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M&A Names on Notice

US Credit Strategy
Shobhit Gupta
+1 212 412 2056
shobhit.gupta@barclays.com
BCI, US

James K Martin
+ 1 212 412 2345
james.k.martin@barclays.com
BCI, US

Bradford Elliott, CFA
+1 212 526 6704
bradford.elliott@barclays.com
BCI, US

Fundamental Credit Strategy
Priya Ohri-Gupta, CFA
+1 212 412 3759
priya.ohrigupta@barclays.com
BCI, US

Brittany Chen
+1 212 412 3841
brittany.chen@barclays.com
BCI, US

Andrew Keches, CFA
+1 212 412 5248
andrew.keches@barclays.com
BCI, US

Maggie O'Neal
+ 44 (0) 20 7773 6924
maggie.oneal@barclays.com
Barclays, UK

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In a somewhat ironic development for the investment grade market, the day after one of the largest M&A deals was put on negative watch saw large acquisition-related supply. While demand remains accommodative for now, the potential risk posed by companies that have added significant leverage to fund ambitious acquisitions has been a key source of concern (see *Deleveraging Post-M&A: Implications in the Case of a Credit Downturn* and *Gauging the Effects of Falling BBBs*). While companies have added more leverage for recent M&A deals than in previous cycles (Figure 1), two factors lower the fundamental risk of these transactions, in our opinion. The scale of recent deals has been much larger, and companies have needed to utilize several "levers" (dividend cuts and/or asset sales), in addition to the customary suspension of share repurchases, to achieve leverage targets. Furthermore, acquirers in this cycle have been heavily weighted toward defensive sectors (Figure 2), which, in theory, should help insulate them in an economic downturn (see *Tuesday call: Debt-Funded M&A: The Bad, the Ugly and the Good*).

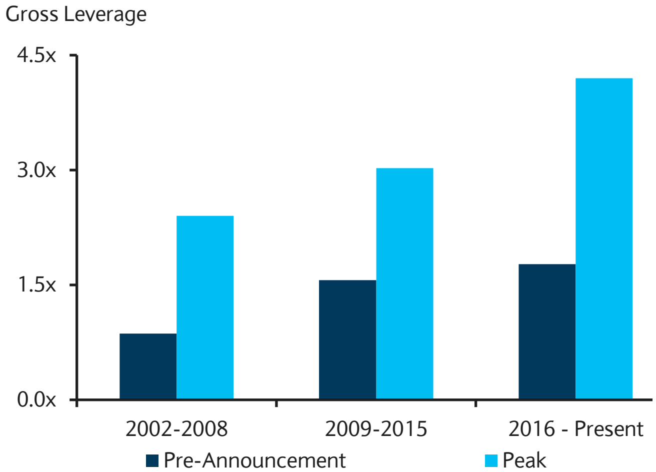
We believe the biggest risk posed by these deals stems from negative rating agency actions. As discussed in *M&A Deleveraging Stuck in the Slow Lane*, rating agencies have shown far more leniency toward companies that have increased leverage during the post-crisis era; the pre-crisis correlation between increased leverage and the number of downgrades no longer exists. The two factors mentioned above (scale and a more defensive mix) justify this leniency, but this also leaves the market exposed to negative rating actions should the agencies become less accommodative. Although many of the companies have potential levers to pull, there is a risk that they will be reticent to do so until compelled by challenges to their credit ratings. Most will likely avoid significant downgrades, in our view, although the related volatility and spread reactions are unlikely to be benign.

Moody's has already become more stringent with companies that have lagged their initially communicated paths of deleveraging. The most recent example came this week with its decision to put ABIBB's rating on review for downgrade, suggesting that the agency may be taking a closer look at leveraging transactions (we first highlighted this trend in *General Mills and Conagra: Consolidation Stays in Focus*, and since, the agency has put Campbell and Newell on review for downgrade as well). Similar to Campbell and Newell, we view this as a signal to the company (and the market) that it should take action to accelerate deleveraging, which has been long delayed. In its recent release on ABIBB, Moody's mentioned a "very high dividend payout level" as one of the factors that has contributed to limited free cash flow availability for debt paydown. The agency further noted that the "dividend was not reduced commensurately" to offset a reduction in scale that occurred as a result of asset sales (which were used to support deleveraging).

While the decision to put ABIBB's ratings on review was in part due to idiosyncratic factors, such as the company's EM exposure and FX considerations, we think it also reflects a trend of rating agencies' becoming increasingly uncomfortable with companies that are running behind on their deleveraging targets. Particularly when combined with potential fundamental weakness – whether due to idiosyncratic factors or a broader economic slowdown – we think the risk that rating agencies will adopt a more aggressive attitude toward leveraged M&A deals remains elevated.

FIGURE 1

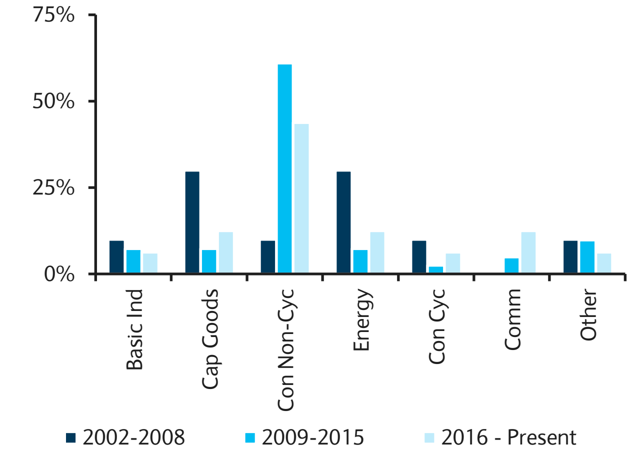
Historical M&A Cohort Leverage, Pre-Announcement to Peak



Source: Factset, Barclays Research

FIGURE 2

Historical M&A Cohorts by Sector



Source: Factset, Barclays Research

Although we expect economic growth to remain robust through 2019 (see our latest *Global Outlook* for more details), companies that have fallen behind in their deleveraging schedules are more at risk in the event of any slowdown in growth. Figure 3 lists companies that have increased leverage to fund acquisitions, along with their target leverage and the timing of their deleveraging plans.

In the far right column, we estimate whether a company is ahead or behind schedule based on its target leverage and the duration of its deleveraging plan. We do this through linear interpolation – for example, ABIBB increased its leverage to 5.5x in January 2016, and its long-term target leverage is 2.0x. If we assume that "long term" means five years, we would expect it to reduce leverage 0.7x every year. Using this trajectory, by June 2018, we would expect leverage to be 3.7x. Given, that current leverage is 4.8x, this implies that the company is 1.1x "behind schedule." We admit that this is an oversimplification; deleveraging plans are rarely linear, the analysis does not take into account any planned divestitures, and it reflects no synergies for the most recent transactions, but it is a benchmark that we can use to assess each company; if a company is ahead of schedule, there is likely less concern about its deleveraging path compared with a company that is behind schedule.

It is important to note that those running behind are not automatically at risk for downgrades – for instance, companies may have upcoming planned asset divestitures that are not reflected in current leverage metrics. To help estimate how much risk these companies face, we include comments from our fundamental analysts on some of the names under their coverage.

FIGURE 3
Deleveraging Paths of Highly Leveraged M&A-Related Companies

Ticker	Rating	Market Value ($bn)	Date of print	Pro Forma Leverage at Acquisition	Target Leverage	Target Year	Current Leverage	Leverage Turns Above/(Below) Target Path
ABIBB	A3	$68	Jan-16	5.5x	2.0x	Long Term	4.8x	1.1x
MYL	BAA3	$9	May-16	4.0x	3.0x	2018	3.9x	0.9x
NWL[1]	BAA3	$8	Mar-16	4.9x	3.0-3.5x	2019	4.7x	0.6x
BAYNGR[1]	A3	$19	Jun-18	4.8x	2.0x	Long Term	5.4x	0.6x
CAH	BAA1	$7	Jun-17	2.6x	>2.0x	June 2020	3.0x	0.6x
BATSLN	BAA2	$29	Aug-17	4.1x	3.0x	2019	4.1x	0.4x
SHW	BAA2	$8	May-17	4.5x	2.0-2.5x	2019	4.0x	0.4x
TAP	BAA3	$6	Jun-16	4.8x	3.8x	Mid-2019	4.2x	0.1x
BDX	BAA3	$14	May-17	4.7x	3.0x	2020	4.2x	0.0x
T	BAA2	$78	Jun-18	3.2x	2.5x	2019	3.2x	0.0x
VZ	BAA1	$75	Mar-17	2.6x	1.8x	Long Term	2.4x	0.0x
CPB	BAA3	$6	Mar-18	4.8x	3.0x	2021	4.8x	0.0x
GIS	BAA2	$8	Apr-18	4.3x	3.5x	2020	4.3x	0.0x
KDP	BAA1	$11	May-18	5.5x	3.0x	2020	5.5x	0.0x
DISCA	BAA3	$13	Sep-17	4.9x	3.5x	2020+	4.3x	-0.3x
BNFP	A2	$5	Oct-16	4.0x	<3.0x	2020	3.3x	-0.3x

[1] Gross leverage. Net Leverage shown for all other names.
Market Value includes 144s. Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

Anheuser-Busch InBev (Priya Ohri-Gupta)

While the tone from Moody's suggests that a downgrade could be likely, it appears possible that the company can hold on to its rating given the past precedents of Campbell and Newell (which were able to keep ratings intact, albeit with negative outlooks). However, the cost of doing so appears fairly high and could require some combination of a meaningful dividend cut and asset sales or possibly a full suspension of the dividend (at least through the end of 2019) to generate enough cash to deleverage toward Moody's target. While we are confident that the management would consider cutting the dividend in an effort to preserve the rating, we view Moody's action as somewhat surprising given the sudden change in tone and the short-term actions that could be required to comply with its targets. As such, the near-term uncertainty keeps us on the sideline, supporting a Market Weight rating.

If ABIBB were to lose its single-A rating, we would expect the most widening pressure in GBP given that it is the smallest market, followed by EUR, then USD – in GBP/EUR, this could suggest widening potential of as much as 20-25bp, (see Figure 4 for how ABIBB currently ranks in each market and where it could fall relative to other BBBs). We think that if ABIBB is downgraded by Moody's or S&P (or both), spreads could overshoot to the downside. While we believe that downside at either agency is limited to one notch (or high BBB), the credit could approach Cigna-like levels (or possibly wider) in USD before support arrives. This implies around 10bp of widening in the front-end USD curve and as much as 15bp in intermediates, while long bonds would likely experience more limited widening.

Our view is supported largely by technical considerations, including a lack of CSPP buying, NAIC classification for the bonds by insurance accounts, holdings in rating-constrained accounts (with single-A mandates), and possible risk limit considerations for BBB holdings. Furthermore, given the already-elevated weight of BBBs in the index, the downgrade of a capital structure of this size is likely to put further pressure on portfolios that are already overweight BBBs. This could be disruptive for ABIBB and potentially existing BBBs. That said, one mitigating consideration would be the recent rise in rates, which could provide buying support from yield-sensitive investors.

FIGURE 4

Anheuser-Busch InBev Market Values and Ranks in Major Currency Indices A Rated Baskets and Estimates If It Were Downgraded to BBB

	Market Value in Index (in billions)	% of As Corporate Index	Rank	Potential Weight in BBB Corporate Index in the Event of Downgrade	Rank
USD	$ 67.7	3.3%	6th	2.7%	4th
EUR	€ 24.0	3.2%	1st	2.4%	2nd
GBP	£ 3.5	2.4%	7th	1.8%	11th

Based on Bloomberg Barclays Indices, Source: Bloomberg Barclays Index, Barclays Research

Although we think a dividend cut is likely, the extent of the move is important, since it could determine whether ratings remain intact at low-A. In our view, a meaningful cut could be required to show bondholders that the company making a strong effort to try to retain its A-rating. In the case of ABIBB, while we estimate that a 50% cut in the fall dividend could be sufficient to hit S&P's target, Moody's expectation is more stringent and could require a full suspension of the dividend or some combination of a meaningful reduction (at least half the annual amount) and asset sales. While the earning call's tone on October 25 should give investors some directional indication about ratings, full clarity may not come until November, which could result in continued uncertainty/pressure on the credit for the next two months.

Based on consensus expectations for 2019, we estimate that Anheuser-Busch would have to reduce debt by about $26bn by the end of next year to hit Moody's target of 4x leverage; S&P (which also has a 4x leverage objective for the company by YE19) would require closer to $13bn in debt reduction.[1] Suspending the dividend through YE19, starting this November, could potentially free up approximately $12bn in cash, and conservatively, we believe the company could generate $10bn in free cash flow after capex in 2019 (with an additional $4bn over 2H18).

Consumer Non-Cyclical (Priya Ohri-Gupta)

Of the other consumer non-cyclical companies, we think that General Mills could come under the most pressure. As discussed in *General Mills (GIS): Lower to Underweight on Valuation*, it has a back end-weighted deleveraging story with limited deleveraging expected this year. Furthermore, early results from Blue Buffalo, its recent acquisition, have been below expectations. Keurig Dr Pepper has the highest leverage among the recent leveraging transactions and has yet to report its first quarter as a joint company (though year-to-date trends have been somewhat underwhelming for the standalone businesses). Finally, BAT (covered by Karine Elias) is expected to make modest progress toward its deleveraging target this year, with the bulk biased toward 2019. We would be cognizant of risks to these credits given the rating agency trend. From a valuation perspective, we view these risks as more than reflected in BATSLN (Overweight) and less so in General Mills (Underweight).

Newell and Campbell appear better positioned from this perspective. Both have articulated plans to use asset sale proceeds to support deleveraging and are in the process of executing them.

[1] We note that the variance is driven by Moody's agency-specific adjustments and that S&P's calculations are closer to the company's definition. Moody's figures also include a half a turn of FX translation, which is another consideration.

Mylan (Brittany Chen)

Mylan issued $6.5bn of debt in May 2016 to fund the $9.9bn acquisition of Meda AB, which closed in August 2016. At the time of the deal, management committed to reducing leverage below 3.0x by year-end 2017 from approximately 4.0x on a pro forma basis. Since that commitment was made, the generic drug industry has weathered a significant amount of turbulence, driven primary by accelerated price erosion due to the FDA's record pace of ANDA approvals. Accordingly, the company has progressively walked back its initial guidance, easing the target from "below 3.0x," to "approximately 3.0x," to "approximately 3.2x," to "below 3.5x," to "towards 3.5x." To maintain enough cushion given this slower-than-expected pace of deleveraging, in November 2017 Mylan amended its credit facilities to extend a temporary lift of its maximum leverage covenant through year-end 2018. Despite the lack of progress since the Meda AB transaction, the rating agencies have continued to give Mylan the benefit of the doubt because of several high-value launches in its drug pipeline (eg, Advair, Restasis). However, during the company's last earnings call, management expressed disappointment in its inability to secure approval for either of these products, hampering its ability to deliver earnings growth. We remain wary of the company's tendency to prioritize share buybacks and bolt-on M&A over debt repayment, as we believe it is operating with limited headroom until it can improve its organic trajectory, and we maintain our Underweight rating.

Cardinal Health (Brittany Chen)

Cardinal Health added $4.5bn of incremental debt to help fund its $6.1bn acquisition of select assets from Medtronic's Patient Care, Deep Vein Thrombosis, and Nutritional Insufficiency businesses in June 2017, taking leverage from approximately 1.6x to 2.6x on a pro forma basis. At the time of the deal, management indicated an expectation to reduce leverage to slightly above 2x by the end of fiscal 2020 (ending June 30, 2020). However, since then, margins in the pharmaceutical wholesale distribution business have been squeezed by sell-side pressures driven by the consolidation of large national customers and independent pharmacies; issues with its ability to supply Cardinal Health-branded exam gloves due to manufacturing problems in China; and the underperformance of Cordis, a relatively recent acquisition that closed in October 2015, due to soft hospital volumes. As such, the company has been forced to lower its fiscal 2018 and fiscal 2019 guidance, and leverage today is higher than at the time of the Medtronic acquisition. Absent a material improvement in the underlying business, particularly if the company pursues buybacks in excess of what is needed to offset dilution, we believe that Cardinal Health will struggle to defend its current ratings – not only has it not made progress since completing the transaction, but leverage has, in fact, increased. As such, we maintain our Underweight rating on CAH.

Sherwin-Williams (Andrew Keches)

The debt-financed acquisition of Valspar in June 2017 increased SHW's leverage to 4.5x from 1.0x. SHW experienced multi-notch downgrades from each of the agencies as a result, but maintained investment grade status (Baa3/BBB/BBB), largely because of its commitment to deleverage post-closing. Management has guided to achieving 3.0x leverage in 2018 and thinks it will meet the 2.0-2.5x longer-term target in 2019. While our model suggests that SHW has the cash flow capacity to meet those metrics, the company has been slow to repay debt, as leverage remains at 4.0x as of 2Q18. We expect debt repayment to accelerate over the next year, but note that any deviation from the plan would be scrutinized by investors, as both the market and the ratings agencies appear to be giving SHW credit for the anticipated deleveraging, in our view. Though the credit trades tight relative to its ratings, we think the strong cash conversion profile and anticipated deleveraging support valuations. We have a Market Weight rating on SHW.

Bayer (Maggie O'Neal)

Bayer management is looking to regain an A- rating, although it has not provided specifics on the timing of its deleveraging plan. Moody's usually requires gross leverage of between 1.25x and 2.00x for companies to have an A- rating, and in fact, it has a negative outlook on Bayer at its Baa1 rating. Moody's explicitly cited the degree of financial leverage that Bayer added for the $63bn Monsanto purchase as a reason for the downgrade to Baa1, and the agency expects deleveraging for the company to avoid further downgrades. Depending on the outcome of recent Roundup litigation, Bayer may have to settle claims in the near future, further slowing any deleveraging plans. We remain wary of potential litigation costs and negative headlines about existing cases, but do not expect a material cash outflow from litigation in 2H18 because of the timing of the court cases; our rating for the credit is Market Weight.

Analyst Certification

We, Brittany Chen, Bradford Elliott, CFA, Shobhit Gupta, Andrew Keches, CFA, James K Martin, Priya Ohri-Gupta, CFA and Maggie O'Neal, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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Representative Bond: ABIBB 2.7 03/31/26 (EUR 109.73, 04-Oct-2018)

AT&T INC, Market Weight, A/CD/CE/D/E/J/K/L/M/N
Representative Bond: T 4 3/4 05/15/46 (USD 90.18, 03-Oct-2018)

BAT INTERNATIONAL FINANCE PLC, Overweight, CD/D/J/K/L/M/N
Representative Bond: BATSLN 0 7/8 10/13/23 (EUR 99.20, 03-Oct-2018)

BAYER AG, Market Weight, A/CD/D/J/K/L/M/N
Representative Bond: BAYNGR 1 7/8 01/25/21 (EUR 103.61, 04-Oct-2018)

BECTON DICKINSON AND CO, A/CD/CE/D/J/K/L/M/N

CAMPBELL SOUP CO, Overweight, A/CD/CE/D/J/K/L/M
Representative Bond: CPB 4.15 03/15/28 (USD 94.23, 03-Oct-2018)
Representative Bond: CPB 4.8 03/15/48 (USD 88.24, 03-Oct-2018)

CARDINAL HEALTH INC, Underweight, CD/CE/D/E/J/K/L/M/N
Representative Bond: CAH 2.616 06/15/22 (USD 95.57, 03-Oct-2018)

DANONE SA, A/CD/D/J/K/L/M

Discovery Inc, Overweight, CD/CE/D/J/K/L/M/N
Representative Bond: DISCA 4 7/8 04/01/43 (USD 91.10, 04-Oct-2018)

GENERAL MILLS INC, Underweight, A/CD/CE/D/J/K/L/M/N
Representative Bond: GIS 4.2 04/17/28 (USD 97.77, 03-Oct-2018)

Representative Bond: GIS 4.7 04/17/48 (USD 93.19, 03-Oct-2018)

KEURIG DR PEPPER INC, CD/CE/J

MOLSON COORS BREWING CO, Market Weight, CD/CE/J/K/N
Representative Bond: TAP 3 07/15/26 (USD 89.81, 03-Oct-2018)

MYLAN NV, Underweight, CD/CE/J
Representative Bond: MYL 3 1/8 01/15/23 (USD 95.08, 04-Oct-2018)

NEWELL BRANDS INC, Market Weight, CD/CE/D/J/K/L/M/N
Representative Bond: NWL 3.15 04/01/21 (USD 98.59, 03-Oct-2018)
Representative Bond: NWL 3.85 04/01/23 (USD 97.92, 03-Oct-2018)
Representative Bond: NWL 4.2 04/01/26 (USD 94.15, 03-Oct-2018)

SHERWIN-WILLIAMS CO/THE, Market Weight, CD/CE/J
Representative Bond: SHW 4 1/2 06/01/47 (USD 95.03, 03-Oct-2018)

VERIZON COMMUNICATIONS INC, Overweight, A/CD/CE/D/E/J/K/L/M/N
Representative Bond: VZ 4.862 08/21/46 (USD 98.80, 03-Oct-2018)

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

Market Weight (MW):
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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be less than the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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Sectors in U.S. High Grade Research are defined using the sector definitions of the Bloomberg Barclays U.S. Credit Index and are rated against the Bloomberg Barclays U.S. Credit Index.
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To view sector definitions and monthly sector returns for Asia, EEMEA and Latin America Research, go to https://live.barcap.com/go/research/EMSectorReturns on Barclays Live.

Explanation of the Barclays Research Corporate Credit Rating System

For all High Grade issuers covered in the US, Europe or Asia, and for all issuers in Latin America and EEMEA, the credit rating system is based on the analyst's view of the expected excess return over a six-month period of the issuer's index-eligible corporate debt securities* relative to the expected excess return of the relevant sector, as specified on the report.

Overweight (OW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to exceed the six-month expected excess return of the relevant sector.
Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.
Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.
Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity in a merger or strategic transaction involving the company.
Coverage Suspended (CS): Coverage of this issuer has been temporarily suspended.
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For all High Yield issuers (excluding those covered in EEMEA or Latin America), the credit rating system is based on the analyst's view of the expected total returns over a six-month period of the rated debt security relative to the expected total return of the relevant sector, as specified on the report.

Overweight (OW): The analyst expects the six-month total return of the debt security subject to this rating to exceed the six-month expected total return of the relevant sector.
Market Weight (MW): The analyst expects the six-month total return of the debt security subject to this rating to be in line with the six-month expected total return of the relevant sector.
Underweight (UW): The analyst expects the six-month total return of the rated debt security subject to this rating to be less than the six-month expected total return of the relevant sector.
Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity in a merger or strategic transaction involving the company.
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Where a recommendation is made at the issuer level, it does not apply to any sanctioned securities, where trading in such securities would be prohibited under applicable law, including sanctions laws and regulations.

*In EEMEA and Latin America (and in certain other limited instances in other regions), analysts may occasionally rate issuers that are not part of the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or Bloomberg Barclays EM USD Corporate and Quasi Sovereign Index. In such cases the rating will reflect the analyst's view of the expected excess return over a six-month period of the issuer's corporate debt securities relative to the expected excess return of the relevant sector, as specified on the report.

Distribution of ratings assigned by Barclays Corporate Credit Research at the issuer level:
24% have been assigned an Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Buy rating; 69% of issuers with this rating category are investment banking clients of the Firm; 81% of the issuers with this rating have received financial services from the Firm.
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24% have been assigned an Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating; 69% of issuers with this rating category are investment banking clients of the Firm; 78% of the issuers with this rating have received financial services from the Firm.

Explanation of the Barclays EM Sovereign Credit Issuer Rating System
Overweight (OW):
The analyst expects the three-month excess return of the country's index eligible bonds to exceed the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Market Weight (MW):
The analyst expects the three-month excess return of the country's index eligible bonds to be in line with the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Rating Suspended (RS):
The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity.

Distribution of ratings assigned by Barclays Emerging Markets Sovereign Research at the issuer level:
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