Peripheral vision

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Peripheral credit has outperformed this year, reflecting its wide spreads at the start of the year and its high beta to the market. We expect further outperformance next year, given that these credits continue to trade at a premium to core credits and our constructive outlook for credit in 2014.

- **We expect the systemic components of peripheral premium to fall.** Peripheral credits continue to carry a premium to similarly rated core credits. In our view, fair value for IG rated peripherals is between core credits of the same rating, and core credits rated one-notch lower – reflecting the potential (but not certainty) of a sovereign-driven ratings downgrade. That implies room for further compression from current levels.
- **In financials, we recommend positioning for the peripheral/core compression in senior bank debt**, where the premium for peripheral risk is by far the most attractive on a risk-adjusted basis. In sub debt, we think it is better to position for compression in LT2s, given that in this sector, the premium has actually not compressed this year despite a material tightening in Spain and Italy spreads.
- **In IG non-financials, we believe in the core thesis that operational trends are the greater risk to ratings**. In our view, the optimal way to invest in IG non-financial peripheral credit is to focus on issuers with strong fundamentals rated Baa2 or higher. We would pair these with underweight positions in core names with negative operational trends.
- **In HY non-financials, we expect perceived refinancing risk to abate.** Currently, the remaining peripheral premium is concentrated in the 2-to-4 year duration portion of the curve, particularly for lower quality (single-B) credits. We believe this reflects investor concern over the potential for these names to refinance beyond their visible liquidity horizon. With high yield primary markets being increasingly accommodating to peripheral names, these concerns look misplaced.
- **In corporate hybrids, the peripheral/core theme is less pronounced.** The price action in the sector is generally more idiosyncratic, especially after a wave of new issuance from names facing a variety of operating headwinds as opposed to being linked to the weakness in the sovereign.

Selected Trade Ideas

- Switch out of ACAFP €3.9 '21s LT2 into UCGIM €6.125 '21s LT2.
- Switch out of ORAFP €3.875% '21s into TELEFO €3.961% '21s:
- Buy Wind Telecomunicazioni (WINDIM) senior secured €7.375% '18s
- Buy Nara Cable Funding (ONOSM) senior secured €8.875% '18s and Ono Finance senior unsecured €11.125%'19s.
- Buy Avanza Grupo (AVAN) senior secured 7.5% '18s.

Peripherals 'Beta' the market in 2013

Peripheral credit has outperformed non-peripheral credit year-to-date (YTD), as would be expected of high-beta securities in a rallying market. In line with a more general high-beta, low-beta compression over the course of 2013, the spread between peripheral credits and non-peripheral credits has fallen significantly – from c.165bp to c.115bp for financials and from c.105bp to c.70bp for non-financials (Figure 1).

At the sovereign level, peripheral risk is now perceived as being less systemic, as evidenced by the lack of contagion between domiciles during various risk flare-ups over the course of 2014 (eg, Cyprus). This is also the case for corporates, where peripheral fallen-angels have resulted from operational trends rather than sovereign re-ratings. The transition from systemic to idiosyncratic risk has been our key theme in 2013 and is something we expect to continue through 2014. And as systemic risks recede, we expect the market in general to rally and peripherals to outperform in the move tighter (reflecting both their beta to the market and their proximity to the source of systemic risk in Europe).

Decomposing the (remaining) peripheral premium

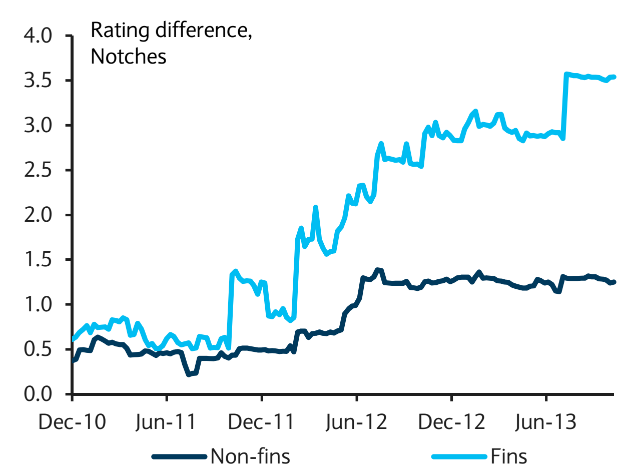
When considering the likely performance of peripheral credits over the next 12-18 months, we believe it makes sense to decompose the "peripheral premium" into three components:

- **Weaker operations**: Peripheral European economies remain weak relative to the euro area average and this is unlikely to change in 2014. In particular, domestic demand will remain subdued due to the ongoing process of "internal devaluation". Corporates with significant exposure to demand in these countries are likely to see continued weakness in organic revenue growth.
- **Sovereign rating risk**: For the majority of peripheral corporates (in particular financials), ratings remain capped by their sovereigns – as evidenced by mutual negative outlooks. Hence, peripheral corporates should provide additional spread relative to non-peripheral peers given the risk of sovereign-driven rating downgrades.
- **Redenomination risk**: At the height of the euro area crisis, there was significant investor concern that some peripheral countries could exit the euro area and redenominate their economies, creating FX risk between corporate revenues and their debt obligations (plus the risk that debt obligations themselves would be redenominated).

FIGURE 1
Senior €-IG credit, peripheral versus non-peripheral

Note: 3-7y senior bonds only. Source: Barclays Research

FIGURE 2
Rating trends, peripheral versus non-peripheral



Source: Barclays Research

Redenomination risk is close to zero

Since Mario Draghi's "Whatever it takes" comments, followed by the announcement of the ECB's OMT programme, concerns that one or more member states could exit the euro area have fallen to (essentially) zero. This has been reflected in the sharp fall in sovereign spreads over this period – which has been a significant tail-wind for peripheral corporate debt. In our view, the risk premium for redenomination should remain very close to zero during a period in which economic growth is accelerating (albeit slowly).

Sovereign risk is stabilising, but still matters

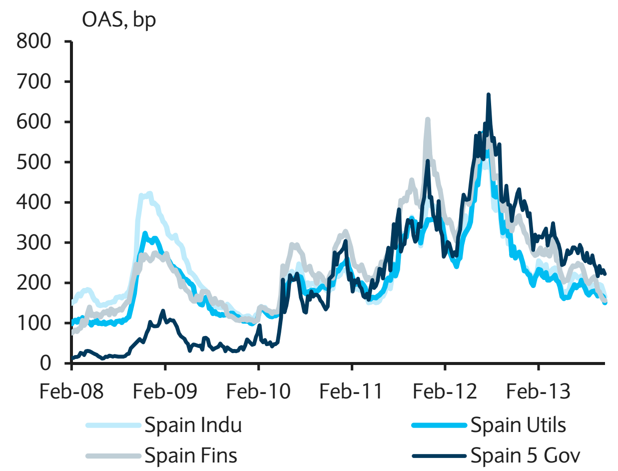
The nature of peripheral sovereign risk has changed over the past year, in our view. Rating agencies maintain their negative outlooks on Spain, Italy and Portugal but focus has shifted away from market access and toward long-term growth-friendly reform, political stability and long-term debt sustainability. As peripheral Europe emerges (slowly) from recession, downgrade risks move from being an acute, near-term overhang to a long-term concern. Near-term downgrade (and hence junking) risks for peripheral credits are now more likely to be driven by operational performance than sovereign downgrades.

The sovereign outlook remains important for investment grade peripheral credits, however. In particular, the upside for peripherals credit is likely to be capped by the performance of the sovereign. As shown in Figure 3, blue-chip Spanish credits already trade through their sovereign – the same is true of Italian corporates versus the Italian sovereign. This is not unreasonable, given that many of them are now rated 1-2 notches above their governments (Figure 4). However, the strong correlation of these spreads suggests that there is a limit to how rich corporates can trade versus their government. Indeed, client conversations tell us that the relative value between corporates and governments is key for domestic investors. In our view, sovereign spreads will need to continue to perform if IG peripheral spreads are to compress further against core credits.

Further, the sovereign rating (and outlook) remains a cap on rating upside for corporates and a continued overhang to the downside. While the downgrade risk to Italy and Spain has become less acute, it has not completely dissipated. To isolate the "downgrade" risk in peripheral credits, we analyse the current OAS spread difference between peripherals and non-peripherals in two scenarios: where the index ratings are the same; and where the non-peripherals are rated one-notch lower. The results are shown in Figure 5.

FIGURE 3

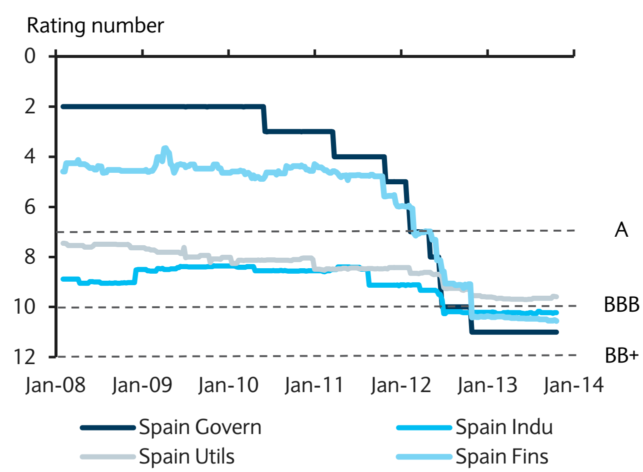
Spanish corporate spreads versus the Bono spread



Note: Spread measured versus the Bund curve. Source: Barclays Research

FIGURE 4

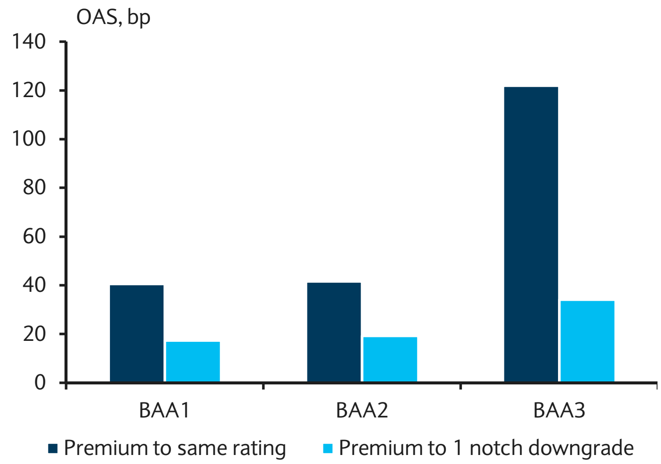
Spanish corporate rating trends versus the sovereign



Source: Barclays Research

FIGURE 5

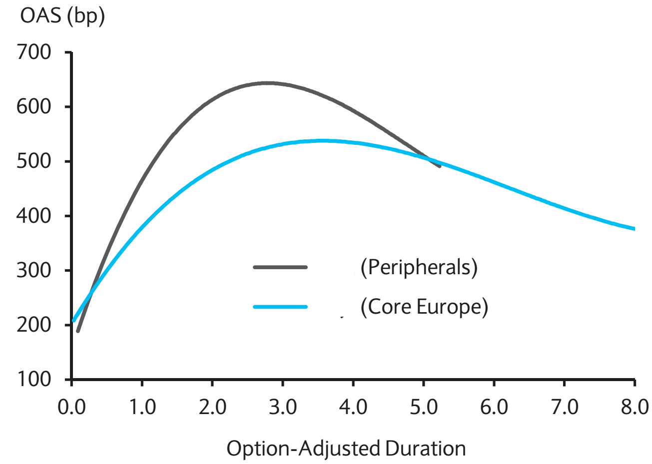
Spread premium, peripheral versus non-peripheral credit



Source: Barclays Research

FIGURE 6

Single-B rated peripheral and non-peripheral cash curves



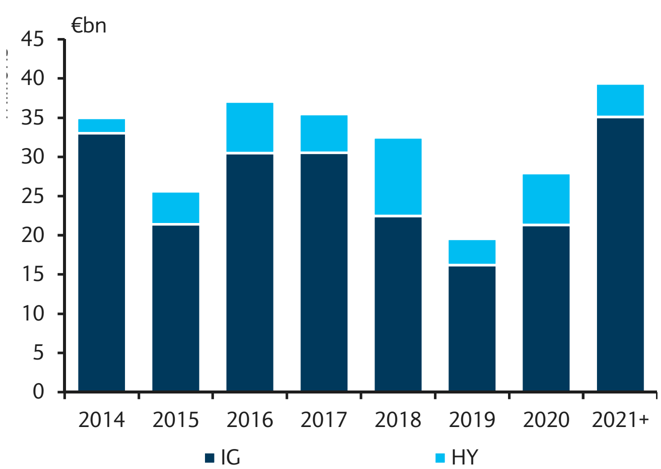
Source: Barclays Research

This analysis highlights that the risk of a one-notch downgrade can explain some, but not all, of the peripheral premium in investment grade credit. In high yield credit, the downgrade premium is very small – which makes sense as many rating agencies loosen their sovereign linkages below IG (ie, the HY corporate rating is not capped). Overall, it appears that there is at least 15bp of excess risk premium in €-IG peripheral credit (allowing for the potential impact of a one-notch downgrade). We expect this to fall in 2014.

The downgrade premium in Baa3 credits is particularly large, which we would expect given the importance of the Investment Grade/ High Yield rating transition for many investors. At the same time, we note the relative smoothness with which the market absorbed Moody's downgrade of Telecom Italian to High Yield. While TITIM bonds have not yet left investment grade indices, this seems to indicate that investors are well-prepared for the potential for peripheral credits to migrate out of Investment Grade portfolios. This makes sense to us, given that the euro area crisis was in focus for so long many investors will have had to plan for events such as mass downgrades of Spanish and Italian corporates.

FIGURE 7

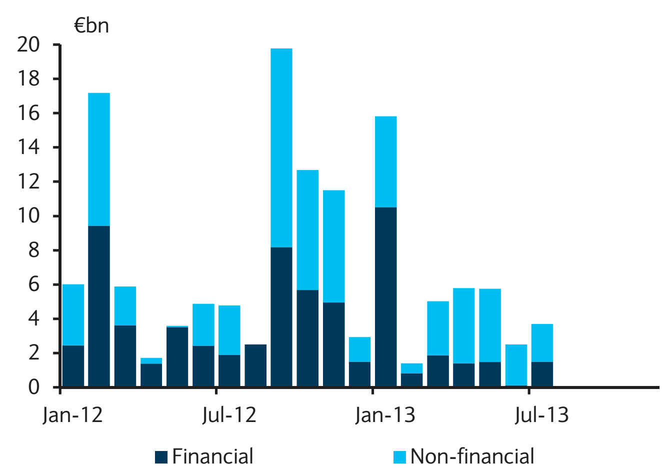
Peripheral credit redemption profile



Note: Based on Barclays corporate bond indices. Source: Barclays Research

FIGURE 8

Peripheral corporate debt issuance



Source: Dealogic, Barclays Research

Finally, we note that the peripheral premium tends to have a clear term structure, for both High Yield and Investment Grade names. In particular, it tends to peak around the 3-4 year area, which makes some sense from a fundamental perspective as this tends to be the area where most peripheral credits have meaningful, uncovered redemptions – ie, where refinancing risk peaks as most peripherals issuers maintain 18-24 months of liquidity coverage (Figure 7). That said, market access for peripherals has seen a clear improvement over the past year with rising issuance volumes (Figure 8). Further, we have seen other signs of confidence such as issuance of subordinated instruments (corporate hybrids, bank capital securities, and PIK toggle notes).

Operational risks remain

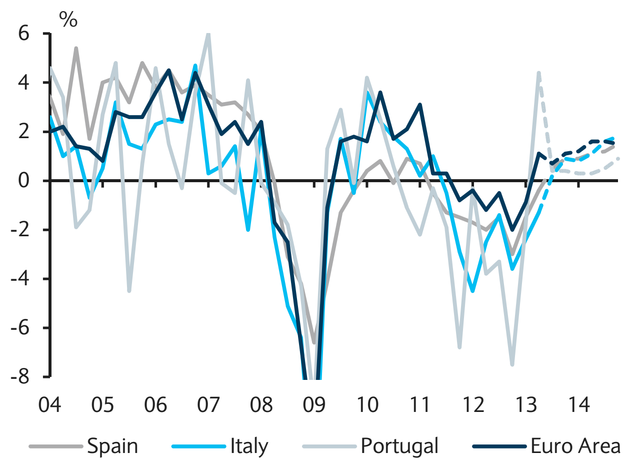
One component of the peripheral premium that is likely to be more enduring, in our view, is that associated with operating in countries with below-average growth. The peripheral countries have, in general, suffered much deeper and more protracted recessions than the rest of Europe, and are likely to see only gradual recoveries given the continued weakness in credit growth. As a result, their growth rates are likely to lag the rest of the euro area for most of 2014 (Figure 9).

While the programme countries (plus Spain) have undertaken significant structural reforms, which should raise trend-growth in the long term, most of these have been associated with "internal devaluation". More simply, the policies pursued have pushed up unemployment, pushed down on wages (unit labour costs) and in so doing depressed domestic demand. Hence, even as they emerge from recession, consumption in these countries is likely to remain extremely weak by historical standards. That, in turn, will weigh on the revenue growth of corporates with exposure to these markets.

All that said, we believe that this economic reality is already reflected in credit ratings, in the outlook on ratings and in sovereign rating linkages (where applicable). We acknowledge that credit ratings tend to lag balance sheet and operational developments, but the pace of change in fundamentals has slowed significantly over the past 12 months. In our view, ratings have "caught up" to credit fundamentals in the periphery. Hence, we do not see a strong argument for peripherals to carry a significant spread premium over core credits with the same ratings and rating outlooks.

FIGURE 9

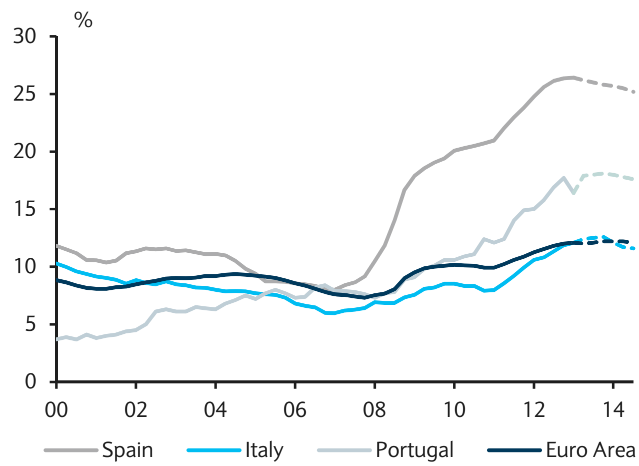
Euro area GDP growth (% q/q saaar)



Source: Barclays Research, Eurostat

FIGURE 10

Euro area unemployment trends



Source: Barclays Research

We expect the systemic components of the peripheral premium to fall

Summarising the arguments laid out in the preceding sections, we expect peripheral credit to outperform next year on the basis of two distinct factors:

- **Our bullish outlook for credit implies high-carry, high-beta securities will outperform**. Peripherals continue to trade wide of core credits and with a beta of greater than one (though the beta of peripheral credit to the index has been falling since the beginning of the year). Mechanically, this implies that they should outperform the index in a year when we expect excess returns to be positive.

- **The peripheral spread premium should continue to fall**. Peripheral credits continue to carry a premium to similarly rated core credits. In our view, fair value lies somewhere between core credits of the same rating, and core credits rated one-notch lower – reflecting the potential (but not certainty) of a sovereign-driven ratings downgrade. That implies room for further compression from current levels.

To these, we would add one further factor:

- **Positioning is favourable:** Though hard to measure, in our view many European real-money investors remain structurally underweight peripheral credits and offset this with subordinated instruments (Bank capital, corporate hybrids). If the outlook for peripheral Europe, and corporates domiciled there, continues to improve, then we could see shifts in portfolio positioning to reduce portfolio underweights. That would result in significant demand for peripheral credits.

Positioning in the periphery

Given our bullish outlook for peripheral credit over the next 12-18 months, we lay out our preferred investment themes in Financials, Investment Grade and High Yield corporates as well as corporate hybrids.

IG Non-Financials: Strong peripheral credits versus weaker core credits

For IG-rated, non-financial peripheral credit, we believe in the core thesis that operational trends are the greater risk to ratings than sovereign downgrades. As evidence of this, we note that both Telecom Italia and Finmecannica have suffered downgrades to high yield due to operational performance this year (notably, TITIM remains in IG indices).

In our view, the optimal way to invest in this area of peripheral debt is to focus on issuers with strong fundamentals (which we would define as names on which our analysts are not Underweight) in the Baa2 or higher rating bucket. In particular, we think it makes sense to pair these against Underweights in core names with negative operational trends. In this way, investors can benefit from both a decrease in the peripheral premium (as discussed above) and from divergent fundamental trends in the names. For Baa3 credits, we believe that peripheral credits will need to trade wide of BB+ rated peers to compensate investors for the risk of a sovereign induced transition to high yield ratings. This will act as a brake on compression of the peripheral premium in this rating bucket.

FIGURE 11

Barclays analyst credit ratings, across peripheral (Overweights and Market Weights) and non-peripherals (Underweights)

	Peripherals (OW/MW)		Core (UW)	
Banks	BBVA	Banco Santander	Commerzbank	
Telecoms	Telefonica		BT	Reed
			Orange	Wolters
			Pearson	
Utilities	EDP	Iberdrola	Dong Energy	SSE
	Edison	Gas Natural	Fortum	Suez Environnement
	ENEL	Terna	RWE	UU plc
	ESB			
Industrials	Atlantia		ABB	Go-Ahead
	Abertis		Alstom	GSK
			Astra Zenecca	Lanxess
			Bayer	Sanofi

Note: Shows all peripheral credits rated OW/MW by our analysts and all core credits rated UW by our analysts for the sectors highlighted. Source: Barclays Research

High Yield peripherals

For non-financial credits that already carry high yield ratings, remaining peripheral risk is predominantly operational, driven by peripheral issuers' exposure to slower growing economies. As previously described, we currently view redenomination risk as essentially zero and sovereign linkages are typically much weaker in high yield given that issuers are often rated well below their sovereign already. As these systemic risks have receded, the aggregate high yield peripheral premium has shrunk considerably. Peripherals now yield approximately 40bp more than core names on average, despite the fact that peripherals are slightly higher rated, shorter duration, and tend to be more liquid (Figure 12).

FIGURE 12

Aggregate core and peripheral market stats for Pan-Euro high yield non-financials

	Core	Peripherals
Issuer Count	197	37
Total Par Outstanding (€bn)	151.9	39.2
Average Debt per Issuer (€mn)	771.0	1,059.5
Coupon	7.04	6.71
Index Rating	BA3/B1	BA2/BA3
Index Rating Number	14.3	13.9
Price	106.83	104.84
Yield to Worst	4.32	4.73
OAS	360	400
OAD	3.17	3.41
Liquidity Cost Score	0.87	0.76

Source: Barclays Research

The decreased importance of a high yield issuer's peripheral domicile can be seen in various market metrics. For example, as we initially described in *Debut offerings shine brightly,* the peripheral premium attached to the coupon on new issues, which was a healthy 1.24% in 2012 after controlling for ratings, market climate, size, and other factors, has shrunk to less than 40bp this year, and is no longer statistically significant as a determinant of new issue yields. Moreover, the beta of peripherals to the broader market, currently 1.2 on a 60-day

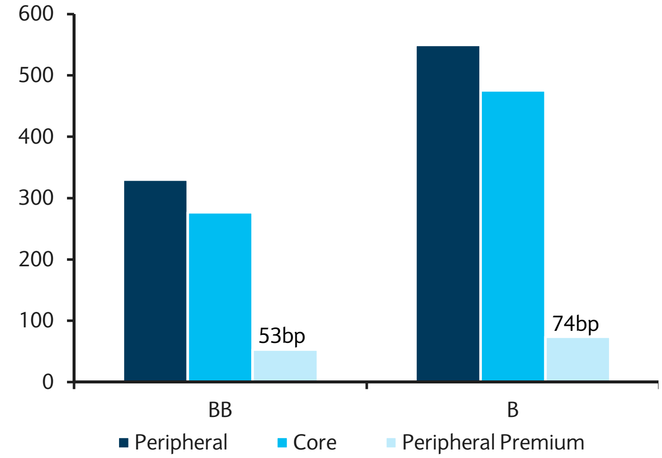
FIGURE 13

Rolling 60-day beta of peripherals to Pan-Euro high yield

Source: Barclays Research

FIGURE 14

Average OAS by quality, peripheral vs. core (bp)



Source: Barclays Research

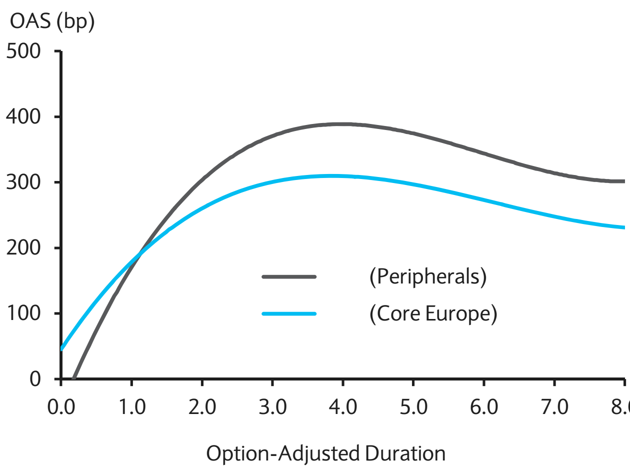
trailing basis, has declined considerably relative to 2012, when it averaged almost exactly 2.0 (Figure 13). Importantly for our 2014 call, however, it still remains above the 0.9 average from 2009 prior to the first real flare-up in European sovereign risk, suggesting that room for further compression still exists.

Looking past the aggregates, we also note that the remaining peripheral premium is unevenly distributed across the high yield cash market. On a duration- and ratings-matched basis, the premium is larger for single-Bs at 74bp than it is for BBs at 53bp (Figure 14). Moreover, the premium is also differently distributed across the curves for the higher and lower quality parts of the market. For BBs, the premium is reasonably uniform beyond the 3-year point on the duration curve (Figure 15), while for single-Bs peripherals tend to pay much more in the 2-to-4 year duration buckets (Figure 16). We believe this reflects investor hesitancy to commit to lower quality peripherals beyond their visible refinancing horizon.

However, multi-year issuance trends suggest that this concern might be misplaced. High yield primary markets have strengthened considerably over the past two years, and have become increasingly accommodating to peripheral issuers who were all but shut out when sovereign concerns first came to the fore in 2010. As Figure 17 shows, peripheral issuance excluding refi has risen in each of the past three years, to an all-time record (refi volumes

FIGURE 15

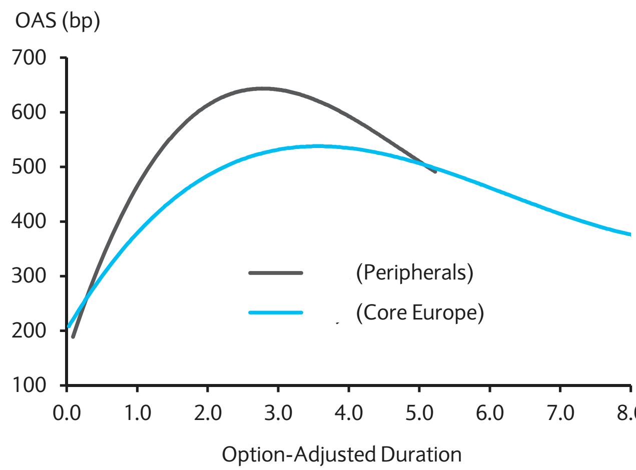
BB rated peripheral and core aggregate credit curves



Source: Barclays Research

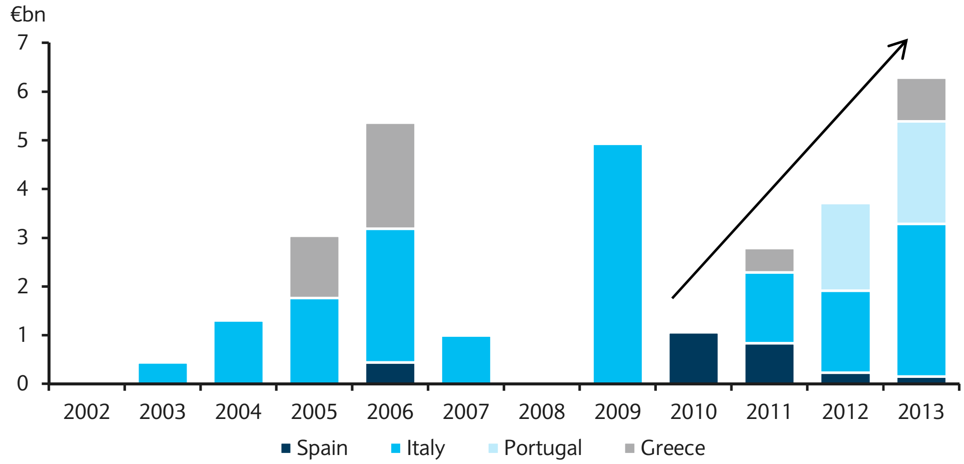
FIGURE 161

B rated peripheral and core aggregate credit curves



Source: Barclays Research

FIGURE 17
Non-financial high yield peripheral issuance, excluding refi



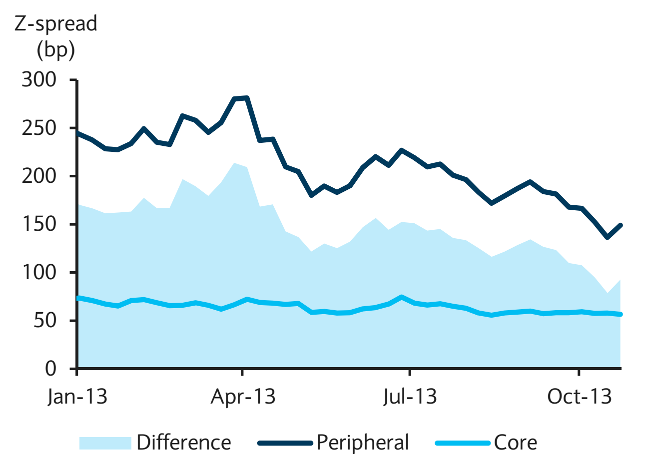
Source: Barclays Research

have also risen sharply). Recent peripheral issuers include multiple Italian gaming names (some of which were loan-only offerings), as well as the first-ever Spanish PIK toggle deal (Befesa Zinc). We expect the issuer-friendly trend to continue in 2014, suggesting that lower-rated peripherals currently trading at a discount because of perceived refinancing risk are likely to see further compression in the year ahead.

Financials – position for compression in senior unsecured bank debt

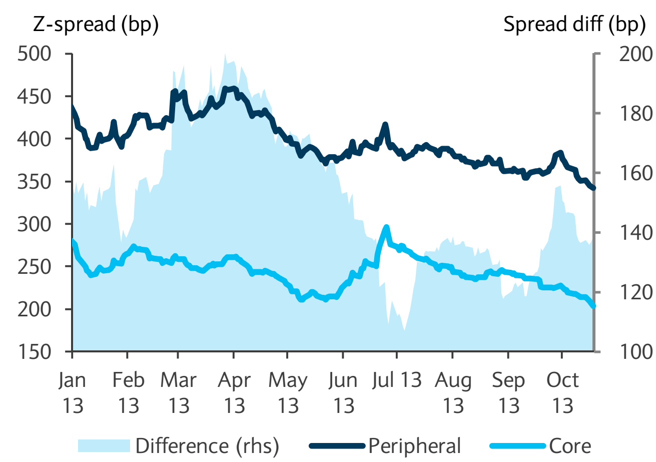
Peripheral capital securities comprise a relatively small fraction of the overall European bank debt space with 16%, 7% and 13% peripheral securities in our senior unsecured, bullet-LT2 and T1 basket, respectively.[1] The bulk of the actively traded securities were issued by Italian (ISPIM, UCGIM) and Spanish banks (SANTAN, BBVASM).

FIGURE 18
Bank senior unsecured – peripheral vs core



Note; Based on Barclays Euro Agg Bank senior unsecured sub-index. Source: Barclays Research

FIGURE 19
Bank LT2 – peripheral vs core



Note: Based on a basket of 116 actively traded bullet LT2s, across €, £ and $. Source: Barclays Research

[1] We based our senior basket on the constituents of Barclays Euro Agg bank senior unsecured sub-index, while the LT2 and T1 baskets were based on the 116 actively traded bullet LT2s and 104 actively traded T1s, across €, £ and $.

Looking at the senior, LT2, and T1 baskets split by peripheral/core domicile shows that peripherals have materially compressed versus core in seniors and T1s this year, with the average spread differential dropping from c.170bp to 90bp and from c.225bp to c.150bp, respectively (Figure 18 and Figure 20). Somewhat surprisingly, the compression has not really happened in LT2s, with the peripheral-core spread differential trading range-bound over the past 10 months and remaining little changed year-to-date despite a material tightening in spreads overall (Figure 19).

Peripheral/core split is the most pronounced in senior unsecured debt

To get a better gauge of the extra compensation offered by peripheral securities, it makes sense to compare the peripheral and core spreads adjusting for the duration of the bonds, the standalone fundamental strength of the issuer (excluding the sovereign support) and the structural features of the security (relevant in bank capital securities).

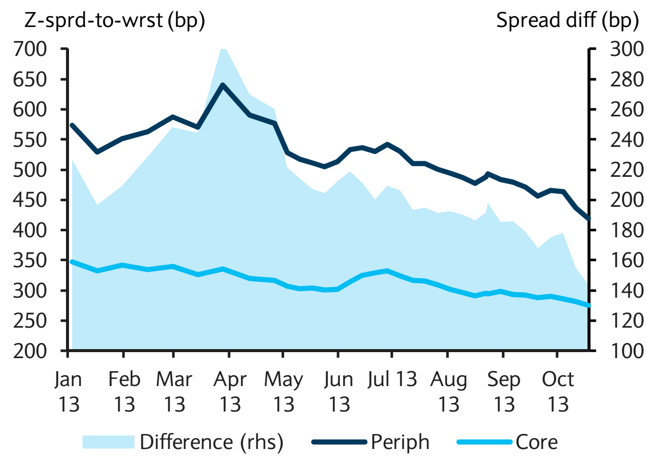
For senior unsecured debt, we estimate a cross-sectional regression of 5-year senior CDS spread versus the average S&P standalone credit profile (SACP) and a dummy variable for peripheral/core domicile (we do not need to adjust for tenor given that we are using 5-year CDS spreads). For European bank T1s and LT2s, we estimate a cross-sectional regression of the hybrid z-spreads-to-worst versus the tenor (we take the time to first call date for the T1s), average hybrid ratings from Moody's, S&P and Fitch,[2] and a dummy variable for peripheral/core domicile. We show the peripheral-core premium estimates based on these regressions in Figure 14.

Our analysis indicates that the peripheral/core split is the most pronounced in senior bank debt – the difference in R-squared from the cross-sectional regression described above with and without the peripheral/core dummy variable is 26pp (Figure 13). The fact that adding the peripheral/core indicator vastly improves the fit of the regression means that this theme remains firmly embedded in the senior bank sector, even if less so than at the beginning of the year ("R-squared improvement" was much higher in January at 43%; Figure 13).

Peripheral/core split remains strong in T1s and LT2s as well, but it is materially weaker than in senior debt (Figure 21). In addition, the average peripheral-core premium looks much higher in seniors than in LT2 or T1s on a risk-adjusted basis – a 100bp average peripheral-core pick-up in senior unsecured looks high versus 90bp in LT2s and 140bp in T1s if we take into account the materially higher risk of impairments in the sub debt (Figure 22).

FIGURE 20

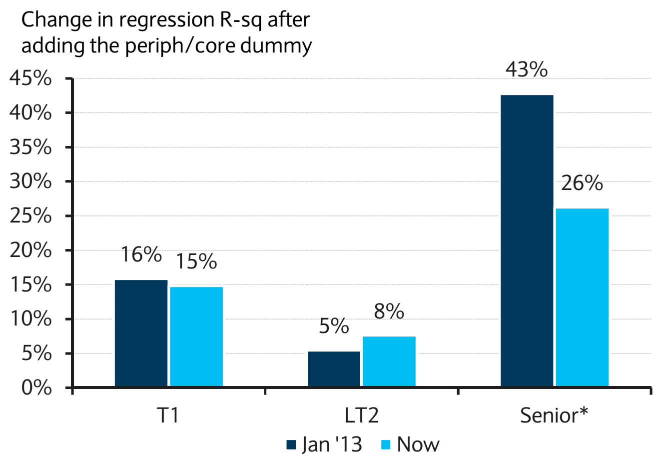
Bank T1 – peripheral vs core



Note: Based on a basket of 104 actively traded bullet T1s, across €, £ and $. Source: Barclays Research

FIGURE 21

How strong is the peripheral/core split?



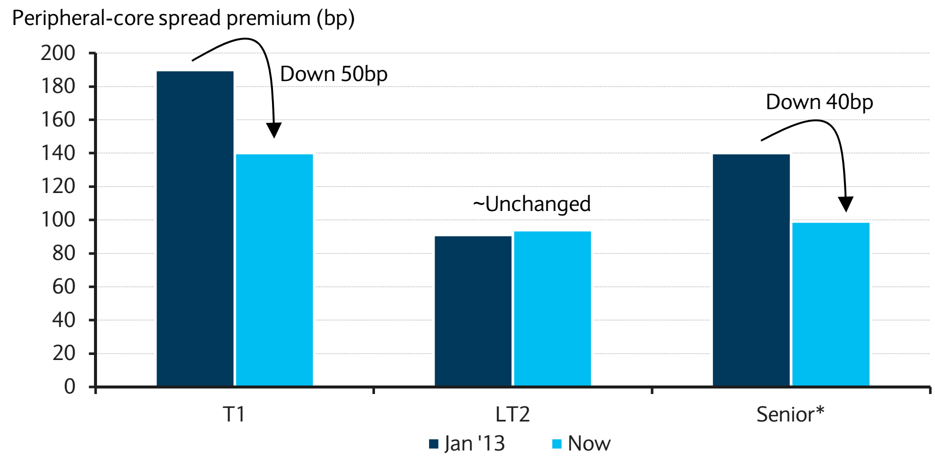
Note: The change in R-squared = R-squared of the regression including the dummy variable minus R-squared of the regression excluding the dummy variable. Source: Barclays Research

[2] Hybrid ratings are based on the standalone fundamental strength of the bank and the structural features of the bond and are not notched up/down for the link to the sovereign.

The strength and magnitude of the peripheral/core differentiation in senior debt is somewhat surprising, but in our view can be explained by a mix of: 1) the difference in investor bases in senior and sub debt (in senior, we would expect the majority of the participants with low risk appetite to require relatively higher compensation for peripheral risk, while in sub debt more risk-seeking hedge-fund/retail type accounts ready to accept relatively less compensation for peripheral risk in return for higher all-in yields); 2) stronger dependence of senior ratings on sovereign ratings and the expectations of state support in distress; 3) the market being pre-positioned for downgrades to HY in LT2 and less so in senior (average rating for peripheral banks in our senior and LT2 baskets are BBB and BBB-, respectively).

FIGURE 22

Average peripheral premium is the highest in senior on a risk-adjusted basis



Source: Barclays Research

On that basis, at a macro level we recommend positioning for the peripheral/core compression in senior bank debt, where the premium for peripheral risk is by far the most attractive on a risk-adjusted basis. In sub debt, we think it is better to position for compression in LT2s, given that in this sector, the premium has actually not compressed this year despite a material tightening in Spain and Italy spreads, and it now looks more attractive on a risk-adjusted basis than in T1s.

Corporate hybrids – the peripheral/core split blurred by idiosyncrasies

Peripheral issuers have only recently become a material feature of the corporate hybrid market, with the new issues from IBESM (Feb '13), TITIM (Mar), TELEFO (Sep) and ENEL (Sep). Including the GTKIM hybrid (issued in 2006), the total amount outstanding for peripheral corporate hybrids is €6.5bn, which amounts to 13% of the total size of the space.

The average spread in peripheral hybrids is currently 460bp versus the broad corporate hybrid average of 330bp. Although the pick-up of 130bp seems substantial, this number does not adjust for the duration and structural features of the bonds and the fundamental strength of the issuer excluding sovereign support. After adjusting for these factors (we estimate a cross-sectional regression of current hybrid spreads versus the time to the first call, average hybrid ratings from Moody's, S&P and Fitch, and a dummy variable for peripheral/core domicile), we estimate the average spread premium for peripheral domicile in corporate hybrids currently at c.80bp.

That said, we also find that the peripheral/core split is not a significant theme in this space, as evidenced by the fact that the peripheral/core dummy variable adds little to the explanatory power of the regression (R-squared with the variable included is 67% and 62% without). This generally makes sense to us, given that the corporate hybrid space is generally characterised by a more idiosyncratic nature of the price action – especially after a wave of new issuance in 2013, which brought about a large number of names that are facing rating pressures driven by weak operating performance (as opposed to being driven by the contagion from the sovereign crisis).

Key trade recommendations

Financials

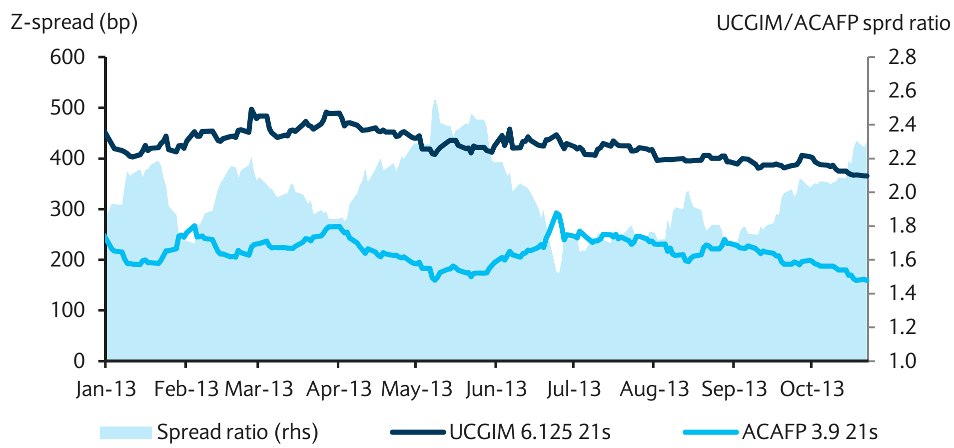
In line with our view that senior unsecured bank debt is the best sector in financials to position for peripheral/core compression, we recommend switches into SANTAN and BBVASM (our bank analysts hold an Overweight view on both) out of CS, UBS (both Market Weight), LLOYDS and/or BNP (Overweight, but senior outperformed recently).

In sub debt, we think it is better to position for compression in LT2s, given that in this sector, the premium has actually not compressed this year despite a material tightening in Spain and Italy spreads, and it now looks more attractive on a risk-adjusted basis than in T1s.

- **Switch out of ACAFP €3.9 '21 LT2 into UCGIM €6.125 '21 LT2.** Despite the less favourable fundamental picture for UCGIM (our analysts hold an Underweight rating on UCGIM and Market Weight rating on ACAFP), we think the material underperformance in UCGIM versus ACAFP over the past two months (see the spread ratio in Figure 23) is inconsistent with the general rally in spreads, the stabilised situation in Italy (even if only temporarily) and the sharp rally in Italy CDS. We also take comfort in the fact that the UCGIM LT2 pays more than 200bp above the ACAFP LT2, (although the rating differential between the two securities at the moment is two notches) and the fact that the basis in the UCGIM LT2 is negative while it is positive in ACAFP.

FIGURE 23

UCGIM-ACAFP switch – spread ratio at YTD highs



Source: Barclays Research

Utilities

At 48% of the index (by market value), peripheral performance is key when considering the outlook for European Utilities. In line with our bullish outlook for 2014, our analysts have recently upgraded their view on the sector to Market Weight (*European Utilities: Peripheral risk abates*, 24 October 2013). Similarly, they have upgraded their ratings on Iberdrola (to OW), Gas Natural (to MW) and Enel (to MW).

Their top picks in the peripheral space are:

- **Iberdrola recently upgraded to Overweight from Market Weight.** Our analysts believe that the Iberdrola EUR cash curve could separate from the Gas Natural Curve by a further 20bp. They also hold a sell view on Iberdrola 5y CDS versus buy Gas Natural 5y CDS and see a 30-40bp differential as fair.

- **ESB**. Our analysts see at least 20bp of tightening based on a positive sovereign story for ESB to trade tight of Terna (their tightest trading peripheral utility). They also target the ESB GBP'20s trading up to 40bp tighter.

- **EDP**. Our analysts see 65-90bp of tightening potential from the front end EDP bonds (EUR '15s and '16s), where the curve trades relatively flat versus other peripheral utilities (including Enel and Gas Natural). They have a sell view on EDP 5y CDS (target c.50bp of tightening) and are Overweight the USD '18s.

Telecoms

Similar to Utilities, Telecoms have a high concentration of peripheral issuers – including several of the largest issuers in our indices. Our fundamental analysts are currently Market Weight the sector. While the potential for Telecom Italia to be downgraded in the near term could put pressure on other high yield telecoms from substitution effects, we believe there are select opportunities for outperformance in both IG and HY names:

- **Switch out of ORAFP €3.875 '21 into TELEFO €3.961 '21**: Our analysts maintain an Underweight rating on Orange given operational pressures, rising leverage and the fact they see very few near-term positive catalysts for the company. On the other hand, they hold a Market Weight rating on Telefonica as the company has made continued progress in reducing its overall level of net debt during 2013 presenting at the same time improvements in financial results from its domestic operations.

- **Buy Wind Telecomunicazioni (WINDIM) senior secured €7.375 '18** – Despite the challenging operational environment in Italy, our fundamental analysts continue to be impressed with Wind's ability to increase market share while maintaining EBITDA margins. The bonds become callable at 105.53 in November of this year, and are currently trading slightly below 105, leaving some upside relative to the call price. On their most recent earnings call on 7 August, VimpelCom reiterated its desire to refinance Wind debt prior to maturity. Q3 results are scheduled to be released on 6 November; see *Outperforming the peer group* for further details.

- **Buy Nara Cable Funding (ONOSM) senior secured €8.875 '18 and Ono Finance senior unsecured €11.125 '19**. While churn rates remain elevated (23.2% in Q2) due to intense competition, Ono was able to achieve 3.0% y/y revenue growth and sequentially flat EBITDA in the second quarter. Liquidity is ample at €243.0mn, with no meaningful maturities until 2016. The 2018s become callable in December; the 2019s in January. Both offer significant yield pickup relative to other short duration TMT bonds under our coverage. Please see *Doing well in a tough environment* for further details.

Industrials

- **Overweight Finmeccanica**: Following the disposal of Ansaldo Energia, which our analysts assume has served to stabilise current ratings over the near term, they see further upside to valuations, which they believe offer more than adequate compensation for an Italian-domiciled BB+ credit and risks to prospects in 2014. In particular, they highlight the GBP'19s and the USD'19s, USD'39s and USD'40s.

- **Overweight Atlantia**: Atlantia's credit metrics are slightly weakly placed at both S&P and Moody's and are vulnerable to weak domestic traffic trends. However, our analysts note improving traffic trends in Italy, while the group's underlying performance should remain supported by the growth potential of Chilean and Brazilian operations. With reference GBP'22s, they target 20bp of spread tightening over the next quarter.

- **Buy Avanza Grupo (AVAN) senior secured 7.5% 2018s** – After its acquisition by Grupo ADO, Avanza will continue to operate independently and has stated its intent to maintain its own capital structure. Although suburban and long distance passenger volumes were down in Q2, the declines were partially offset by increases in tariffs. Despite a 10+ point rally off the June lows, the bonds now yield c.6.5% to their June 2015 call and still provide above-average spread (OAS c.560bp) relative to similarly rated mid-duration bonds. For full details on Avanza's operational outlook, please see our coverage initiation: *Compelling relative value opportunity*.

Analyst Certification

We, Zoso Davies, Darpan Harar, Ioannis Kallianiotis, Mike Kessler and Dominik Winnicki, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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