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European High Yield Outlook for 2018

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Please refer to important disclaimer at the end before reading the contents of this document.

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European High Yield Outlook for 2018

2017 was a strong year for European HY, both in terms of performance and new issue activities. While a few events temporarily led to increased volatility, the Barclays European HY index delivered a return of nearly 7% in a low interest rate environment.

Our Investment Outlook 2018 opens with a Guest Commentary by Dr Jochen Felsenheimer, Managing Director of XAIA Investment. We then discuss the key developments that defined 2017 and the outlook for 2018. At the issuer level, we review the performance of companies in our coverage universe over the past year. We also assess our model portfolio's showing for 2017, and the bonds that we particularly like or dislike.

Guest Commentary: It's NOT the Economy, Stupid!

At first glance, the outlook for European credit markets in 2018 seems very compelling, and there are not many issues of concern to investors. The improvement on the macro front continues, companies are generally exhibiting stable profit-generation capabilities and, most importantly, the ECB will maintain the supportive monetary environment. So, everything should be fine, isn't it?

On the flip side, this is reminiscent of the backdrop in 2007. Despite the sound economic environment then, the worst financial crisis in history hit markets just a few months later. Hence, even if there are no obvious negative signals on the economic front, there are several potential risk factors that investors should be mindful of.

First, there has been a persistent concentration of credit risk amid the recent boom in this area. In contrast to 2007, however, it is the asset-management industry that is most exposed at present, not the banking sector. We are also slightly concerned about a general trend dating back to 2007 - the continuous rise in leverage in all economic segments, regions and sectors. This makes the recent recovery more fragile should an external shock occur. Finally, the increasingly erratic nature of global policy decisions (led by the US) cannot be ignored. This adds huge risks with regard to credit spreads in general, and especially for the relative valuations of sectors and regions.

Against the backdrop of very low-risk premiums, we see a decent chance that the current Goldilocks scenario will come to an end in 2018, which would contradict the slogan used in Bill Clinton's campaign for the US presidential election in 1992: "It's about the economy, stupid." Actually, we think it is everything but the economy posing potential threats to credit markets.

Risk Concentration in Credit Markets

After being more of a junior partner of banks and insurance companies in credits at the start of the 21st century, asset managers have become the major buyers of HY bonds since 2010. This is driven by the many constraints introduced by regulators against risk taking by banks and the insurance industry. Another factor is the rising dominance of ETFs and leading multi-asset managers in credit markets, given their power to attract massive fund inflows in recent years.

One could ask why risk concentration in a specific investor group might be a problem if there are many players within the group? The answer is simple: It is only a risk if all group members apply similar strategies (i.e. the group is homogenous). This is precisely the case, especially in the ETF world. One of the most questionable ideas developed by the finance industry during the last decade was that ETFs could transform an illiquid market into a frequently and liquidly traded segment. This is nonsense, as we saw when US HY indices became very volatile in Q4/17, in response to slightly disappointing earnings results (at least in some sectors). Since then, it has become plain to see why plotting the correlation between HY fund flows and credit spreads is crucial for analysing systematic credit risk.

Risk concentration in a homogenous market structure means that investors react the same way. Hence, it would not matter if there are numerous investors or only one, if everybody is doing the same. In the event of an exogenous shock (regardless of what this looks like and the origin), a majority of asset managers want to leave the market "through the same door". And this door is very tight as there are not many other risk takers, with banks remaining reluctant to take risk on their books. In such a situation, even minor geopolitical or economic shocks could trigger pronounced spread moves. These spread moves would lead to further outflows, and given the important role of multi-asset managers in the HY segment, such outflows could affect other market segments as well. This is largely the same spillover mechanism as experienced throughout 2007 and 2008.

Leverage Me Up, Scotty!

In reaction to the 2007-2009 global financial crisis and the 2010-2012 European debt crisis, "global" leverage has increased continuously over the past 10 years. This is true for almost all governments in advanced economies, as they had to bear the highest share in costs generated from fighting negative spillover effects from the crises on their economies. Moreover, the non-financial segments of many countries experienced increases in leverage. This was primarily driven by very attractive refinancing costs, on the back of record-low yields and the cyclical low in credit spreads. This is especially true for European companies, owing to the ECB's extended purchase programme. Lastly, some European countries have registered rising leverage in the household segment, which is also driven by historically low interest rates.

One could say that the ECB successfully fought the financial meltdown, at the cost of significantly higher leverage especially on an aggregated basis. Barring exceptions such as Germany, almost all European countries have exhibited increasing leverage on an aggregated level, which is reflected in the table below:

Debt-to-GDP ratios		Advanced Economies					
		Japan	US	UK	Italy	France	Germany
General	2006	184	64	41	103	64	66
Government	2016	239	107	89	133	96	68
Households	2006	59	96	90	36	44	65
	2016	57	79	88	42	57	53
Non-financial	2006	100	65	79	67	56	49
Corporations	2016	92	72	73	71	72	46
Total	**2006**	**343**	**225**	**210**	**205**	**164**	**180**
	2016	**388**	**259**	**250**	**246**	**226**	**168**

Source: IMF, GFSR, 10/17, S. 34

So far, increasing leverage could be seen as an idiosyncratic risk factor. There are some black sheep in the market, with Agrokor, Astaldi, Norske Skog and New Look being among the most prominent examples in European HY markets last year. However, every more pronounced spread widening would trigger rising refinancing costs for the whole segment. If idiosyncratic risk is becoming a systematic characteristic, this would be highly negative for a very leveraged non-financial segment and especially for HY issuers.

Trump-onomics

Talking about politics is always a bit tricky for people working in the financial industry, and we typically try to avoid any political comment. That said, we highlight that the signals especially from the US administration are a risk factor for global credits. The erratic nature of political decisions puts the long-term strategies of companies at risk, while from a European perspective, the US tax reform and especially potential trade barriers would greatly impact the absolute and relative values of European companies.

Such major policy decisions could affect markets via several transfer mechanisms. For example, US President Donald Trump's tax reform will most likely cause the country's Budget deficit to grow, as the highly optimistic view that the reform will be self-financing appears to be a far-fetched scenario, going by independent analysis performed by credible sources. A rising Budget deficit would have two effects, with the first (direct) effect being a weakening of the USD against the EUR. This would put pressure on the global competitiveness of European companies.

This effect could be partly compensated by higher interest rates, another result of a rising Budget deficit. However, we expect political pressure to keep interest rates low, as the US administration would try to avoid negative impulses in financial markets from the monetary side, given Mr Trump's message that he is responsible for the all-time high in stock markets. While these effects might be less or more pronounced, and there are many more which we have not included in our analysis, the major changes in US economic policy will significantly influence the European HY segment.

Conclusion

Despite all the credit-supportive developments in markets during the past few years on the economic and especially the monetary fronts, we believe that trading is currently close to the cyclical low in credit spreads. Tight valuations (i.e. low carry income) and the above-mentioned structural risk factors make the case for a more defensive positioning in European HY this year.

"It is not the economy, it is the market structure" will be the most important guidance for investors in European HY markets for 2018.

Jochen Felsenheimer, Managing Director

XAIA Investment

Key Drivers

Economic Recovery Gains Pace

Markets were supported by a broad-based global economic recovery supported by policy stimulus, with inflation and wage growth remaining subdued. In its January 2018 Global Economic Prospects report, the World Bank stated that the global economy grew 3% in 2017, up from 2.4% in 2016. Interestingly, the World Bank raised its forecast by 0.3% from the June 2017 projection.

While the turnaround was broad-based, the Eurozone in particular experienced an acceleration in its economic recovery, with the World Bank raising the 2017 growth estimate by a significant 0.7% to 2.4% (vs. 1.8% in 2016). For the US, the forecast was increased from 2.1% to 2.3% (vs. 1.5%). Japan's economy also picked up, with growth up from 0.9% to 1.7%. However, Brexit had a negative impact on the UK, where GDP growth contracted from 1.9% to 1.6%. Emerging markets performed well overall, with China expanding by 6.8% (vs. 6.7% in 2016), and both Brazil and Russia returning to growth.

The outlook for 2018 is rosy, according to the World Bank, which expects global economic growth to accelerate to 3.1% this year. The momentum should come from emerging markets, with 4.5% growth projected (0.2% more than in 2017). Advanced economies should expand at a still-healthy 2.2% (0.1% less than in 2017). While US growth is expected to accelerate to 2.5%, that for the Eurozone is forecast to shrink by 0.3% to 2.1%, and to contract 0.2% to 1.4% in the UK. For details, please refer to the table below:

Real GDP Growth (%)	Annual estimates and forecasts						Quarterly growth					
	2015	2016	2017e	2018f	2019f	2020f	Q2/16	Q3/16	Q4/16	Q1/17	Q2/17	Q3/17e
World	**2.8**	**2.4**	**3.0**	**3.1**	**3.0**	**2.9**	**2.7**	**2.4**	**2.8**	**3.0**	**3.0**	**3.4**
Advanced Economies	**2.2**	**1.6**	**2.3**	**2.2**	**1.9**	**1.7**	**1.7**	**1.6**	**1.8**	**2.2**	**2.1**	**2.4**
United States	2.9	1.5	2.3	2.5	2.2	2.0	1.2	1.5	1.8	2.0	2.2	2.3
Euro Area	2.1	1.8	2.4	2.1	1.7	1.5	2.4	1.6	1.6	2.7	1.8	2.3
Japan	1.4	0.9	1.7	1.3	0.8	0.5	0.7	0.9	1.5	1.5	1.6	2.1
United Kingdom	2.3	1.9	1.6	1.4	1.5	1.7	1.8	2.0	2.0	2.1	1.9	1.7
EM and developing countries	**3.6**	**3.7**	**4.3**	**4.5**	**4.7**	**4.7**	**4.3**	**3.9**	**4.4**	**4.6**	**4.5**	**5.0**
China	6.9	6.7	6.8	6.4	6.3	6.2	6.7	6.7	6.8	6.9	6.9	6.8
Brazil	(3.5)	(3.5)	1.0	2.0	2.3	2.5	(3.4)	(2.7)	(2.5)	0.0	0.4	1.4
Russia	(2.8)	(0.2)	1.7	1.7	1.8	1.8	(0.5)	(0.4)	0.3	0.5	2.5	1.8

Source: World Bank Global Economic Prospects January 2018, Lucror Analytics

The recovery should be driven by a broad-based global cyclical upturn, benign financing conditions, the recovery of commodities, accommodative public policies, and improved confidence among consumers and producers. However, several risk factors remain, such as rising geopolitical tensions, increased protectionism and potential interest rate hikes. Overall, we foresee that the economic environment will remain supportive in 2018.

Politics as a Risk Factor

On the political front, Brexit loomed large in Europe, with the UK triggering Article 50 of the European Constitution on 29 March 2017, thus starting the clock for two years of negotiations about the conditions for the country's exit from the EU. The talks have been tough, and it remains to be seen whether the two sides will be able to reach acceptable compromises. On the continent, the Catalan independence movement was in the spotlight. In 2018, Brexit will again be a factor to consider, and will test the willingness of EU members to keep the union in its current form.

2017 was the first year of Donald Trump's presidency. His biggest achievement during the period appears to be in tax reforms. This will lead to USD 1.5 tn in tax cuts, with the corporate income tax rate to be reduced from 35% to 21%. Moreover, the top tax rate for individuals will be revised from 39.6% to 37%. While the reforms will substantially lessen the tax burden of US-based companies, it remains to be seen whether there will be a major effect on GDP. The fiscal deficit could increase significantly, although the Trump administration envisions that higher corporate gross profits on the back of GDP growth will mitigate the lower tax rates.

Meanwhile, Mr Trump's foreign policy actions were a marked departure from US diplomatic norms, and included fiery rhetoric with North Korea, threats to revoke the nuclear accord with Iran, moving the US Embassy to Jerusalem and questioning the One China policy. Protectionism could also increase as a result of the President's America First policy. Lastly, the ongoing probe into Russian interference during the presidential election continues to haunt the Trump administration.

Politics will pose a risk factor to markets in 2018, especially given Mr Trump's erratic character.

Less Monetary Support

Driven by the strong recovery in the US and especially the solid labour markets, the Fed continued to hike rates, albeit at a moderate pace. As Chair Janet Yellen had signalled, the US central bank raised rates thrice (in March, June and December 2017) by 25 bps each, with the Fed funds rate currently at 1.25-1.5% and the discount rate at 2%. Interestingly, two members of the nine-strong FOMC were against the December increase, citing the flattening yield curve as a concern. One member had dissented for the March and June hikes.

Ms Yellen's term will end on 3 February 2018. She will be replaced by Jerome Powell, who was appointed a Fed governor in 2012. Economists widely expect a slightly more hawkish Fed, albeit a major acceleration in rate increases is unlikely. The Fed funds rate is forecast to rise to c. 2.1% over the course of the year.

While the Fed tightened its policy, the ECB remained supportive in 2017. The latter has not pursued rate actions since 16 March 2016, when it cut deposit rates by 10 bps to negative 40 bps, and reduced rates on marginal lending facilities by 5 bps to 25 bps. However, the ECB will slow net asset purchases from a monthly rate of EUR 60 bn to EUR 30 bn from January 2018 onwards. The ECB aims to maintain the monthly rate of EUR 30 bn until September. Hence, it will continue to flood markets with liquidity, albeit at a slower pace. We foresee that the ECB will not deviate from its supportive policy in 2018, unless inflation unexpectedly spikes.

One factor which could influence interest rates is that China is contemplating a major reduction in or even stopping purchases of US treasuries, which would put more pressure on interest rates.

While interest rate increases are to be expected in 2018, we do not anticipate massive hikes. Still, this will likely have a moderate negative impact on European HY.

Cryptocurrencies

One major development was the increased importance and acceptance of cryptocurrencies. Amid high volatility, bitcoin's value has skyrocketed since the beginning of 2107, with other cryptocurrencies following in its wake. That said, bitcoin's market value remains low at less than USD 300 bn. The price development has all the indications of a bubble, with a possible spillover into other asset classes if the price crashes. Hence, cryptocurrencies could make an impact in 2018.

HY Developments

New Issuance to Remain High, but Unlikely to Match 2017

The 2017 new issuance volume of EUR 96 bn eclipsed the previous record of EUR 76 bn in 2014, according to Bloomberg data. While refinancing was the key driver, 25% of supply came from debut issuers (vs. 14% in 2016), according to LCD News. As a result, the market gained depth. Most new issues were well-received, with an estimated 75% pricing at the tight end or inside guidance.

Moreover, investors were open to aggressive structures, with several PIK Toggle transactions being placed, including from Picard, Burger King France and Kloeckner Pentaplast. Several dividend recapitalisation deals were also placed, including for debut issuers such as Raffinerie Heide. The appetite for risk remains high, and we expect the positive trend to continue in 2018, albeit we doubt that new issuances will match the 2017 level.

Defaults

Norske Skog became the latest casualty in the European HY space in December 2017, with the company filing for insolvency after negotiations with creditors failed. Defaults were low in 2017, with the default rate by principal of the European Leverage Loan index in November falling to an all-time low of 1.16% for LTM.

However, several high-profile names went into financial restructuring, including Agrokor at the start of 2017. Solocal voluntarily carried out a financial restructuring, while Algeco Scotsman executed a business and financial restructuring, with bondholders being taken out at par. In addition, a restructuring is looming for Four Seasons Health Care, and the company has failed to pay the coupon on its bonds. After a highly challenging process, Abengoa executed its financial restructuring during the year, but the outlook for the company remains challenging.

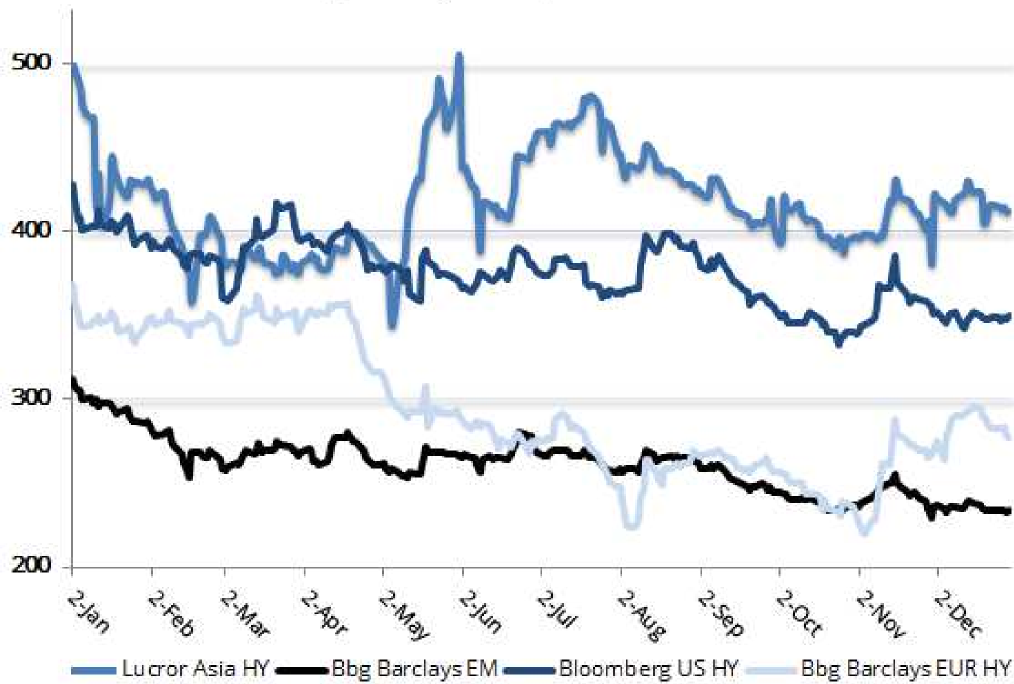
Given the benign environment, we expect default rates to remain low in 2018, although certain issuers (e.g. New Look) are still at risk.

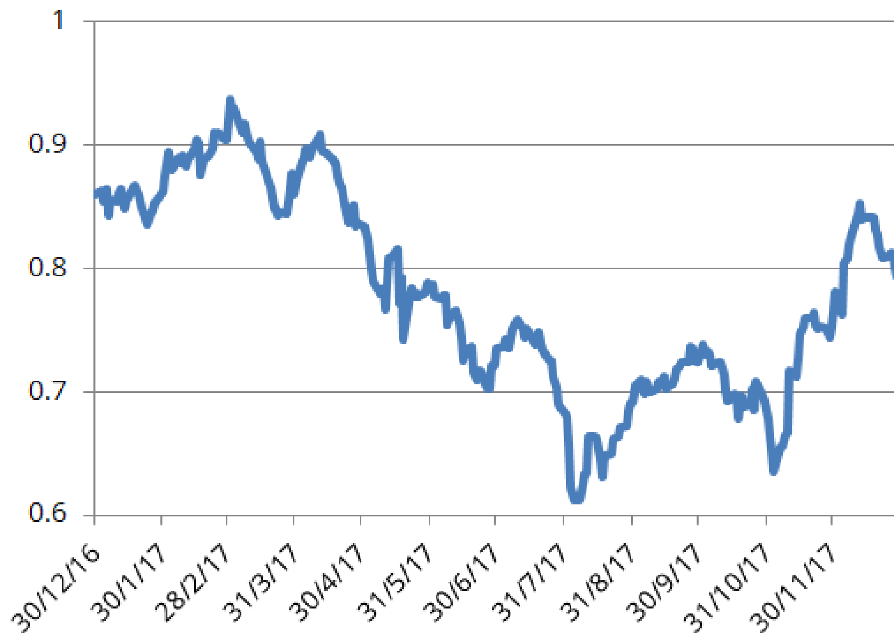
Regulation to Continue Distorting Markets

There was a deluge of regulatory initiatives in 2017, with Mifid2 being the most prominent. Upon implementation in 2018, it will place a substantial burden especially on asset managers, and could have a negative impact on liquidity and markets. In particular, smaller asset managers could struggle amid the increasing regulatory burden, which could lead to a concentration of asset managers and greater volatility over the medium term.

Model Portfolio Performance

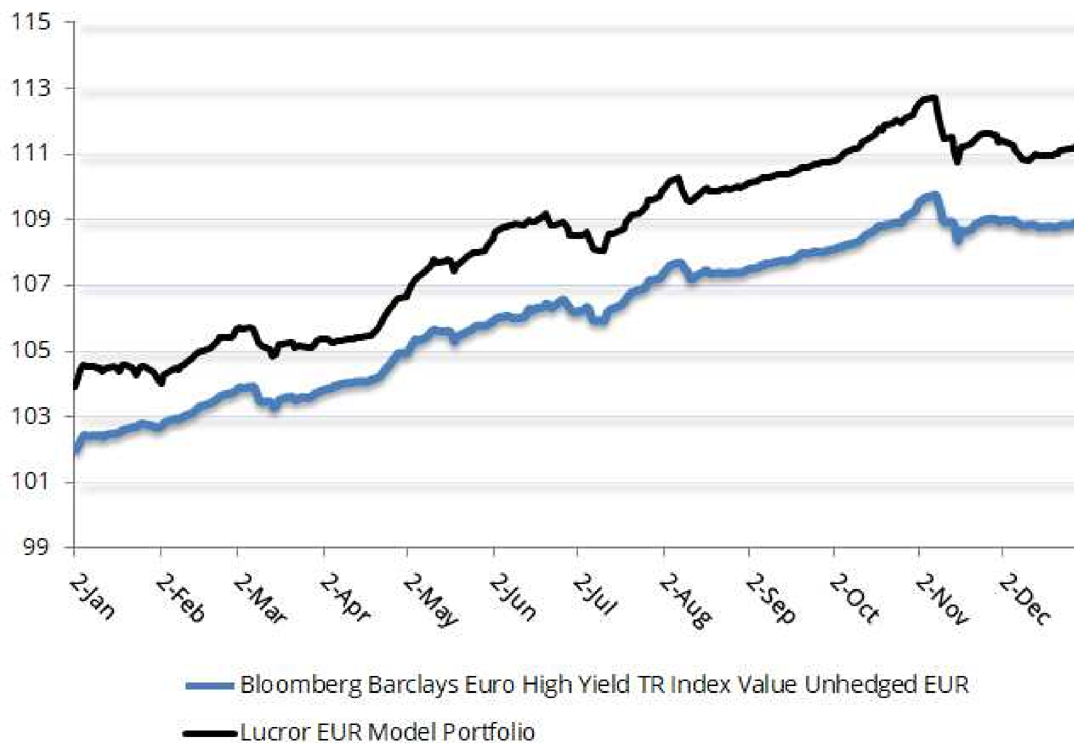
Our European HY Model Portfolio comprises 40 Europe HY corporate credits issued in EUR. The portfolio benchmark is the Bloomberg Barclays Euro HY TR Index Value Unhedged EUR (BB ticker: LP02TREU). Our bonds are generally equally weighted at 2.5% each in the portfolio, albeit the weightage of individual bonds might be increased/reduced selectively. Our portfolio has delivered a total return of 11.53% since its inception on 12 August 2016, outperforming the benchmark by 220 bps.





Source: Bloomberg, Lucror Analytics

In 2017, European HY was one of the stronger performers among the indices, with the OAS narrowing 92 bps to 277 bps. Other indices also tightened, with the Lucror Asia HY tightening by 92 bps, US HY by 79 bps and EM HY by 78 bps. As a result of the European HY outperformance, the ratio of European against US HY spreads declined from c. 0.85x to c. 0.80x.



Source: Bloomberg, Lucror Analytics

Our European model portfolio delivered a total return of 7.03% in 2017, modestly exceeding the benchmark by 10 bps. The top performers included:

- ALDESA 04/21: +24.7% since we entered a position on April 5th.
- WITTUR 02/23: +17.1% in 2017.
- TITIM 03/55: + 14.4% since we entered a position on June 2nd.
- ARGID 09/23: +13.5% in 2017.
- INEGRP 08/24: +11.4% in 2017.

On the flip side, key laggards in our portfolio included:

- AGROK 05/19: -24.6% before we closed our position on February 3rd.
- MANTEN 08/20: -5.7% before we closed our position on April 5th.
- CBRFHG 10/22: -4.5% after we opened our position on November 6th.
- ALTICE 01/28: -4.2% after we opened our position on November 6th.
- ATCNA 02/25: -3.9% after we opened our position on February 3rd.

Sector Developments

Auto and Auto Parts

The positive momentum in global auto markets was sustained in 2017, with annual sales growing c. 2% y-o-y, albeit regional trends varied. The growth was driven by Europe, APAC and LatAm, while US auto sales slumped c. 2%. Companies in our coverage universe took advantage of the benign financing conditions to tap the markets to refinance existing debt (Adler Pelzer, Grupo Antolin, Samvardhana Motherson) and fund M&A (Superior Industries).

The divergence in regional auto sales growth is projected to continue in 2018, with the outlook for sales in the US remaining bearish. Higher interest rates and longer replacement cycles will pose headwinds in the US. Furthermore, the renegotiation of NAFTA and a potential US exit from the agreement could affect US auto sales as well. That said, the outlook for other regions is still decent, helped by recovering sales in LatAm and Eastern Europe.

Building Materials and Construction

The building materials sector enjoyed a substantial recovery in 2017, albeit developments varied for different geographies. US markets continued to improve, with cement makers successfully executing price hikes, while volumes disappointed slightly. The situation in Europe was mixed, as a strong recovery in Spain and solid development in Germany were offset by a soft UK market. Some emerging markets (especially Colombia, the Philippines and Egypt) came under pressure, weighing on CEMEX to an extent. Still, the credit profile continued to strengthen, thanks to the ongoing recovery in the US. Wienerberger benefited from surprisingly strong markets in Eastern Europe.

Developments in engineering & construction were varied, depending on the different markets. CMC registered a strong improvement in its order book, especially in Q4/17. Aldesa was supported by the recovery in Spain, but there was some pressure with regard to the highly profitable public sector contracts in Mexico. We believe that the overall outlook for E&C remains solid.

Chemicals

In line with crude development and given the robust demand, the global chemicals sector had a good run in 2017. There was also support from supply disruptions, with hurricanes affecting the US Gulf Coast, which caused prices to spike.

Looking ahead, we think it unlikely that the situation will be as rosy, given that: a) the rally in crude prices towards end-2017 could lead to higher feedstock costs, which might not be passed down the chain; b) the industry will have to contend with a strong comparable in 2017, amid the backdrop of new capacity scheduled to come online in 2018 and the return of facilities shut for TARs or due to force majeure.

Key names including Perstorp and Ineos had a strong year, both fundamentally and from a technical perspective. Perstorp took advantage of the robust market conditions and its excellent performance

(record EBITDA of SEK 2.1 bn in LTM Q3/17) to extend its maturity profile slightly, and issued subordinated bonds via a SPV and with the mezzanine debt as collateral. We think that yields on the senior secured bonds offer good value, but would await further widening on the subordinated tranche (which we think was priced to perfection).

CABB was an outlier in the chemicals space, due to the weak agrochemical markets and idiosyncratic challenges. The bonds weakened considerably over the course of 2017, although they have retraced somewhat since the Q3 results stage. Still, the outlook remains uncertain, and we foresee possible liquidity-related difficulties over the next 12 months.

Industrials

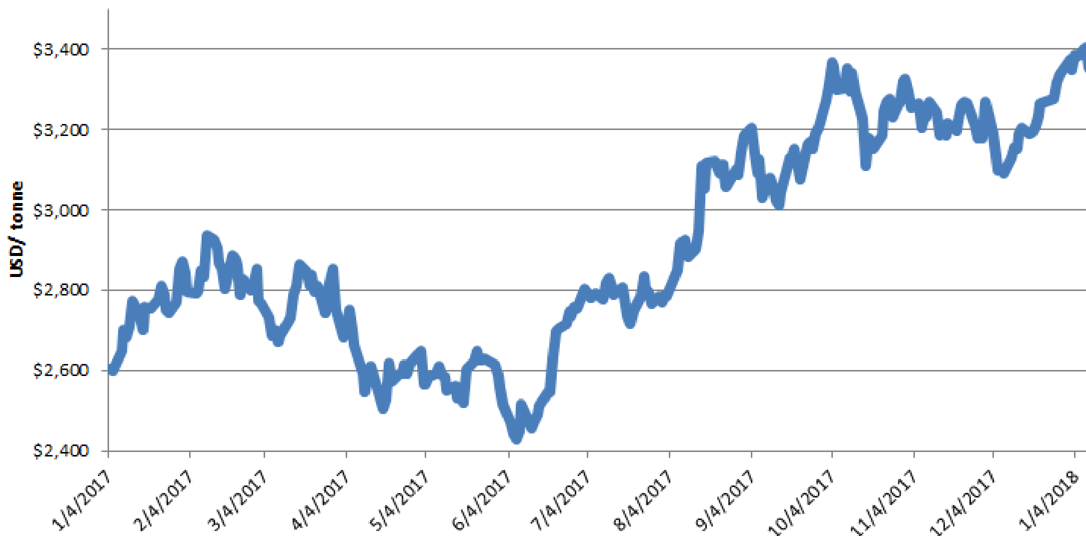
There were diverse developments in the sector, driven by the underlying industries. Overall, companies enjoyed solid demand (as evidenced by strong PMI data). With regard to sub-industries and our coverage universe, we note that:

- Bombardier's Transportation segment performed well, with the outlook remaining strong. However, the market could come under pressure as a result of the Alstom/Siemens merger. For its aerospace operations, demand for business jets is recovering, while the trade dispute with Boeing will drive commercial aircraft developments.
- Constellium benefited from strong demand from the automotive industry and a recovery in aerospace. Industry-wide, several large-scale M&A transactions were contemplated, with current valuations at high levels. The outlook remains sound.
- Fives' performance was volatile. While the company has come under some pressure owing to low demand for spare parts, the outlook is strong.
- Heat Exchangers faced severe pressure due to internal issues, as well as muted demand from several sectors (including power and oil & gas). Even as the outlook for the industry improves, it will be key for the company to resolve its internal issues.
- Norican also struggled with internal issues, and soft demand for new equipment. These were mitigated by favourable developments in aftermarket services. We believe that demand for new equipment will recover.
- Schenck Process made a strong recovery in 2017, after a very weak 2016. We expect the equipment market to grow moderately in 2018, as some pressure on metals should be mitigated by greater demand from other industries.
- Senvion was pressured by weak demand from Germany, which was only partly mitigated by higher demand in other markets. While volumes look set to improve, we are cautious on account of the rising pressure on prices.
- CNH Industrial delivered excellent results in 2017, thanks to operational efficiencies and improving markets. The company was upgraded to investment grade last year. We remain comfortable with the credit profile, and believe that CNH will continue to be prudent in its financial policy.

- The cable manufacturers achieved decent results in 2017. Nexans' y-o-y improvement outpaced that of Prysmian, thanks to operational efficiencies. In December, Prysmian announced the acquisition of General Cable, which would increase leverage materially. We expect both companies to deliver broadly stable to slightly improved results in 2018. That said, we prefer Nexans' bonds to those of Prysmian, due to Nexans' lower leverage and Prysmian's integration risk with regard to General Cable.
- Cable distributor Rexel delivered solid results last year. We forecast a better showing in 2018, as its differentiated customer approach, and focus on operational efficiencies and digitisation starts to bear fruit.
- SGL Carbon posted good results, thanks to the strong performance of its Graphite Materials & Systems segment. We expect solid numbers in FY 2018 thanks to positive market trends, but partly offset by cost inflation.

Metals and Mining

The recovery in metals accelerated in H2/17, with most metal prices rising substantially. While zinc fared poorly in the first five months of 2017, prices subsequently surged by almost 40%.



Source: Bloomberg, Lucror Analytics

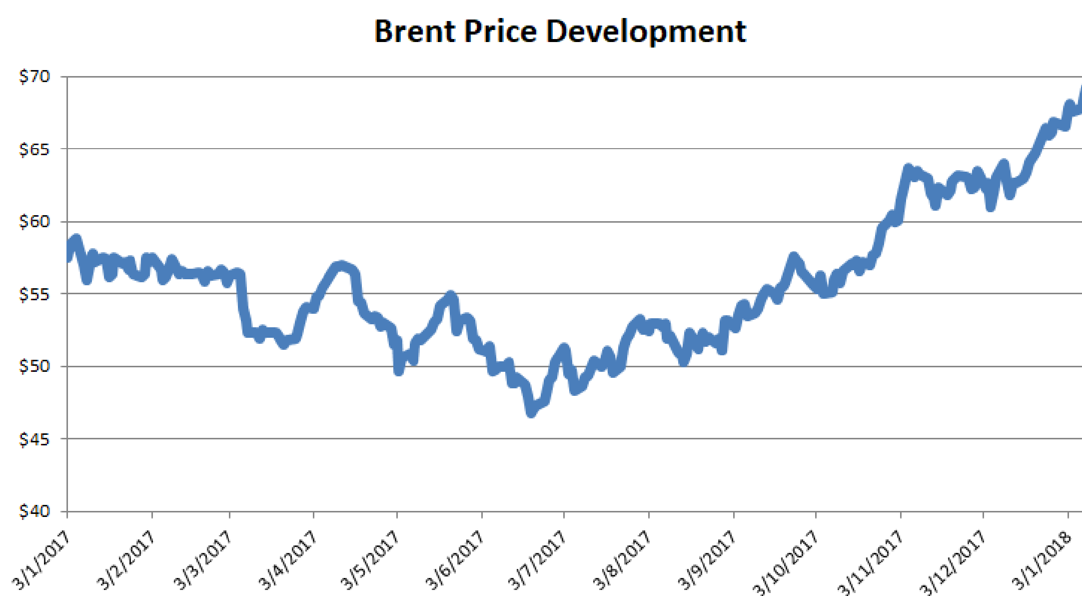
While this benefited Nyrstar, the company was affected by severe pressure stemming from treatment charges. We believe that the outlook for metals remains positive, driven by the solid global economic growth.

Last year, there was a substantial recovery in steel, on account of high demand from most industries. This led to increased volumes and prices, with all steel companies under our coverage benefiting. In particular, developments for stainless steel were positive, with Outokumpu being a major beneficiary. Furthermore, companies under our coverage enjoyed the fruit from restructuring initiatives executed during the downturn. Even Vallourec appears to have turned the corner, thanks to increasing demand

from the oil & gas industry. The outlook remains bright and 2018 should be another strong year for steel makers. Risk factors include lower consumption in the Chinese market, while exports to the EU increase (European players are protected to an extent by tariffs).

O&G and Refining

The oil & gas sector endured yet another volatile period in 2017. The year began with a bearish market outlook and by mid-year, prices had slipped below USD 50/bbl. With the OPEC decision in October to sustain production cuts until Q2/18, oil prices recovered substantially and Brent is presently trading just shy of USD 70/bbl.



Source: Bloomberg, Lucror Analytics

Another driver was the slew of natural disasters in recent months that hit the US Gulf Coast and caused offshore rigs to stop production, impacting crude inventories. Lastly, a broad market rally in stock markets towards year-end also seemingly fed investments in oil futures, thus supporting prices. The key question is whether this is sustainable, with several analysts suggesting that the market has overheated and that players are not paying enough attention to the gradual resumption of oil production in the US.

Refining also has had a robust year, thanks largely to limited new capacity and robust demand. Moreover, the reduction in crude supplies fed into the gasoline and diesel chains, thus positively impacting their pricing. With the recent cold wave across most of the US and Europe, the outlook for heating oil has also improved. Over the next 12 months, refined product inventories are likely to gradually build up, but should be offset by reasonable demand.

Names such as Tullow Oil and Aker BP from our coverage universe have done well, both fundamentally as well as from a technical point of view, with bond yields tightening materially.

Nevertheless, we still see some value in Tullow (despite having tightened c. 5 pts to par) especially with the continued underwhelming performance of the HY bonds (vs. the stock price).

On the refining front, Preem bonds have seen significant gains, thanks largely to the robust operational performance. While the outlook is reasonable, there is limited upside in our view, especially considering that the graft probe against its shareholder could affect both the company's liquidity and that of the bonds. To that effect, despite having tightened by over 1.5% since debut, Raffinerie Heide's bonds seem to still offer good value. Moreover, the Preem bond is a holdco-issued PIK Toggle, while Raffinerie Heide's is senior secured and with a decent security package.

Retail

2017 was a mixed year for this sector. While the Agrokor debacle and the struggles of New Look and IKKS Group led to great scrutiny, Takko and HEMA's refinancing exercises brought some much-needed optimism to the sector, as they exemplified successful turnaround initiatives. Agrokor fell under state administration following liquidity issues, and after financial audits revealed that it had been understating liabilities and overstating earnings. Nevertheless, the industry attracted decent investor interest, with several new issuers entering the market (e.g. Cortefiel, Maxeda and CBR Fashion).

We believe that 2018 will present limited opportunities for organic growth, given the changing consumer preferences, stiff competition, and growing penetration of multi-channel retailers. Companies will have to achieve growth through higher customer satisfaction, enhanced product ranges, productivity improvements and strict cost control. In our view, industry players will take a conservative approach to expansion in new international markets, with capex discipline and working-capital management to remain in focus. Furthermore, the fates of New Look and IKKS should be decided in 2018. The outlook for New Look is poor, and the company could default in the coming year. In contrast, IKKS' chances of a turnaround, while still uncertain, are looking up, following the stabilisation in the last quarter. Meanwhile, given the improvement in its credit stats over the past few quarters, we think Matalan has an opening to refinance its bond maturities.

Services

This sector generally performed well during the year, reflecting its broadly stable and defensive characteristics. For companies under our coverage, we note that:

- SPIE's results were supported by its acquisitive strategy (mainly SAG). However, organic development was slightly soft in some of its segments. We expect the company to achieve a stronger organic performance and modest deleveraging in FY 2018, given the decent outlook.
- Atalian released solid numbers, thanks to acquisitions and cost efficiencies. We believe that it will continue with its acquisitive growth strategy, while keeping pro-forma net leverage in line with its 3-3.5x medium-term target.

- Manutencoop experienced weak organic development, due to pricing pressure and reduced volumes. That said, the key risk lies in its antitrust and legal issues. Looking ahead, the credit will likely continue to be affected by news about these issues.
- Verisure again produced excellent results and deleveraging, supported by strong organic growth. We expect the growth trajectory to continue, but note that any deleveraging in the next 18 months could be offset by a dividend distribution.

Shipping and Aviation Services

Shipping had a very strong year, driven by positive industry developments, including consolidation and alliance reorganisations. More importantly, industry players displayed some much-needed capacity discipline. Freight rates stabilised to an extent, but earnings were driven by cost efficiencies and synergies from M&A. For 2018, we would mainly be concerned about new capacity and high bunker fuel costs (driven by the recent spike in crude prices). These should be mitigated by cost-control measures, but we do not expect that earnings will grow as briskly as in 2017. Moreover, the strong prior-year comparable will pose a challenge. That said, we do not expect rates and earnings to collapse as they have in the past, and instead foresee a steady-state year, marked by the consolidation of various acquisitions.

Hapag-Lloyd and CMA CGM displayed strong fundamentals throughout the year, with the latter outperforming peers. Arguably, this could be attributed to the weak prior-year comparable (i.e. FY 2016), but we believe that CMA managed its financial profile laudably. Despite their slightly long-dated nature, we like the CMACG '25s, which yield c. 5.25%.

Operating trends were positive for both airport-services companies within our coverage, with growth in both passenger and cargo volumes. In YTD October 2017, air passenger volumes (measured in revenue passenger kilometres, RPKs) rose 7.7% y-o-y, while air cargo volumes (freight tonne kilometres, FTKs) advanced a more robust 9.7%. Between the two, Worldwide Flight Services (WFS) outperformed Swissport, benefiting from its more significant exposure to air cargo (which outperformed) and synergy realisation due to its early-2016 acquisition of CAS.

Swissport had a more turbulent year, which featured a EUR 718 mn equity injection from parent HNA Group, a bond-exchange offer (with a EUR 200 mn repayment of its outstanding term loans) triggered by a technical covenant breach of the term loan documentation, and the acquisition of Aerocare, a ground handling company operating in Australia and New Zealand. Swissport's bonds have been experiencing volatility recently, owing to investors' concerns about HNA's tightening liquidity, and whether a EUR 400 mn loan to HNA's offshore affiliate will be rolled over again.

Going into 2018, we expect industry trends to remain solid, albeit not as strong as in 2017. Over the near term, the performance of Swissport's bonds will depend on whether the EUR 400 mn related-party loan will be rolled over again, and when more details on the Aerocare transaction will be disclosed.

Telecommunications

This sector underwent a period of heavy investment in 2017, in both mobile and fixed, and we expect this to continue in 2018. For many issuers, capex has largely offset their strong cash flow generation and leverage has overall remained unchanged. We expect demand for telecoms services to remain strong in 2018, supported by the continued digitalisation of the economy and daily life. Consolidation is likely to continue, with Eircom and ComHem currently targeted by larger players (NJJ and Tele2). We believe that converged players with strong networks and content will maintain a competitive advantage. Further asset swaps between the Vodafone and Liberty Global groups remain a possibility.

Despite strong demand, revenues in Western Europe are only expected to grow at a moderate pace, as higher data consumption is paired with a decrease in prices per data unit consumed. Some operators are experiencing shrinking revenues, although often paired with margin expansion due to improved cost discipline, leading to an overall neutral to positive effect on EBITDA and cash flow. The outlook for revenue growth is stronger in the less developed markets of Europe, including the former Yugoslavia, Romania and Greece. We expect increased competition throughout Western Europe, in particular with Italy likely to be impacted by the entry of Iliad. In France, renewed consolidation is possible given the still highly competitive nature of the market.

We expect the regulatory environment to remain overall benign, with a trend towards encouraging incumbents to provide better access to their networks, as well as a focus on broadband expansion in rural areas.

While sector leverage is high, debt maturity profiles are long-dated and interest cover is overall strong. However, the recent cheapening in the bonds of the Altice group shows that investors are increasingly concerned about high debt levels, and we expect issuers to put more emphasis on deleveraging, in the case of Altice supported by asset sales.

Valuations in the sector were largely flat over the year, as cheapening in the first six months was largely reversed in H2/17. An exception was Altice and its subsidiaries, which saw a significant sell-off. Sector yields remain overall tight, although this is to a degree justified by the stable operating environment and high margins.

Travel and Leisure

2017 was a decent year for most tourism players in our coverage universe, with Brexit having minimal impact on UK tourism demand. That said, the weaker GBP put pressure on UK margins, as non-GBP-denominated input costs became relatively higher. The outlook remains positive, underpinned by global economic growth, and a recovery in demand for destinations such as Turkey and North Africa. In travel management, the expansion in traffic was partly offset by persistent client-yield erosion, which is set to continue.

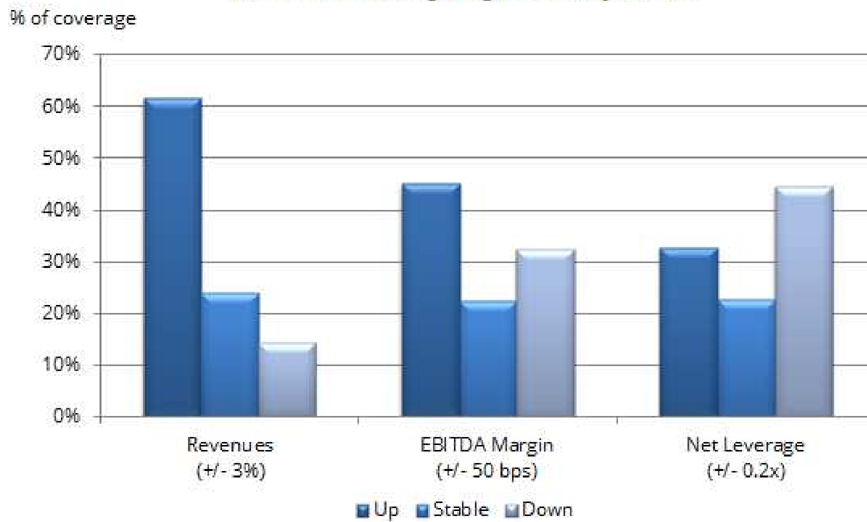
Airlines had a robust year, thanks to low fuel prices, which boosted earnings. Going forward, higher oil prices will squeeze margins, although the outlook for passenger-travel demand is still good. The year

was more of a mixed bag for ferry operators, as higher fuel costs weakened earnings, especially for Moby Lines and Hurtigruten. Within our coverage, the former's bonds were among the most volatile, due to concerns over its ability to meet the semi-annual net leverage covenant test, and the resignation of its CEO. In 2018, demand for passenger and cargo ferry transport should remain decent, but we expect fuel prices to continue affecting earnings. Hence, the effectiveness of a given company's hedging policies will likely be a driver of its performance.

Company Results

On average, the companies in our coverage universe reported good numbers. About 60% of these firms posted higher revenues y-o-y, with 15% reporting lower revenues across the first three quarters of 2017. Around 25% of the companies registered stable revenues. EBITDA margins rose (at least by 50 bps) for c. 40% of the players that we cover, slightly more than the number of companies whose margins weakened. Interestingly in Q3, 45% of the firms reported higher EBITDA margins, while only 33% posted declines. Furthermore, net leverage fell by at least 0.2x for over 40% of the companies in each of the three quarters. This indicated continued financial discipline. The table below gives an overview of quarterly developments, while the graph provides Q3 data:

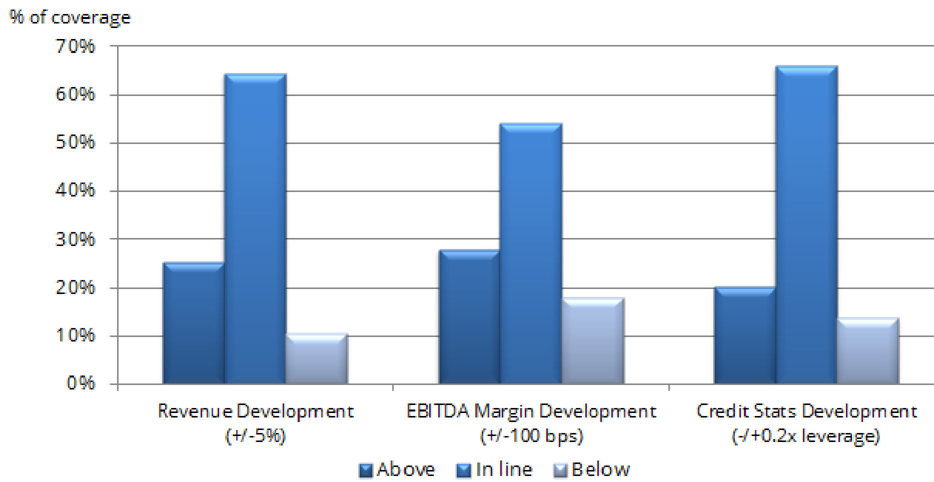
		Revenues (+/- 3%)	EBITDA Margin (+/- 50 bps)	Net Leverage (+/- 0.2x)
Q1	Up	61%	38%	23%
	Stable	24%	23%	36%
	Down	15%	39%	40%
Q2	Up	58%	36%	29%
	Stable	27%	26%	25%
	Down	15%	38%	46%
Q3	Up	62%	45%	33%
	Stable	24%	23%	23%
	Down	14%	33%	45%



Source: Lucror Analytics

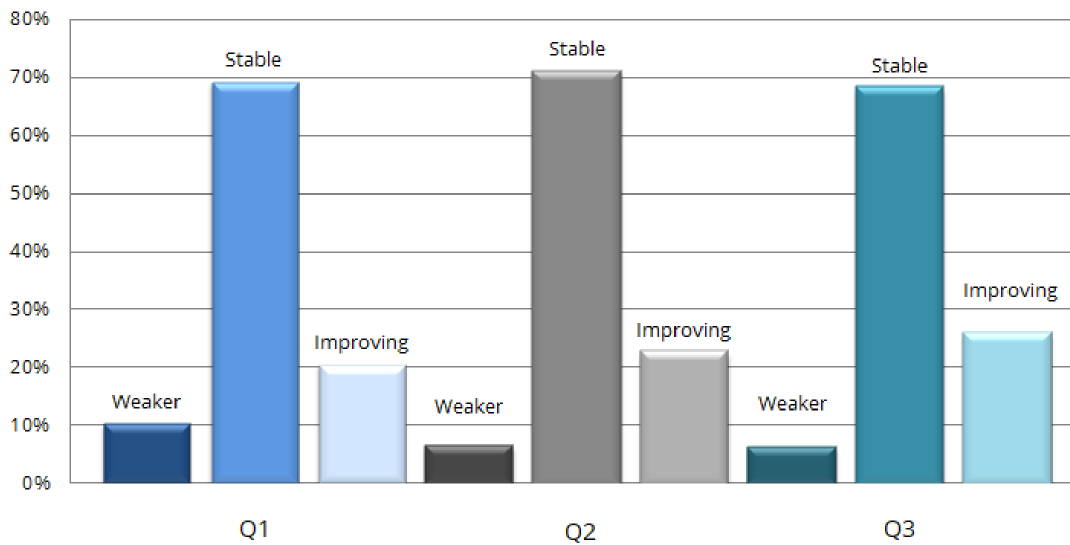
Compared to our expectations, our coverage universe outperformed in all three quarters. For Q3/17, 25% of the players under coverage beat our expectations in terms of revenues (+/-5%), while 10% came in below our forecasts. For EBITDA margins (+/-100 bps), 28% surpassed and 18% lagged our projections. Regarding net leverage (-/+0.2x), 20% reported lower net leverage than projected, while 14% surprised us with a more pronounced increase than anticipated. Outperformance in terms of revenue development was the highest in Q1.

		Revenue Development (+/-5%)	EBITDA Margin Development (+/-100 bps)	Credit Stats Development (-/+0.2x leverage)
Q1	Above	31%	27%	18%
	In line	59%	42%	70%
	Below	9%	30%	12%
Q2	Above	19%	21%	14%
	In line	68%	61%	72%
	Below	12%	18%	13%
Q3	Above	25%	28%	20%
	In line	64%	54%	66%
	Below	10%	18%	14%



Source: Lucror Analytics

Overall, we remain positive on the development of credit profiles in the next 12 months. We foresee that 26% of companies under our coverage will register improvement, while only 6% will see a deterioration in their credit profiles. We became slightly more optimistic over the course of the year. Hence, we are reasonably optimistic on the development of the credit quality of companies that we cover.



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