flow generating capacity, and the maintenance of moderate financial policies. A stable outlook reflects the expectation that Home Depot will continue to benefit from an improving U.S. housing market, supporting strong free cash flow generation, and that management will maintain balance sheet strength despite substantial shareholder distributions.
- Lowe's (A, Stable) rating was affirmed in July 2017 based on its leading competitive position in home-improvement retailing, consistent free cash flow, and the maintenance of a moderately leveraged balance sheet. A stable outlook reflects the expectation for continued solid operating performance within an improving U.S. housing market, along with the maintenance of a modestly leveraged capital structure.
- Bed Bath & Beyond's (BBB-, Stable) rating was downgraded two notches in October 2017 reflecting an acceleration of multiyear profitability declines and weakening credit metrics that cut into its Business Risk, Solvency Score, and Distance to Default pillars. While Bed Bath & Beyond has undertaken a number of initiatives to stabilize operations, the current rating incorporates heightened uncertainty and a lack of visibility into the company's market environment over the next several years. A stable outlook reflects Morningstar's expectation that while Bed Bath & Beyond may be successful in executing its initiatives, the company will continue to experience substantial pricing and margin pressure, limiting its ability to significantly improve returns and credit metrics.

Department Stores

Exhibit 3 Department Stores Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of October 31, 2017
(UR) = rating under review / (p) = positive outlook / (n) = negative outlook

Credit Trends and Spreads

Operating results at department stores have been negatively impacted by increased competition and changing consumer buying habits. All three department stores that are rated by Morningstar have a negative outlook, generally indicating the potential for a lower rating if strategic investments are unable to stabilize profitability and competitive positioning. Most traditional store-based retailers continue to struggle to maintain market share as online-only retailers grow at double-digit rates. In response, department stores have been forced to adjust their business models and substantially increase investment spending on e-commerce initiatives. Further, declining foot traffic has prompted many department stores to close locations in overstored markets, further pressuring profitability.

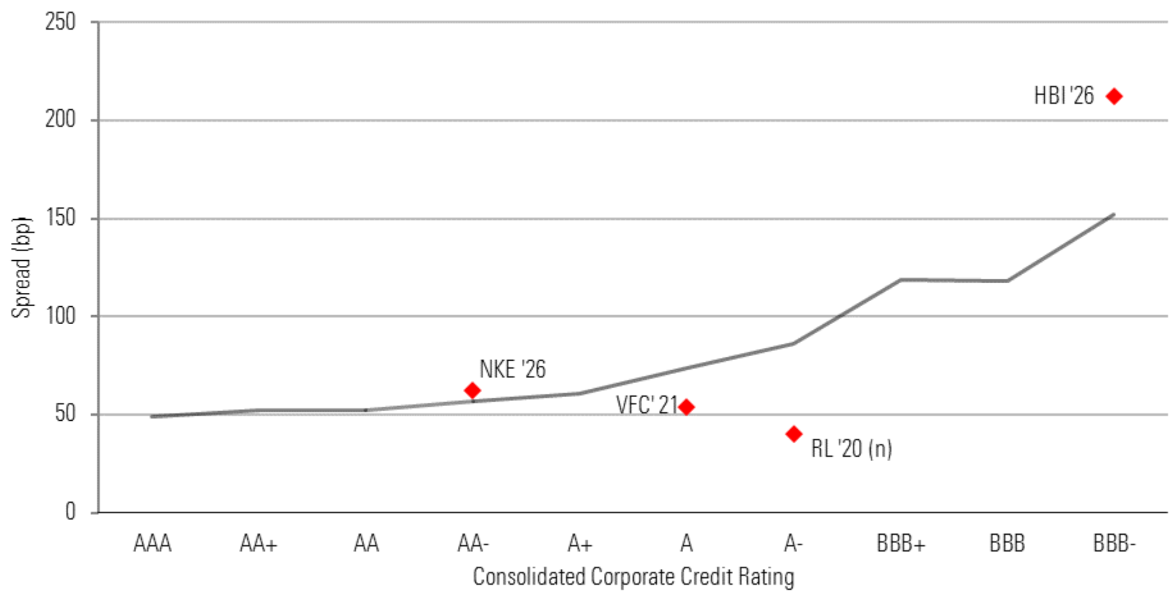
Despite these trends, department store credit spreads improved since our last publication in June, as evidenced by the average credit spread in the Morningstar-rated universe of department stores, which tightened by an average of 33 basis points. Kohl's (BBB-, Negative) 2025 bonds tightened by 70 basis points to +170 basis points over Treasuries, the largest move of any issuer in this subsector, aided by an announced partnership with Amazon.com. In addition, Macy's (BBB-, Negative) 2024 bonds and Nordstrom's (BBB+, Negative) 2027 bonds also improved, tightening by 27 and 19 basis points, respectively.

Issuer Highlights

- Nordstrom's (BBB+, Negative) rating outlook is negative, reflecting the possibility of the rating being lowered if initiatives fail to stabilize profitability. Nordstrom's outlook was revised to negative from stable in March 2017 following ongoing earnings weakness. Nordstrom's rating continues to reflect its solid competitive market position and financial policies that target the maintenance of a moderately leveraged balance sheet, despite recent profit weakness.
- Kohl's (BBB-, Negative) rating outlook remains negative, reflecting the possibility that the rating could be lowered if profitability continues to decline or management fails to maintain balance sheet strength. Kohl's outlook was revised to negative from stable in March 2017, due to lower revenue and profit. Kohl’s rating reflects its good position as a low-cost provider of branded apparel, the ability to generate solid free cash flow despite EBITDA margin deterioration, and the expectation that management will maintain a moderately leveraged capital structure despite ongoing share repurchases.
- Macy's (BBB-, Negative) rating outlook is negative, reflecting the expectation that the rating could be lowered if management's efforts fail to stabilize profitability and leverage. Macy's outlook was revised to negative from stable in March 2017 after its 2016 operating results included ongoing profit weakness and higher debt leverage. Macy’s rating reflects a sizable, yet weakened competitive position in department store retailing, management’s commitment to reduce debt leverage to within its targeted range of 2.5 to 2.8 times, and the company’s efforts to stabilize ongoing revenue and EBITDA declines.

Apparel Retailers

Exhibit 4 Apparel Retailers Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of October 31, 2017
(UR) = rating under review / (p) = positive outlook / (n) = negative outlook

Credit Trends and Spreads

Apparel issuers continue to adjust to the ongoing growth of ecommerce. Increasing price transparency, a decline in store-based inventory levels, and the increasing consumer acceptance of non-branded merchandise has pressured margins in the sector. Declining foot traffic at traditional store-based retailers has prompted many apparel manufacturers to increase the percentage of revenue that they generate from their own direct to consumer channel. Furthermore, issuers have implemented programs designed to lower supply chain costs and speed time to market.

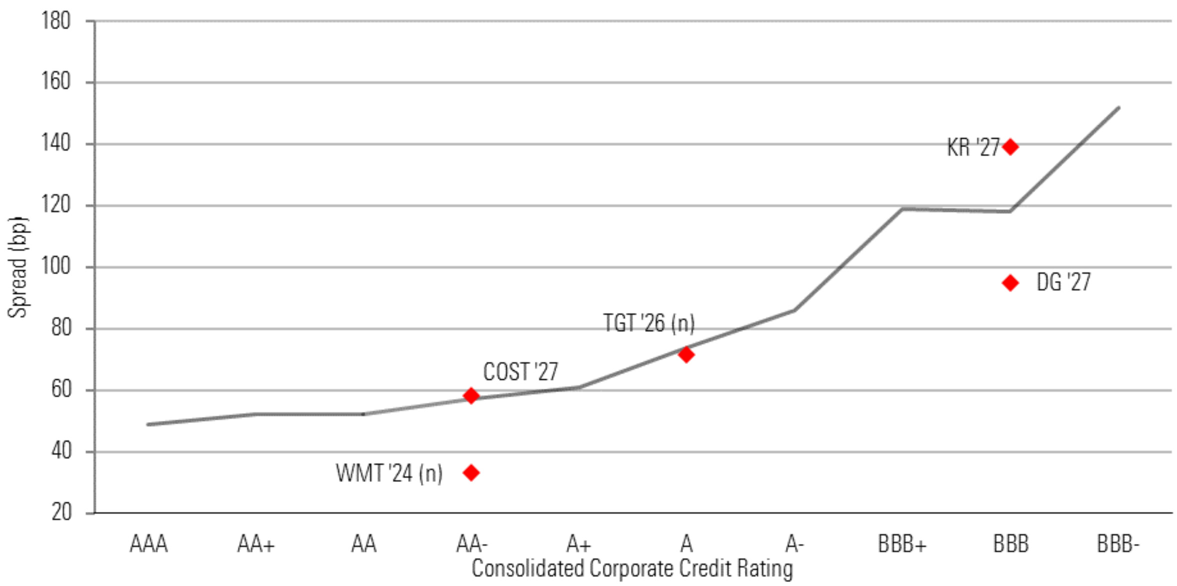
The average credit spread in the apparel manufacturing sector tightened by 26 basis points since the last chartbook publication. Hanesbrands (BBB-, Stable) 2026 bonds were a stand-out, as the spread on this bond tightened 51 basis points.

Issuer Highlights

- Ralph Lauren (A-, Negative) was assigned a negative outlook in December 2016 reflecting the expectation that the rating could be lowered if the company is unable to demonstrate material operating improvements from its restructuring efforts over the next 12-18 months. Ralph Lauren’s credit rating is supported by its solid competitive position offset by operational challenges and rising adjusted debt leverage, which is high for its rating at 3.3 times.
- Hanesbrands' (BBB-, Stable) rating was affirmed in October 2017, reflecting the company's leading positions in the apparel industry, the maintenance of strong margins and profitability, and a successful acquisition strategy despite modestly higher balance sheet leverage. A stable rating outlook reflects the expectation that Hanesbrands will maintain debt leverage near its net debt/EBITDA leverage target of 2 to 3 times, despite temporary increases in leverage due to its ongoing acquisition strategy.
- L Brands' (BB+, Stable) rating was affirmed in October 2017 based on a strong competitive position, solid cash flow generation despite substantial shareholder distributions, and moderately high debt leverage. A stable rating outlook reflects the expectation that L Brands will stabilize profitability and returns, albeit at somewhat lower-than-historical levels. In addition, the rating expects management will maintain balance sheet strength near historical levels, which could entail reducing shareholder distributions.

Discounters and Grocery

Exhibit 5 Discounters and Grocery Versus Morningstar Corporate Bond Index



Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of October 31, 2017
(UR) = rating under review / (p) = positive outlook / (n) = negative outlook

Credit Trends and Spreads

In an increasingly competitive marketplace, big-box discounters and grocers have posted progressively lower profitability since peaking in 2015. Market participants have been forced to reduce prices and accept lower operating margins in an effort to maintain store traffic and market share. Further, Morningstar does not expect to see a reversal of this lower margin trend, which has been exacerbated a need to make investments in IT, supply-chain, and delivery. In the grocery space, while food deflation has moderated, increasing grocery penetration from big-box discounters, online competition, and store expansion from low-priced chains have depressed results.

The discount and grocery subsector of the consumer cyclical industry also performed well as credit spreads tightened by 19 basis points on average since our last chartbook publication in June. Target (A, Negative) and Dollar General (BBB, Stable) were outliers, as demonstrated by 29 basis points and 31 basis points of tightening, respectively. Meanwhile, Wal-Mart's 2024 bonds tightened 8 basis points, well below the sector averages.

Issuer Highlights

- Wal-Mart (AA-, Negative) was assigned a negative rating outlook at the time of its one-notch downgrade in January 2017, reflecting the potential for ratings to be lowered if the company's investments in existing stores and e-commerce do not improve comparable sales growth or stabilize operating margins and return on invested capital. In October, Wal-Mart sold $6 billion of new bonds across six tranches ranging from two years to 30 years. The new issuance included $1.0 billion 2.65% 7-year senior unsecured notes at a spread of +48 basis points over Treasuries. Proceeds were used in part to pay for a cash tender offer for outstanding debt securities.
- Target's (A, Negative) rating outlook remains negative, reflecting the potential for a lower rating if proposed investments can't stabilize Target's competitive position and lead to a recovery in revenue, profitability, and returns. Target's outlook was revised to negative from stable following weak 2016 results. Morningstar believes management's accelerated investment actions are appropriate, but the company will be challenged to maintain its historical competitive positioning. In October, Target issued $750 million 3.90% 30-year senior unsecured notes at a spread of +110 basis points over Treasures. Proceeds were used to pay for a tender offer for outstanding debt.
- Kroger's (BBB, Stable) rating outlook remains stable, reflecting Morningstar's expectation that the company will maintain historical profit metrics and adjusted debt leverage ratios. In July, Kroger sold a total of $1.5 billion of new bonds at maturities including five, 10, and 30 years. The 10-year maturity was a $600 million 3.70% coupon note, with a spread of +140 basis points over Treasuries. Proceeds were used to fund a contribution to the company's underfunded pension plan and to refinance an August 2017 maturity.

Exhibit 6 Consumer Cyclical Coverage

Issuer	Rating	Outlook	Rating Date	Direction	Coupon	Maturity	Bid	YTW	STW
Apparel									
Ralph Lauren Corp.	A-	Negative	12/6/2016	Affirmation	2.63%	8/18/2020	101.43	2.08%	40
VF Corp.	A	Stable	12/6/2016	Affirmation	3.50%	9/1/2021	103.96	2.34%	54
Nike Inc.	AA-	Stable	12/6/2016	Affirmation	2.38%	11/1/2026	95.43	2.96%	62
Gap Inc.	BB+	Stable	6/1/2017	Affirmation	5.95%	4/12/2021	108.39	3.17%	142
HanesBrands Inc.	BBB-	Stable	10/17/2017	Affirmation	4.88%	5/15/2026	103.13	4.42%	212
L Brands Inc.	BB+	Stable	10/17/2017	Affirmation	5.63%	10/15/2023	106.88	4.30%	219
Department Stores									
TJX Cos Inc.	A	Stable	12/13/2016	Affirmation	2.25%	9/15/2026	93.59	3.08%	75
Kohls Corp.	BBB-	Negative	3/29/2017	Affirmation	4.25%	7/17/2025	101.93	3.95%	170
Nordstrom Inc.	BBB+	Negative	3/20/2017	Affirmation	4.00%	3/15/2027	98.47	4.20%	185
Macy's Retail Holdings Inc.	BBB-	Negative	3/28/2017	Affirmation	3.63%	6/1/2024	93.67	4.76%	257
Discounters & Grocery									
Wal-Mart Stores Inc.	AA-	Negative	1/18/2017	Downgrade	3.33%	4/22/2024	104.56	2.50%	33
Costco Wholesale Corp.	AA-	Stable	1/17/2017	Affirmation	3.00%	5/18/2027	100.40	2.95%	58
Target Corp.	A	Negative	3/6/2017	Affirmation	2.50%	4/15/2026	96.15	3.02%	71
Dollar General Corp.	BBB	Stable	12/28/2016	Upgrade	3.88%	4/15/2027	104.40	3.32%	95
Kroger Co.	BBB	Stable	12/16/2016	Affirmation	3.70%	8/1/2027	99.30	3.78%	139
Gaming, Lodging & Leisure, Casino									
Carnival Corp.	BBB+	Stable	3/15/2017	Upgrade	3.95%	10/15/2020	105.10	2.16%	38
Royal Caribbean Cruises LTD	BBB-	Stable	3/14/2017	Upgrade	5.25%	11/15/2022	110.80	2.93%	89
Marriott International Inc.	BBB	Stable	8/29/2017	Upgrade	3.13%	6/15/2026	99.34	3.21%	90
Priceline Group Inc.	A-	Positive	3/6/2017	Affirmation	3.60%	6/1/2026	102.09	3.31%	101
Hasbro Inc.	BBB+	Stable	10/17/2017	Affirmation	3.50%	9/15/2027	98.90	3.63%	122
Hyatt Hotels Corp.	BBB-	Stable	8/28/2017	Affirmation	4.85%	3/15/2026	109.31	3.52%	123
Expedia Inc.	BBB-	Positive	3/6/2017	Affirmation	3.80%	2/15/2028	97.40	4.11%	169
NCL Corp. LTD	BB	Stable	3/14/2017	Affirmation	4.75%	12/15/2021	104.00	3.18%	174
MGM Resorts International	BB-	Positive	6/20/2017	Affirmation	4.63%	9/1/2026	100.13	4.61%	228
Wynn Las Vegas	BB-	Stable	4/13/2017	Affirmation	5.50%	3/1/2025	105.00	4.66%	243
Mattel Inc.	BBB-	Negative	11/03/2017	Downgrade	3.15%	3/15/2023	90.05	5.30%	325
Information Services & Publishing									
Thomson Reuters Corp.	BBB+	Stable	2/23/2017	Affirmation	3.35%	5/15/2026	99.99	3.35%	104
Specialty Retail									
Home Depot Inc.	A+	Stable	5/27/2017	Affirmation	3.00%	2/12/2026	100.70	2.90%	61
Amazon.com Inc.	A	Stable	2/21/2017	Upgrade	3.15%	8/22/2027	100.66	3.07%	69
Lowe's Companies Inc.	A	Stable	5/27/2017	Affirmation	3.10%	5/3/2027	100.10	3.09%	73
Best Buy Co. Inc.	BBB-	Stable	3/20/2017	Upgrade	5.50%	3/15/2021	108.83	2.54%	80
eBay Inc.	BBB+	Stable	2/21/2017	Affirmation	3.45%	8/1/2024	101.81	3.14%	97
O'Reilly Automotive Inc.	BBB+	Stable	2/13/2017	Upgrade	3.55%	3/15/2026	101.34	3.36%	107
AutoZone Inc.	BBB+	Stable	2/3/2017	Upgrade	3.75%	6/1/2027	101.63	3.54%	116
Advance Auto Parts Inc.	BBB	Stable	2/3/2017	Upgrade	4.50%	12/1/2023	104.75	3.59%	149
Bed Bath & Beyond Inc.	BBB-	Stable	10/2/2017	Downgrade	3.75%	8/1/2024	99.32	3.86%	166

Source: Morningstar Credit Ratings, LLC, Morningstar, Inc., and Interactive Data as of October 31, 2017

About Morningstar® Credit Research

Morningstar Credit Research provides independent, fundamental equity research differentiated by a consistent focus on sustainable competitive advantages.

For More Information

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