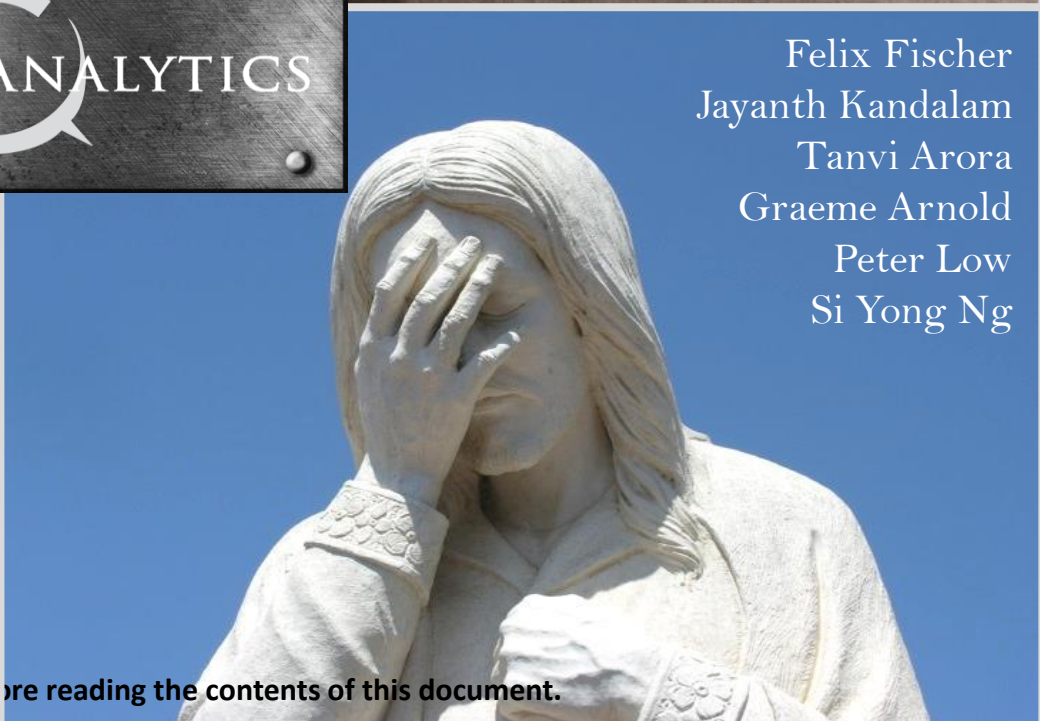




EU HY 2016  
Investment Book

LUCROR ANALYTICS



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

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## INTRODUCTION

2015 was a year that largely set the stage for the increased volatility in global equity, currency, and credit markets that we are currently experiencing. Our Investment Book 2016 opens with a brief commentary on key developments that defined 2015, followed by our outlook for High Yield markets for the year ahead. In our assessment of 2016, Charles Macgregor, Lucror's Head of Asia, briefly outlines his views on China, as we feel the country's effect on global financial markets is formative. In addition, Dr. Jochen Felsenheimer, Managing Director at alternative asset manager XAIA, shares his outlook for the High Yield markets in a guest commentary.

On an issuer level, we review the performance of companies in our coverage universe over the past year and then examine the performance of our "top-trades" recommendations from last year's Book. Briefly, our long/short "top-trades" list outperformed by 23.9% a theoretical portfolio with an equal weighting of long/short ideas that generated a 0% return. Thereafter, we proceed to outline our [Top Picks for 2016](#). Lastly, we present a snapshot summary for each of the companies in our coverage and expected key drivers for this year.

## 2015 DRIVERS

Main drivers in 2015 were:

- **US economy:** The US economy continued its recovery, with GDP growth of 2.6%e in 2015 (source: IMF) up from 2.4% in 2014. Labour markets continued to recover, with the unemployment rate dropping to 5% in November 2015, the lowest level since April 2008. This prompted the Fed to hike interest rates by 25 bps to 0.25% (target funds rate) in December, the first rate increase since June 2006. While a significant part of 2015 was dominated by fears of higher interest rates, following the rate increase, Fed chair Janet Yellen delivered a speech that was well received by financial markets, as she guided for a moderate pace of future rate hikes. Specifically, the Fed stated "The committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen."
- **Eurozone:** In contrast to the US, Eurozone 2015 GDP growth remained lacklustre, with a diverse picture across the various member states. While Germany (+1.7%) and the UK (+2.5%e) posted decent growth rates, Spain (+3%e) and Portugal (+1.6%e) reported healthy recoverys. However, France (+1.2%e) and Italy (+0.8%e) struggled and the situation in Greece deteriorated under the Syriza government, with the economy expected to shrink by 2.3%.
- **Greece** remained in the focus throughout 2015, with long and arduous negotiations between its newly-elected left government and the troika. Failed negotiations led to the country postponing an IMF installment (June 5<sup>th</sup>), the closure of Greek banks and

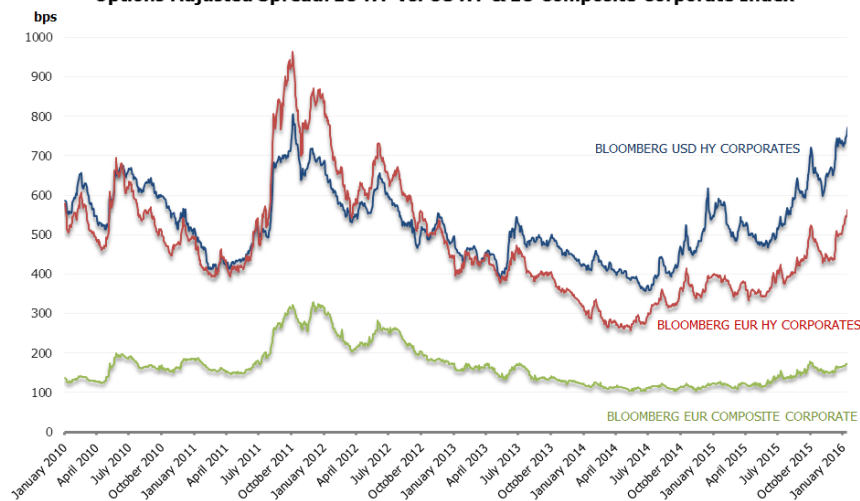
## 2015 DRIVERS (CONT'D)

the imposition of capital controls (June 28<sup>th</sup>), and missing an IMF loan payment (June 30<sup>th</sup>) that culminated in a bailout referendum (July 5<sup>th</sup>). The majority of the population voted against the austerity measures proposed by the troika in return for financial aid. Under the threat of expulsion from the Eurozone, on July 23<sup>rd</sup> the Greek parliament approved a second set of austerity measures proposed by its creditors. Notwithstanding some increased nervousness, markets' reaction to a potential Grexit was rather muted.

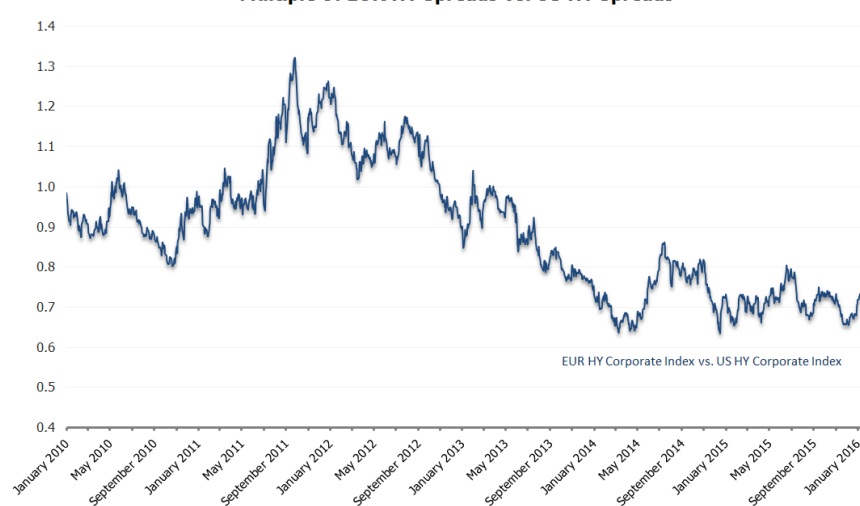
- **China:** In the latter part of the year, concerns about the health of the Chinese economy accelerated, with GDP growth expected to decelerate by c. 0.5% to 6.8%. Fears further intensified in January 2016 after the Caixin Manufacturing PMI came in well below consensus, with some economists now expecting a hard landing in China.
- **LatAm** also had a very challenging year, with particularly Venezuela and Brazil facing severe headwinds. Several market participants expect Venezuela to default this year, while Brazil is facing its worst economic crisis since the Great Depression, with the economy expected to contract by 3% in 2016.
- **Commodities:** 2015 also was a disastrous year for commodities, with all major raw materials posting substantial losses. In the last twelve months, crude has dropped c. 45%, which in turn has led to several defaults in the oil & gas space in the US and emerging markets. We note that the decline was driven by increased output rather than weakness in demand, which has held up relatively well (in contrast to what we experienced in the aftermath of the Global Financial Crisis in 2008-2009). Likewise, coal, steel and iron ore are trading around or slightly below the lowest levels of the GFC. Base metals dropped between 20% (aluminum) and over 40% (nickel).
- **Defaults** increased y-o-y, partially as a result of higher defaults by oil & gas related companies. Moody's trailing 12-month global speculative grade default rate was 2.9% in November, up from 2.7% in October. The latest reading came in worse than the rating agency's prediction of 2.6% a year ago. According to S&P, European default rates remained relatively low at c. 1.5%; however, the agency predicts a rise to 2.4% this year. By far the most prominent default in Europe was that of Abengoa towards the end of 2015.
- **Geopolitical uncertainty:** Geopolitics took centre stage during Q4/15 and continuing into 2016, with terror attacks in several countries, the war in Syria causing massive migration movements and verbal confrontation between several EU countries, as well as heightened nationalistic sentiment.

Performance of EU HY was mixed in 2015, with particularly cyclical names declining. The Bloomberg European HY Index<sup>[1]</sup> rose c. 1.5%, compared to a c. 7% increase in 2014. In contrast, US HY had a very weak year, with the Bloomberg USD HY Index<sup>[2]</sup> down c. 3.5%, as a result of weakness in the energy complex (Bloomberg Energy sub-index declined c. 40%). Consequently, US HY continued to lose ground against EU HY. In the chart below we show the spreads of EU HY vs. US HY, which currently only trade at 0.73.

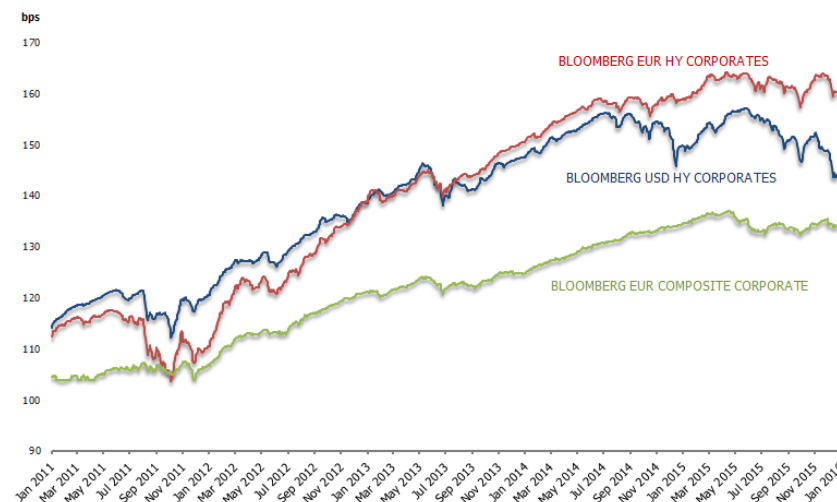
Options Adjusted Spread: EU HY Vs. US HY &amp; EU Composite Corporate Index



Multiple Of EUR HY Spreads Vs. US HY Spreads

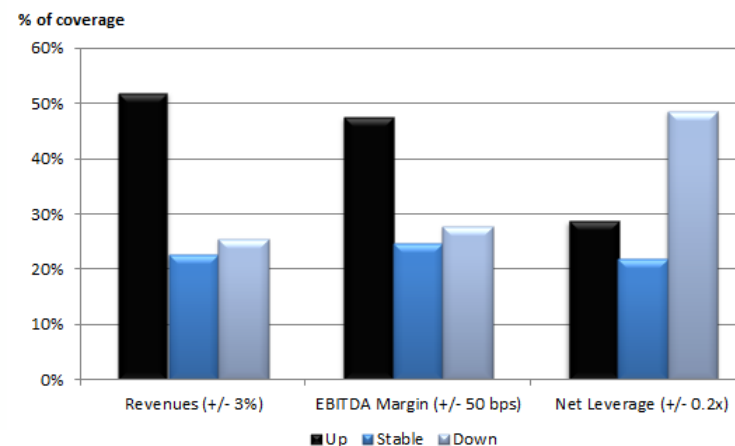


Performance Of EUR HY Vs. US HY &amp; EU Composite Corporate Indices



On average, Q2/15 and Q3/15 earnings in our coverage universe were strong. Of the companies we cover, 57% increased revenues (reported currency) by at least 3% in Q2/15 and 52% in Q3/15. This was supported by favorable F/X. EBITDA margins rose at least 48% for both quarters. We partially attribute this to lower commodity prices and restructuring initiatives. Furthermore, net leverage decreased by at least 0.2x for 49% of issuers in our universe in Q3/15 and 44% in Q2/15, underpinning that companies are continuing to exercise financial discipline.

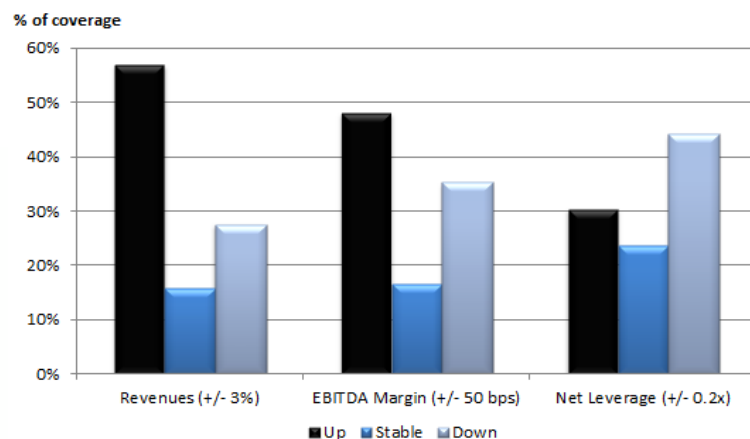
Q3/15 Actual Results Y-O-Y Development



<sup>[1]</sup> based on EUR denominated HY issues; while a few issuers outside the Eurozone are included in the index, we still think it serves as a good proxy

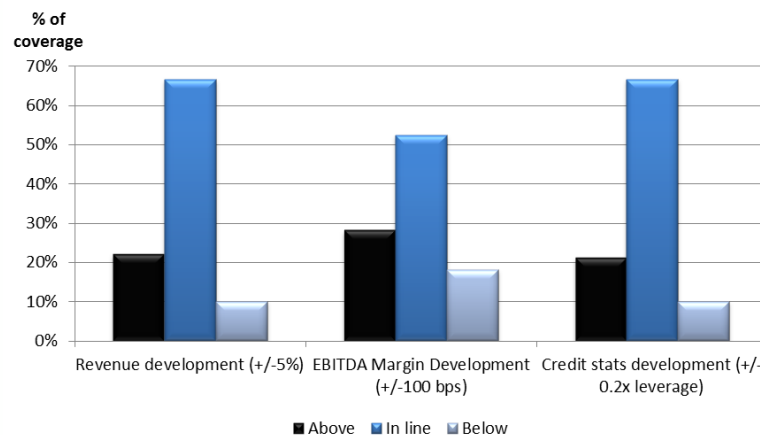
<sup>[2]</sup> based on USD denominated HY issues; while non US issuers are included in the index, we still think it serves as a good proxy

## Q2/15 Actual Results Y-O-Y Development

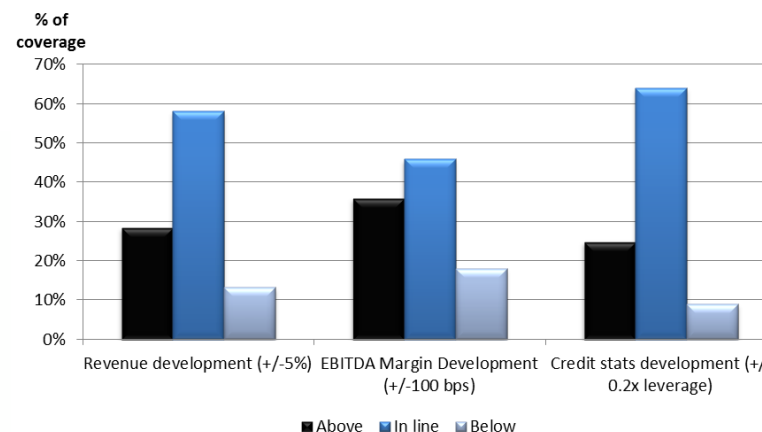


Compared to internal expectations, our coverage universe outperformed both in Q2/15 and Q3/15 (marginally more companies outperformed in Q2 compared to Q3). For an overview of actual performance versus our expectations on revenues, EBITDA margins and credit stats, please refer to the charts below.

## Our Expectations Vs. Actual Performance In Q3/15



## Our Expectations Vs. Actual Performance In Q2/15



We are slightly less optimistic about the development of credit profiles in the next 12 months, and now only expect 30% of companies in our coverage to improve their respective credit profile (down from 43% after Q2/15 results). That said, we expect only c. 13% of issuers in our coverage to see a weaker credit profile in 2016 (up from 11% after Q2/15 results). Hence, we are still reasonably optimistic on the overall development of the credit quality of companies in our universe.

- As outlined in our [2015 Investment Book](#) (published on 9 January 2015), our recommended top-picks from last year had a 12 month time horizon.
- During 2015, we closed some trades, while others are still open to date. In particular we closed our “Buy” recommendations on Agrokor, Avanza, HEMA, Isolux, Matalan and Solocal, and “Sell” recommendations on Four Seasons, Ovako and Perstorp.
- The analysis below shows the performance of our top-picks from 9 January 2015 till date (assuming all trades were executed and held to date).
- We assume an equal weighting for the long/short list in our portfolio. For bonds in currencies other than EUR (i.e. USD and GBP), we assume F/X hedging at no cost.
- Our recommended long/short list generated a total outperformance of 23.9% vs. a theoretical return of 0% for a portfolio with an equal weighting of long/shorts. This was primarily driven by our short recommendations (note: including the bid/offer, the “benchmark return” would be negative; however, we prudently bid/offer spreads into our calculations).
- Our combined “Buy” recommendations generated a negative return of 4.2% (including interest), driven by our trades on Isolux, Solocal and Matalan, which we closed over the course of 2015.
- Our combined “Sell” recommendations (including negative carry) generated a profit of 24.1%. This was driven by our shorts on New World Resources, Four Seasons and Ovako, all of which collapsed. Our recommendation to “Sell” New World Resources is still open, though we closed our other two shorts during the year.

Long	Recommendation Level	Current Price	Price Gain/ Loss	Interest Gain	Total Gain/ Loss
AGROK 9.125% 02/20	110	106.3	-3.7	9.28	5.58
ARGID 8.375% 06/19	97	98.3	1.3	8.51	9.81
ARGID 9.25% 10/20	106.5	104.3	-2.2	9.40	7.20
AVAN 7.5% 06/18*	94.5	103.3	8.75	2.25	11.00
HEMABV 6.25% 06/19	84.5	71.5	-13	6.35	-6.65
ISOLUX 6.625% 04/21	87.5	28	-59.5	6.74	-52.76
UPCB 6.375% 09/22	108.8	105.8	-3	6.48	3.48
UPCB 6.75% 03/23	110.2	107.5	-2.7	6.86	4.16
MTNLN 6.875% 06/19	96	83.5	-12.5	6.99	-5.51
PAJFP 8.875% 06/18	97.8	71.3	-26.5	9.02	-17.48
<b>Long Performance**</b>					<b>-4.15</b>
<b>Short</b>					
ALDESA 7.25% 04/21	84	75.9	8.1	-7.37	0.73
FOURSN 12.25% 06/20	107.8	36	71.8	-12.45	59.35
NWRLN 8% 04/20	76	15	61	-8.13	52.87
OVAKO 6.5% 06/19	96	65	31	-6.61	24.39
PERHOL 9% 05/17	101	99	2	-9.15	-7.15
<b>Short Performance**</b>					<b>28.01</b>
<b>Portfolio Performance</b>					<b>23.86</b>

\* We assume we participated in tender offer at 103.25 which was completed on April 27

\*\* Total return for 100%

Key factors impacting the European HY markets in 2016 are:

- **Underlying economic development in the EU:** Clearly, economic growth in several economies remains muted, and the risk of deterioration in specific countries such as France and Italy remains high. In contrast, other major economies such as Germany and the UK appear to be withstanding current global economic headwinds reasonably well. Moreover, we think the situation in Greece is not fully resolved as yet; the result of the upcoming progress assessment will determine whether discussions in regards to a debt relief will commence in earnest. Overall, we expect an environment of slow growth; though do not anticipate a substantial economic crisis in Europe. An event that could potentially shake the foundations of the EU is Britain's exit following the impending referendum.
- **Geopolitical risk factors** such as terrorist attacks, tensions in the Middle East and uncontrolled immigration into Europe have been a serious cause of social and political concern, which may test the EU's cohesion if ignored. Uncertainty will impact consumer confidence and directly affect individual issuers (e.g. Thomas Cook, TUI).
- **Monetary policy:** While the Fed is expected to continue increasing rates over the course of 2016, we expect a gradual pace. Furthermore, we do not anticipate a change in the ECB's supportive stance. We think markets will remain extremely reactive, and we will be closely monitoring statements and announcements in this context.
- **Development of oil prices:** It appears that crude prices will remain under pressure for the foreseeable future, given OPEC's factual abandonment of production quotas, Iran returning to the market, the US decision to lift a four-decade ban on oil exports and ceilings on oil storage capacity in the nation. In our view, it would take a structural change in OPEC's policy to reverse the current trend. Positively, many economies should derive support from low oil prices, which boost consumer confidence and keep inflation in check, allowing central banks to gradually taper supportive monetary policies. A number of European HY companies (for instance in transportation and consumer oriented sectors, where the cost base includes oil and related feedstocks) also benefit from weakness in crude prices. That said, the current situation may also lead to increased defaults of US HY issuers, emerging market players, and even sovereigns such as Venezuela. In turn, this could spark a sell-off in risk oriented assets.
- **Development of metals & mining:** We anticipate prices of coal and a majority of other metals to remain weak, due to oversupply as a result of heavy investments in recent years. Another crucial determinant is China (still accounts for c. 50% of global demand), given muted domestic demand and overproduction (for instance in blast furnace steel), which is likely to pressure European metals markets. In our view, it will take a few years for surplus capacity to clear and for demand to recover. Therefore, we expect metals & mining companies to continue to underperform. Unquestionably, strong liquidity and a low-cost production base are vital in this environment. Specifically, we expect New World Resources to be liquidated, while a successful capital increase will be critical for Nyrstar to avoid a liquidity crunch. On the positive side, lower coal and metal prices favourably influence several industries, including automotive, construction and select industrials.

- **Increasing defaults:** Rating agencies expect default rates to increase in 2016, mostly driven by US HY (particularly oil & gas related players). In addition, we anticipate a moderate increase in European defaults. Issuers with a high default risk include New World Resources, Isolux (especially if the asset sale falls through) and retail names such as HEMA and Takko.
- **China:** The development of the Chinese economy, which remains a key growth engine, will be an important variable. While current sentiment is negative, we feel that the latest market reaction is a bit overdone (please refer to the Excursus above). In our coverage universe, several companies (including Wittur and Aston Martin) will be directly and substantially affected by economic developments in China. Furthermore, there will be an indirect impact on a number of other issuers, for instance in the chemicals, metals & mining and auto parts sectors.
- **Development in emerging markets:** An economic crisis in emerging markets remains a risk factor. As discussed below, a default of Venezuela is not unlikely, and weakness in countries such as Brazil and Malaysia will impact several European HY players (for example, Brazil has a strong impact on Abengoa and Isolux).
- **New issuance:** Given our overall cautious view, we do not expect new issuance to reach 2015 levels. While stronger credits still have solid market access, lower quality issuers face significant challenges in this respect. That said, refinancing needs and banks' reduced ability to offer funding should be supportive of new issuance. As a result, the buy-side is empowered, and we recommend investors to focus on documentation.
- **Regulatory developments:** Ever-increasing regulation has led to a substantial deterioration in market liquidity and has placed onerous requirements on fund managers. We expect this trend to persist, which is detrimental to the HY space (as discussed below).

We broadly concur with our guest commentator's view that several macro developments pose risks. On an idiosyncratic (single company) basis, we are slightly more optimistic, as the outlook still appears decent. Nevertheless, we expect volatility to remain high and credit spreads to widen over the course of the year (we estimate a c. 100 bps widening in the iTraxx X-Over, with risks skewed to the downside). In regards to portfolio allocation, we prefer less cyclical names; however, we also believe there are select opportunities in cyclical sectors where name-picking will be crucial. Given our expectation of widening spreads, we think an overweight position in higher quality credits and shorter duration is the right strategy to generate alpha.



Everything about China now seems to affect global markets, from equities to currencies. We believe the most apparent systemic risk is a collapse in the Chinese Government's perceived competence. Increasingly, investors are forming a view that Chinese authorities are out of their depth when it comes to managing equity markets, thereby earning a reputation for ineffectiveness. The risk is that Chinese authorities will resort to political manoeuvres to shore up their system. This could lead to significant uncertainty at the highest levels of government and less proactive policy making/implementation.

Chinese monetary and currency policy has the potential to be a rogue factor that could impact technicals negatively. It is our expectation that the Chinese authorities will seek to maintain broad stability of the CNY against its chosen basket of currencies. That said, the PBOC may need to intervene to reverse part of the recent depreciation in order to prevent expectations of devaluation from becoming self-fulfilling.

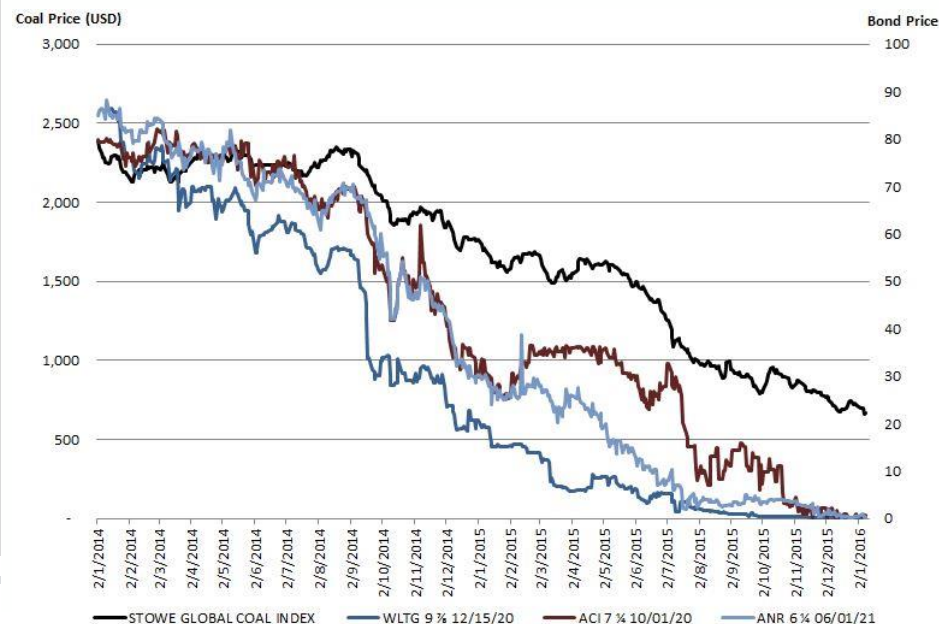
There is a lot of noise around weak Chinese PMIs, which we view as being over-reactive. The December official manufacturing PMI was in line with the average of the previous 4 months, while the HSBC PMI was higher. Moreover, the official non-manufacturing PMI jumped to an 18-month high of 54.4 in December. This is important, as the service sector now accounts for more than half of China's GDP. That said, the data still points to slowing Chinese GDP growth, which combined with the ongoing slide in the CNY will do little to encourage investors.

**Dr. Jochen Felsenheimer**  
Managing Director  
XAIA Investment

## European High Yield Markets in 2016: Always look on the bright side of life

### Review 2015 – the turning point in the credit cycle

Following some prosperous years for High Yield, the credit cycle started to turn in 2015. Led by the basic resources sector, US HY suffered drastically last year, driven primarily by the continuous weakness in the commodities markets. Although the CDX HY widened from 360 bps to 480 bps in 2015, this does not fully reflect all aspects of the turbulence in US High Yield. Besides some heavyweights leaving the playground (such as Radioshack and Caesars), the entire basic resources sector got hammered. The sharp decline in energy prices exerted immediate pressure on oil companies (especially drillers like Transocean), while the US coal industry has been decimated. Alpha Resources, Arch Coal and Walter Energy are already in default, while Peabody is just one step away from Chapter 11. The most devastating point is that recovery rates are approximately zero for all these names, which triggered the most absurd situation we have experienced over the past several years in HY: as ACI bonds traded still with accrued last year, the (dirty) price of the bonds fell below zero in November.



The really negative development is that there have already been negative spillover effects on other sectors. The most obvious one is the weakness of US steel makers (US Steel and AK Steel spreads trade at historically wide levels) and finally on industrials as a whole (including some blue chips). There is already a significant part of the US HY market which has been negatively affected by the shockwaves sent out from the commodities markets, and there are no signs that these spillover effects will reverse anytime soon.

Surprisingly, the European HY sector held up relatively well so far. This was primarily driven by the fact that the weight of the basic resources segment in the index is much smaller than in the US, and hence the direct impact of the drop in commodity prices is limited. Instead, the major source of risk was on the idiosyncratic front. On the back of low quality issuance over the last few years, many first-time issuers managed to tap the market at highly attractive refinancing levels. Consequently, it appears as if the Euro HY market entered a “last in – first out” mode, with retailers like Matalan and HEMA experiencing increasing pressure. Moreover, a few peripheral names, such as Abengoa and Isolux, are (or at least trade) in default mode. Nevertheless, the iTraxx Crossover tightened in 2015 from 360 to 320 bps. This tightening was accompanied by a rising dispersion in the index, namely the widest names widening further and the tightest names tightening further over the course of the year.

Besides macro fundamental concerns, negative geopolitical impetus and the ongoing discussion about the Fed’s monetary stance, some technical risk factors surfaced last year. Firstly, permanently rising regulatory pressure on banks and insurance companies triggered a concentration of HY exposure in the asset management industry, including ETFs. This trend could be seen as a major reason for the continuous decline of liquidity and the rising spread volatility in HY markets, in the absence of major counterparts. Secondly, increasing legal risk on the back of the latest developments, especially in the European banking sector, tends to provide a draft for companies to stretch some basic rights of bondholders in the event of a restructuring or bankruptcy. This is even more of a concern, as many issuers sold bonds during recent years that included some very fancy features, as investors accepted deterioration in covenant quality, driven by their hunt for yield.

We think the central message from 2015 is that loose monetary conditions in Europe pushed investors further into High Yield, which on average overshadowed the deterioration in credit fundamentals. However, it seems we have to face up to the facts in 2016.

## **2016 – The year of “no return”**

### **Commodities, rates, and the ECB**

Being long in commodities was the right formula during the financial crisis we experienced in the recent past. Nonetheless, target prices for commodities have proven to be too ambitious. Following the sharpest price drops ever in some commodities, moderate further price movements in either direction will not materially change the general picture. Many EM countries face severe challenges, which will not be resolved by a potential say 20% increase in exports, and the same holds true for many basic materials companies.

The mechanism behind this problem is very much the same we experienced during the Asian crisis in the mid-1990s. The starting point was the BRICs hype ten years ago, fuelling expectations that growth rates of EM countries would outperform those of industrial countries for decades. This triggered rising capital flows towards EM countries, which could be justified as long as rising commodity prices supported higher growth rates. This resembled a self-fulfilling prophecy, hinging on capital inflows remaining high.

Following a sharp drop in commodity prices, the mechanism reverted, prompting increasing capital outflows and widening current account imbalances. Venezuela provides a perfect example of this in practice. In January 2016, Venezuela CDS trades with an implied one year default probability of 70% (assuming a 25% recovery). Anything other than a default would be a surprise. Unfortunately, Venezuela is not the only fallen angel. Some countries, formerly touted as “rising stars” (like South Africa, Brazil, and Malaysia) are also facing serious problems due to lower commodity prices, reflected in a sharp widening of sovereign credit spreads. We think this will be a prolonged problem rather than a temporary anomaly, as there are presently no signs to support the thesis for a drastic increase in commodity prices. In this context, even the recent geopolitical issues failed to provide a floor for free-falling oil prices.

The global imbalances created in the past decade will finally take their toll, and this will effectively force most of the companies in the basic materials segment to calibrate their business model to cope with lower prices, lower margins and worsening refinancing conditions. In this scenario, spreads are expected to widen, not only for commodity-linked companies, but for the whole HY universe, as negative spillover effects take hold.

Another often-cited potential risk factor for HY markets is the end of monetary easing in the US. However, the latest increase in the target rate did not have any impact on the long end of the US yield curve, with 10Y yields still trading in the 2.0-2.4% range since April 2015. It appears “this time it’s different”. The Fed’s monetary policy since the Lehman crisis in 2008 was driven by crisis management considerations rather than by rational reference to real economic figures. Accompanied by very strong fiscal measures (nominal debt of the US government doubled since the beginning of 2008), the Fed avoided a breakdown of the financial system – unfortunately, at the expense of its independence. Through their provision of zero cost liquidity the Fed created a prosperous refinancing scenario for many companies as well as for countries which link their currency to the USD.

If the Federal Reserve increases rates to an economically justified level, it will not only affect the US economy, but also many EM countries. The central bank is no longer able to perform a “national” monetary policy. That said, we think the Fed will be significantly more moderate in the current rate hike cycle compared to the past. There is simply no room for an increase in the target rate to 4% (a level witnessed in previous cycles) without generating drastic problems in the EM space. From this perspective, we do not foresee an end to the low rate/low yield period in the US, but rather a carefully-timed, gradual move of the target rate to a maximum of 1%.

On the other side of the Atlantic, the ECB will likely persistently provide zero cost liquidity. We even expect some fancy new instruments to be introduced in 2016, as the ECB recognises once more that the current programs are insufficient to generate sustainable growth. At a first glance, this looks like a supportive factor for higher yielding assets, however, this will eventually turn out to be a double-edged sword, in our view. The technical situation for HY remains strong and in 2016 there will again be some investors who will feel compelled to buy into the market. This situation will lead to further decoupling between economic fundamentals and valuations in financial markets (namely a “bubble”). Lower quality issuers are benefitting only indirectly from the ECB’s refinancing rate and need to tap the capital markets for funding, as banks are still reluctant to provide credit facilities to companies at the lower end of the rating category, given tighter regulatory requirements. In stress scenarios, the refinancing pool will likely dry up immediately, as was the case with Abengoa. Loose monetary conditions are worth nothing if they do not lead to economic growth – and this will be the case again in Europe in 2016.

### New dimensions of risk & market concentration

The Lehman disaster and Euro crisis triggered a flood of regulatory adjustments, which not only affect the degree of freedom within markets, but also directly impact the risk aversion of market participants. We expect some alternative risk factors to gain importance in the current stage of the cycle, as described below.

By expropriating some of its investors through the Private Sector Involvement in 2012, Greece created a new paradigm of how to restructure entities at the cost of bondholders. This action was politically motivated and was only possible due to an ex-post amendment of the underlying bond program by introducing a Collective Action Clause. Since then, bonds governed by national law trade with a spread premium to bonds governed by international law. Moreover, legal risk is already a relevant parameter in the financial segment in Europe. Anglo Irish Bank expropriated its subordinated investors in 2010 (which has finally been ruled illegal), SNS did the same in the Netherlands in 2013, and towards the end of 2015 Portuguese Novo Banco randomly transferred senior bonds back to its Bad Bank, clearly breaching basic creditor rights like the *pari passu* treatment. Such measures are already common practice. In combination with a deterioration of investors’ rights in High Yield prospectuses due to the introduction of fancy clauses during the past few years, we think that the compensation for legal risk should be higher in general. Thus, legal risk is clearly becoming a more important part in analyzing High Yield companies, particularly in the current stage of the cycle.<sup>[1]</sup>

“Regulatory Overshooting” is another logical symptom in the current phase of the cycle. In the aftermath of the recent financial crisis, there was a flood of new regulatory measures targeting: a) markets (e.g. the short selling ban in Europe and the establishment of a clearing house for credit derivatives within EMIR), b) market participants (e.g. banks via Basel III and insurance companies via Solvency III), and c) general structural changes, such as strengthening European institutions in regards to market regulation (EBA, EZB). A key problem with introducing new rules is that many of them have opposing effects, and hence

end up offsetting each other. The more severe problem, however, is that the depth and the breadth of markets are negatively affected. The High Yield market has been a major victim of this development.

Due to the regulatory-induced risk reduction within banks and insurance companies, these major players are losing their importance in the credit markets in general, prompting a major shift in the allocation of credit risk among different groups of investors. In the absence of these previously important counterparts, the market’s reaction to exogenous shocks is becoming more volatile. This effect is intensified by rising inflows into multi-asset funds and ETFs, which have risen to the status of the predominant holders of credit risk. Together, these fund types already hold a significant market share in certain bonds/issuers, and we would argue that these investors react in a very similar manner in response to exogenous shocks that hit the market. As banks are no longer able to absorb a sufficient dimension of risk, a sell-off from asset managers & ETFs will trigger much more volatility, as witnessed in the previous crisis.

The latest fund closures from Avenue Capital and Nevsky Capital might be front running indications for what we should expect in the medium term. Markets are becoming less liquid, market moves are becoming more erratic, and old fashioned management techniques are becoming less efficient as diversification loses its power in a technically and systematically driven High Yield market.

### Outlook & attractive opportunities

Rising default rates, a persistent weakness in global stock markets, a decline in global growth momentum driven by EM economies, record outstanding High Yield debt globally due to strong primary market activity in the past years, and accelerating legal risk leaves us with a pretty clear forecast for 2016: HY spreads will tend to widen, with risks definitely skewed to the downside.

The most liquid proxy for High Yield risk in the US, the CDX HY spread index, hit a low in March 2015 @ 300 bps, trading above 500 bps at the beginning of 2016. We think 200 bps should be a good indicator for the widening potential of the iTraxx Crossover in 2016. The X-Over hit its low at around 250 bps in April 2015, and we think a realistic spread target for 2016 is the 450 bps area, which indicates a widening of 100 bps over current levels. Compared to its historical high of c. 1200 bps in the aftermath of the Lehman collapse, there is still room for further widening, especially in the event the Euro crisis resurfaces. The main risks for such a scenario are: a) the seemingly unstoppable immigration flows across Europe that have rekindled nationalistic sentiments among certain EU nations, and b) the ongoing discussions about Great Britain leaving the EU. In this scenario plays out, we expect the X-Over to reach levels of around 600-700 bps.

Wider spreads are accompanied by a widening of the CDS/bonds basis. That said, a more pronounced spread widening would imply an underperformance of bonds versus CDS, which would be supported by the technical situation of the market. In our view, the major risk from this side is the aforementioned skewed market structure, i.e. the dominance of

multi asset funds & ETFs in the cash HY market. This argues for a more drastic sell-off in bonds compared to CDS in the event of an exogenous shock.

Against this background, we think that diversification is not the appropriate tool to reduce risks in 2016. In a systemic crisis, correlations between different segments and issuers will jump to one, as was the case at the end of 2008/beginning of 2009 and in 2011. The good news is that opportunity picking becomes attractive in such a situation, as names with sound fundamentals indiscriminately get drawn into the sell-off. Consequently, single-name analysis and opportunity picking will become the most efficient management tools to generate returns this year.

An alternative way to generate returns without taking default risk is to set nominal hedged curve flatteners in the CDS space. During systemic shocks, credit curves tend to show a bear flattening, i.e. shorter dated CDS underperform the belly of the CDS curve. Single-name flatteners incorporate the favorable feature of providing a hedge against a jump to default. We like the character of single name curve flatteners, which are preferable to directional long positions in case of a dramatic spread widening, while they generate roll-down returns if markets are stable or if spreads grind even tighter.

Finally, investors could also implement some alternative hedging strategies to benefit from single name picks in a more severe market meltdown. Hedging HY risk via equity puts seems to be an appropriate tool, especially in a scenario of front running equity markets. The VSTOXX (implied volatility index on the Euro Stoxx 50) is currently trading at 30%, while it reached the 55-60% level during the peak of the Euro crisis in 2011. Being long in equity volatility to hedge temporary spread spikes is one of our preferred ways to eliminate systemic risk.

To conclude, we expect a difficult year ahead for HY markets, bearing in mind that there are always some very good opportunities in times of high spread volatility. This leaves us with the motto for 2016 in reference to Monty Python: "Always look on the bright side of life!"



# Top Picks 2016



In the following section, we provide an overview of our top investment ideas for 2016. As we are taking a 12 month view, the ideas discussed herein may differ from those provided in our other publications. In general, we are cautious about the short to medium term outlook for European HY; however, we believe that there are opportunities for single-name picking. Given our view on markets and economic risks, we prefer less-cyclical names. Therefore, our short ideas focus on cyclical names (no TMT or Healthcare short recommendations), while our longs are skewed towards non-cyclical issuers. We are apprehensive of metals & mining from a fundamental perspective, but think current levels reflect broadly fair value and do not include any bonds from this sector. The recommendations for other sectors are more diverse.

## LONG TRADE IDEAS

<b>ALTICE</b>	"Buy" the ALTICE EUR 6.5% 01/22 at 104.6 or a Z-spread of 511 bps (YTW of 5.3%)	Altice's growth through large debt-funded acquisitions is being largely matched by EBITDA improvement through cost-cutting. However, we remain concerned about the size and pace of the group's acquisition programme, its elevated leverage, the absence of a credible financial policy and management being overstretched. Nevertheless, Altice's bond yields offer a small premium to reflect the range of risks attached to the group.
<b>ARDAGH</b>	"Buy" the ARGID 6.25% USD bonds due 1/19 at 98 or a Z-spread of 582 bps (YTW of 7%) and the ARGID 6.75% USD bonds due 1/21 at 98 or a Z-spread of 581 bps (YTW of 7.2%)	Ardagh delivered a solid result in 2015, propelled by a steady Glass business and a recovery in Metals. Given our expectation of further cost efficiencies, synergies and growth in the Metals portfolio, we believe organic de-leveraging will continue. Due to macro volatility, Oressa's IPO seems to be off the table for the time being, but could be a positive catalyst in the next 12-18 months
<b>CEMEX</b>	"Buy" the CEMEX 5.25% 04/21 at 96 or a Z-spread of 593 bps (YTW of 6.3%)	CEMEX bonds have been impacted by weakness in emerging markets and F/X has been a drag on the company's finances. However, we still believe that the company will gradually improve its credit profile towards an investment grade rating. Further, the company should benefit from its strong exposure to the US, a recovery in Mexico and a decent performance in Europe.
<b>CIRSA</b>	"Buy" the 5.875% 05/23 at 95 or a Z-spread of 627 bps (YTW of 6.9%)	An optimistic earnings outlook for FY 2016 and a potential IPO should lead to material improvement in Cirsa's credit metrics next year.
<b>CMC</b>	"Speculative Buy" on the CMCRAV 7.5% 08/21 at 84.5 or a Z-spread of 1,109 bps (YTW of 11.7%)	CMC's healthy order book provides a high degree of revenue visibility. In FY 2015, the company increased EBITDA margins, though cash flow disappointed. The credit profile should be supported by a release of working capital, driven by payments from ANA, a shift towards larger-scale international contracts and a settlement of the Ingula project. That said, CMC is subject to cyclical swings and a potential restructuring of Isolux would likely impact margins.
<b>DOUGLAS</b>	"Buy" the DOUGR 8.75% 07/23 at 101 or a Z-spread of 834 bps (YTW of 8.7%)	We like the relatively low degree of cyclicity of the business, Douglas' market leading position, its solid internet platform, strong management team and healthy free cash flow generation capabilities. However, its aggressive growth strategy is of concern.
<b>INEOS</b>	"Sell" 1Y CDS at 198 bps	Given its strong cash buffer and lack of maturities over the next year, there are no short-term liquidity concerns. While Ineos may be subject to market volatility, this is a buy-and-hold-to-maturity trade.
<b>KLOECKNER PENTAPLAST</b>	"Buy" the KPERST 7.125% due 11/20 at 102 or a Z-spread of 643 bps (YTW of 6.5%)	KP has de-levered half a turn since its dividend recapitalisation in mid-2015, driven by F/X tailwinds and organic growth. We expect organic growth to continue, thanks to robust end-market demand and cost efficiencies. While we think management will be prudent in its acquisitions, this remains a modest risk to de-leveraging.

## LONG TRADE IDEAS (CONTD)

<b>LIBERTY GLOBAL: UNITYMEDIA</b>	"Buy" the UNITY 02/26 EUR 4.625% at 100.6 or a Z-spread of 395 bps (YTW of 4.6%)	We think the outlook for Liberty Global is positive, albeit leverage is set to stay high. Unitymedia is a strongly performing credit, with a well-entrenched position in an underpenetrated German market.
<b>LIBERTY GLOBAL: UPC HOLDING</b>	"Buy" the UPCB EUR 6.375% 09/22 at 106.8 or a Z-spread of 408 bps (YTW of 4.0%)	This credit group combines LG's operations in Switzerland, Austria, Hungary and other Central and Eastern European countries. Thus, UPC benefits from modest geographical diversification and from being part of the strongly performing LG group.
<b>SAMVARDHANA MOTHERSON</b>	"Buy" the MSSIN 4.125% 07/21 at 94.3 or a Z-spread of 507 bps (YTW of 5.4%).	SM should continue to benefit operationally from the robust outlook of global auto markets in 2016. Consequently, we expect the firm's credit profile to improve. The bond's are trading below par and we see this as an attractive entry opportunity.
<b>UNITED GROUP</b>	"Buy" the ADRBID 7.875% 11/20 at 105.3 or a Z-spread of 589 bps (YTW of 5.9%)	UG should continue seeing organic and acquired growth over the medium term, leading to a modest reduction in leverage through EBITDA growth. This trend could reverse if a major acquisition opportunity presents itself. Conversely, a credit-positive exit by PE/management shareholders via a trade sale to a large consolidating cable player within the next three years is a strong possibility.

## SHORT TRADE IDEAS

<b>ALDESA</b>	"Sell" the ALDESA 7.25% due 04/21 at 72.5 or Z-spread of 1,485 bps (YTW of 15.6%)	We remain concerned about Aldesa's substantial off-balance sheet liabilities, a potential spill over from Isolux and Abengoa as well as tightening liquidity (currently adequate) if reverse factoring substantially reduces.
<b>CABB</b>	"Sell" the CABBCO E+475 bps 06/21 notes at 99 or a DM of 496 bps and the CABBCO 5.25% 06/21 notes at 98.5 or a Z-spread of 532 bps (YTW of 5.7%)	We expect CABB to face a challenging 2016, and the subordinated notes seem to be already reflecting this. In contrast, the senior notes are trading tight on a relative basis, and we expect at least another 50-75 bps of widening.
<b>IGLO</b>	"Sell" the IGBOND FRN E+450 bps 06/20 at 99.5 or an DM of 463 bps	In the past, Iglo has performed very well, but we are somewhat concerned about integration risk in regards to Findus, the change in strategy and recent margin pressure. We do not believe that current spread levels adequately reflect the risks inherent to the company.
<b>SGL CARBON</b>	"Sell" the SGLGR 4.875% 01/21 at 99 or a Z-spread of 490 bps (YTW of 5.2%)	We expect a very soft FY 2016, driven by weakness in SGL's core electrodes business. Positively, liquidity is adequate for the time being and the technology business has recently improved. Still, we believe that current bond prices do not adequately reflect current risks.
<b>SOLOCAL</b>	"Speculative Sell" on the PAJFP 8.875% due 06/18 at 71.3 (YTW of 27.4%)	Solocal is still struggling to transform quickly enough to a digital business from a paper-based activity. A breach of its bank debt leverage covenant is likely this year, unless the company receives another equity injection and bank A&E. Moreover, management of this accident-prone company has proved in various ways that it has the capacity to surprise negatively.

## SWITCH TRADE IDEAS/OTHERS

<b>SKG/ SAPPI</b>	"Switch" out of the SKG 06/21 EUR bonds at 103.8 or a Z-spread of 223 bps and into the SAPSJ 04/22 bonds at 96 or a Z-spread of 374 bps for a 151 bps pick-up on a lower cash price.	We like the fundamentals of both credits. While SKG faces issues in LatAm, we do not expect these to be onerous. Sappi has delivered a solid performance despite its graphic paper exposure, and is set to de-lever further in the next two years, driven by cost efficiencies and improved returns from recent investments.
<b>MOTHERSON/ SCHAEFFLER</b>	"Switch" out of the SHAEFF 5.75% 11/21 at 106.3 or a YTW of 3.6% and into the MSSIN 4.125% 7/21 at 94.3 or a YTW of 5.4% for a c. 1.8% YTW pick-up	While we are fundamentally positive on Schaeffler in the medium term, we believe the notes are trading very tight relative to other auto names in our universe. Hence, we recommend investors to switch from the SHAEFF 5.75% due 11/21 into the MSSIN 4.125% due 7/21 for upfront cash of c. 12 pts and a c. 1.8% yield pick-up on a better-rated credit and similar maturities.





The positive momentum in global auto markets sustained in 2015, with annual sales growing 1.5% y-o-y, albeit regional patterns varied. Europe and the US continued to exhibit robust demand. In contrast, LatAm and APAC experienced weak demand due to economic uncertainty. Hence, geographic exposure was once again a key driver for performance of companies in this sector. With the exception of Aston Martin, all companies in our universe benefited from robust growth in developed markets, which offset EM weakness. While recovering industry dynamics (especially in Europe) supported growth, they also prompted an increase in capex, impacting credit stats. In H2/15, the industry faced negative publicity from the Volkswagen scandal, which led to some volatility in bonds in the sector. M&A included Grupo Antolin acquiring Magna Interiors, the demerger of Ferrari from FCA, Schaeffler's IPO and an equity injection into Aston Martin. In 2016, the global auto markets are forecasted to grow 2-3% y-o-y. This will likely be complemented by lower fuel prices, ameliorating economic conditions in developed markets, less contraction in LatAm and an improvement in the Chinese auto markets. Further, we expect regulatory scrutiny of compliance with safety and emissions standards to increase. Overall, this year should turn to be another decent one for auto companies in our coverage.

# Building Materials & Construction



2015 was a decent year for building materials companies. Improved results for a majority of players in this space were supported by a continued recovery in the US, with Europe and Mexico performing reasonably well, while LatAm faced challenges. Margins were aided by lower energy prices and cost saving initiatives (particularly Xella). F/X had a substantial negative impact on CEMEX. Industry consolidation continued, with HeidelbergCement agreeing to buy a 45% stake in Italcementi in July. We expect the recovery in North America to continue and anticipate a stable development for Europe, albeit with risks skewed to the downside. We are cautious about emerging markets. Concession type infrastructure had a terrible year, as companies' ability to pursue project funding deteriorated substantially and the high amounts of debt-like instruments (such as reverse factoring) came under scrutiny. As a result, Abengoa filed for creditor protection. Furthermore, Isolux is struggling with asset disposals, its business in Brazil and payment collections, with bond prices trading at distressed levels. We expect another challenging year in 2016. Construction company CMC had a strong year in regards to new orders, but also struggled with payment collection, while HSS Hire faced rapidly deteriorating market conditions following its successful IPO.



# Cable & Communications



Rapid European cable and telecoms market consolidation continued in 2015. This was driven by the convergence of players towards one business model that involves offering multi-product bundles aimed at increasing ARPU and enhancing customer loyalty. The goal is to build and own, rent, or acquire sufficient assets to handle and monetise the strongly growing demand for downloaded TV/feature films and social media. As a result, we expect further investments in high-speed mobile and fibre-based infrastructure as well as in high-tech customer set-top-box equipment to tackle the growing threat from “over-the top” services. 2015 saw Altice take over the lead from Liberty Global in the land-grab for cable and telecoms assets. It bought Portugal Telecom, followed by two US cable-TV companies, turning it into a top-four US cable player. Liberty Global bought Cable & Wireless and Belgian mobile company BASE. Vodafone’s ongoing need to add fixed assets led to asset swap/takeover talks with Liberty Global that failed, but may resurface in 2016. Larger industry players such as Liberty Global and Altice continued to buy content assets such as film and TV production capacity, and sports rights. We anticipate fixed/mobile convergence in a number of markets and note that the EC competition regulator has become skeptical of the consumer benefits of in-market mobile consolidation. One such deal in Denmark has already been abandoned, while regulatory approval is no longer guaranteed for combinations in Italy (Wind and Three), the UK (O2 and Three) and Belgium (Telenet and BASE).

# Chemicals



2015 was a strong year for chemicals. Oil prices hit record lows and issues in China and other EM countries exacerbated, but demand in the US and Europe remained fairly robust, supporting margins. Chemical players in our coverage universe displayed diverse trends. Supply side issues across the US and European olefins stream aided Ineos' margins, well supported by solid demand for polymers. Significantly lower naphtha costs also helped the European businesses. For Perstorp, plasticizer prices remained under pressure due to a supply imbalance. Even so the group generated high margins, thanks to strong volume growth (organic and from Valerox). Kerling completed the JV with Solvay, and strong results following the merger seem to vindicate the move. CABB's earnings were solid, mainly driven by strong contracting and lag effects. We see another challenging year ahead for companies in the agro-chemicals chain and/or exposure to agro-chemicals end markets. Lower oil prices should once again meaningfully impact top lines, but companies like Ineos should be able to pass-down the weakness through the chain and generate fairly stable margins. Supply-side shocks and F/X could be key drivers this year as well. Following the inflow of shale gas into Europe, earnings should be aided by better cost dynamics, however, we expect this to be a medium term driver, given the low differentials between naphtha and ethane at present.





2015 was a mixed year for the consumer industry. Internal efforts and turnaround plans were key themes, given deflationary conditions across Europe. New Look, Maisons Du Monde, Takko and Premier Foods all benefited from improvement initiatives put in place in prior years, while Agrokor focused on realising synergies from Mercator. Iceland Foods, Boparan and HEMA had a challenging year. The biggest negative surprise came from Matalan, where execution issues at its warehouse led to a severely weak operating performance and covenant amendments. That said, the industry attracted reasonable investor interest and witnessed several ownership changes. We think 2016 will present limited organic growth opportunities, given ongoing deflationary pressure. Hence, consumer companies need to devise effective strategies to grow through promotions, innovative products, improved customer satisfaction and productivity enhancements. Expansion in new international markets, portfolio rationalisation, restructuring and capex to improve processes will also be critical drivers in 2016.

# Gaming



The gaming sector in 2015 was dominated by regulation, as Italy and the UK adopted firm stances towards the industry in a bid to manage stakeholders' expectations. The UK witnessed consolidation, with a merger between Ladbrokes and Gala to be completed by H1/16. Operationally, Cirsa, Gala Coral and Gamenet delivered robust results, while Ladbrokes disappointed. Codere finally saw the passage of a restructuring plan that was doing the rounds for over a year. Looking ahead, we expect further consolidation as industry players band together to better address regulatory concerns. While regulation remains a key driver, the nature of changes brought about in Italy via the 2016 Stability Law suggests more rational stakeholder behaviour. In terms of operations, unit bets could increase, driven by fewer machines and a higher share of wallet.



# Healthcare

Government austerity measures continued in the US and Europe in 2015. This affected the healthcare industry, which should in theory be benefitting from strong demand from an ageing population. Instead, UK elderly care providers such as Four Seasons found little revenue growth due to the budget constraints of public payers, while still suffering from significant cost inflation, driven by staff shortages. The staff cost situation is about to get even worse in the UK, with the introduction of a new, raised National Living Wage for low paid workers. As a result, highly leveraged Four Seasons has called in advisers to help it avert a looming liquidity crisis. Priory also has some cost issues, but is at the high-quality end of the industry and benefits from an ongoing and accelerating trend in outsourcing of acute psychiatric care by the National Health Service. These positives were recognised by US behavioral therapy concern Acadia, which is buying Priory from its PE owners. Switzerland-based medical testing and imaging company Unilabs also continued to face pressure on prices, but countered this with organic growth and cost controls driven by a business turnaround programme. Its industry is still fragmented, with the largest players seeking growth through acquisitions and mergers. Meanwhile, US medical device business ConvaTec suffered the multiple negative effects of pricing pressure, higher SG&A costs and USD strength. Compounding this was a catalogue of internal control problems and product recalls (some serious), all of which will likely further delay a shareholder exit.



# Industrials



As the various sub-segments follow different patterns, 2015 was a diverse year for industrials. Algeco Scotsman had a challenging year, but the outlook appears to be improving gradually. Bombardier disappointed, with its Aerospace segment substantially underperforming peers and struggling with delays in the CSeries and the Global 7000/8000, while Transportation continued to post poor margins despite decent new orders. As a result, Bombardier pursued substantial capital raising activities, and we expect 2016 to be another very weak year, with an improvement delayed into 2017. CNH Industrial suffered from market weakness in agricultural equipment and construction equipment, partially mitigated by improving commercial vehicles. The outlook is soft. Heat Exchangers had a slightly improved but still weak 2015. 2016 should see further improvement, despite the slump in the high-margin oil & gas business. SGL Carbon reported very poor results, impacted by its core electrodes business, whereas technology applications reported improving numbers. 2016 will likely be another very poor year for the group. KraussMaffei delivered very good numbers, which should continue this year. Ista and Techem reported solid results, with the outlook remaining decent. Rexel faced significant challenges, driven by weakness in North America, while Nexans appears to be turning around. Senvion had a superb year, with its sponsors aiming for an exit in due course.



# Media



Aided by a slightly improved economic backdrop, market conditions for European media continued to improve in 2015, but were still not buoyant. That said, the economy provided insufficient support to French directory advertising company Solocal, which is still struggling to transform quickly enough to a digital business from a paper-based activity. Thus, another equity injection and bank A&E might be needed this year. Cinemas had a much better year than in 2014, when the combination of the World Cup, a weak film “slate” and unseasonably warm weather hurt attendance across Europe. In 2015, Odeon and Vue benefitted from a vastly improved film slate and slightly improved economies in Europe. Over the recent difficult years, Vue outperformed struggling Odeon and took advantage of a consolidating market by making a number of relatively large international acquisitions. We expect Vue to take part in further industry consolidation in 2016. Management changes and a business transformation plan at Odeon are increasingly benefitting its performance, making a sponsor exit this year more likely. Still, looking further ahead, the cinema business may be pressured by proliferation in consumers’ homes of “smart” devices, including large-format, high-definition flat-screen TVs capable of downloading or streaming top films from Internet-based content providers. While the industry expects a decent film slate across Europe in 2016, the year will also see the Olympics and the UEFA football championship, both of which will depress audience numbers to some extent.

# Metals & Mining



Following a terrible 2014, the downturn in metals & mining accelerated in 2015. This was driven by overcapacity and lower demand (especially in China), leading to severe pressure for most commodities. European coal producers had a disastrous year, with New World Resources having to pursue a financial restructuring. Coal prices remained depressed, with no short-term recovery in sight. Premium benchmark Australian hard coking prices dropped an average 15%, while thermal coal also faced material challenges, as a warm winter resulted in muted demand. European steel producers had a challenging year, including SCHMOLZ+BICKENBACH and Ovako. European steel prices declined by over 50%, depending on the type, driven by structural overcapacity and muted demand. US steel markets also remained weak. Further, delayed pass-through of falling input costs led to margin pressure in H2/15. The outlook for European steel producers remains soft, although reduced energy and input costs as well as the strong USD should be supportive. Other metals also underperformed, with zinc (Nyrstar's main product) slumping c. 32% since the peak in July 2014. While the medium-term outlook remains favourable and industry experts expect demand growth to outpace supply, China remains a risk factor.



# Paper & Packaging

Paper markets remained structurally oversupplied in 2015, despite capacity shutdowns. Newsprint was the worst affected grade globally, with both demand and pricing down considerably y-o-y in 9M/15. We expect some price traction in the near term, albeit its sustainability remains questionable. Norske Skog entered the second round of capital restructuring in less than 12 months. In contrast, Lecta and Sappi generated decent margins on the back of higher pricing for CWF, specialty paper and chemical cellulose. Liquidity for the latter two players is strong, an essential quality during these uncertain times. Cost management was another key factor in 2015, driving differing results across companies. Packaging had a robust year, with all sub-strata (i.e. glass, metals, and paperboard) generating decent margins. Main drivers were low raw material and energy costs (especially in energy-intensive industries), which helped preserve - and in some cases even grow - margins. Looking ahead, we expect specialty paper and packaging companies to generate resilient margins, more so if they exhibit defensive end market characteristics like pharma, consumer staples and F&B. Integrated producers will also benefit from this trend. Pulp costs will likely remain elevated for the first half of 2016, before normalising by early 2017, with F/X playing a key role in this regard.



[illegible]



# Shipping & Logistics



Overcapacity issues continued into 2015, driving down freight rates in container shipping to almost cash-cost levels. This led to the formation of key alliances and several strategic mergers in a bid to generate greater synergies and efficiencies. Operationally, container shipping rates suffered, though volumes were decent, providing some offset. Industry players continue to invest in large TEU vessels in anticipation of the opening of the Panama locks. We think it is imperative for scrapping to catch up, otherwise the recovery in shipping rates will be L-shaped rather than U-shaped. For Stena, Tankers was the best performing segment, followed by Ro-Ro, while Drilling was weak. We expect 2016 and 2017 to be even weaker for Drilling, and while Stena was protected so far due to strong contracts, renewals could be challenging. In the medium term, we anticipate a very gradual recovery in container freight rates (more back-ended), while Tankers is likely to continue to rally, provided oil prices remain low. LNG will likely only rebound in 2017 once market balance is restored, for which oil prices must first recover. Aviation services companies had a decent year, supported by strong growth in passenger traffic and decent air freight volume growth. WFS operationally outperformed Swissport, benefitting from acquisitions and F/X. 2015 was a year of consolidation, with a number of mergers and acquisitions and we expect 2016 to be no different. In the medium term, we anticipate moderate growth in aviation services, driven by increasing passenger numbers and air cargo volumes.

# Technology

During 2015, there was no let up in the exponential growth in demand for downloaded data on computers and on connected devices such as smart TVs, domestic set-top media boxes, “over-the-top” boxes, smartphones and tablets. As a result, telcos and cable companies continued to invest in upgrading their installed equipment and networks to ensure that they can capitalise on the trend. While the major network equipment suppliers continued to benefit from these demand factors, they have also been suffering from soft market prices driven by the successful arrival of Chinese competitors Huawei and ZTE, which have been intent on gaining market share. Despite these pressures Alcatel-Lucent continued to improve in 2015 and is expected to hit its target of generating positive operating cash flow by year end. This was mainly the result of the turnaround plan introduced by senior management, which involved addressing deep-seated cost-based issues, selling or restructuring underperforming units and refinancing and terming-out the group’s borrowings. The telco equipment industry has seen some consolidation over recent years, for example with Alcatel and Lucent merging and with Nokia absorbing the Siemens business. We expected further market consolidation, hence it was no surprise that Alcatel’s business turnaround signaled to Nokia that it was time to make the all-equity acquisition that just closed.



# Travel & Leisure



2015 was a decent year for travel and leisure players in our coverage universe despite geopolitical events, including several terrorist attacks. The UK tourism market developed favourably, while the Nordics recovered. However, Germany suffered from competitive price pressure and France continued to face challenges. Once again, TUI outperformed Thomas Cook, albeit F/X had a negative impact on the latter (reporting currency is GBP). During 2015, Thomas Cook established a JV with Chinese conglomerate Fosun. The outlook appears solid for both companies, with encouraging booking trends for winter and summer. Europcar again delivered credible results and pursued an IPO that substantially improved its credit profile. The outlook is decent, supported by lower fuel prices. In travel management, Europe and North America faced some headwinds with oil & gas-related activities particularly soft, though the FY 2016 outlook points to a recovery. Overall, successfully executed restructuring initiatives should support travel and leisure firms in our coverage universe and we expect a decent 2016, provided there are no major negative geopolitical events.

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