High Yield Market Flash

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The objective of this flash is to assess the potential impact of the current conflict in Ukraine on the High Yield market and its implications on the La Française Rendement Global 2025 (LF RG 2025) and La Française Rendement Global 2028 (LF RG 2028) portfolios. In order to achieve this, as it was the case during the Covid crisis, we will try to:

1. Perform different scenarios and their impacts on the High Yield market (spreads and market default rates)

2. Transpose (in a second step) these scenarios to our portfolios in order to assess their impact on the performance of the LF RG 2025 and LF RG 2028 funds (in particular on the funds' NAVs at maturity).

THE DIFFERENT SCENARIOS AND THEIR IMPACT ON THE HIGH YIELD MARKET

At this stage and on the basis of the information available to us, we can envisage 3 scenarios.

The "**Worst case**" scenario, that of a stalemate in the ongoing conflict with an increase in human casualties. In this case, European countries and their allies will impose new economic sanctions on Russia and continue to support the Ukrainian army. President Putin reacts by deploying larger military forces and threatening other neighbouring countries. It is not excluded that President Putin will attack European countries economically, even interrupting the supply of gas and other raw materials to key partners (e.g. Germany).

The economic and financial impacts of this scenario would be as follows:

- A **significant rise** in **commodity prices** (oil, gas, agricultural products, etc.) for a prolonged period
- A default of **Russia and the vast majority of Russian private or quasi-state companies** with potentially significant contagion effects on the (global) banking and financial system.
- **Risk of contagion to other neighbouring emerging countries (Turkey and others)**
- Increase in High Yield spreads by +150-250bps from the current level (@ 415bps) to reflect the deterioration of the macroeconomic context. A stagflation scenario cannot be excluded in this case.
- Significant increase in global HY default rates to 6.5% by the end of 2022 and 6% in 2023 vs 2% at the end of 2021
- **From a sectoral point of view,** the **most negatively impacted sectors** would be industry (automotive, chemicals, etc.), consumer cyclicals, food, the financial sector (banks, insurance, and other financial services, etc.); the **least exposed sectors** would be TMT, healthcare, services, energy, and commodities.
- **From a geographical point of view,** the US and LATAM High Yield markets would be the main beneficiaries given the weight of the energy and commodities sectors in the indices (up to 70% in the LATAM HY indices). The European market would be much more affected than the US market given its geographical proximity to the ongoing conflict and given the negative impact of rising commodity prices on European economies. Finally, the European and Central Asian high yield markets would be the most damaged with a massive increase in defaults (remember that **Russia, Turkey, and Ukraine** are respectively the **1st, 3rd and 4th largest contributors to the high yield index** in this area with a cumulative weight of around 50%).
- **The only positive point** that would result from this scenario would be the intervention of central banks (ECB and BOE) as a priority to limit contagion and a massive rise in default rates (our forecast of a default rate of 6.5% by the end of the year and 6% in 2023 takes into consideration this implicit "put" by central banks). Remember that the average default rate on the HY market over the last 10 years is 2%.

The « **Best case** » scenario is that of a rapid end to the conflict by diplomatic means, which could satisfy the various parties, at least in the short term, pending a more sustainable solution. In return, the sanctions against Russia would be reduced or even completely lifted.
The economic and financial impacts of this scenario would be as follows:

- Commodity prices would return to their pre-conflict levels

- The risk of default of Russia and Russian companies is reduced and the stress on the financial system is significantly reduced
- HY market spreads return to pre-crisis levels @ 340bps vs. current level @ 415bps
- The risk of an economic recession in Europe and, to a lesser extent, in the world, is averted
- Default rates increase very slightly @ 2.5% at the end of 2022 and 2023 (vs 2% at the end of 2021)
- Central banks do not change their roadmap of a gradual exit from accommodative monetary policies and the market starts to "predict" a gradual rise in interest rates
- **From a sectoral point of view,** cyclical sectors (manufacturing, consumer discretionary and financials) would be the main beneficiaries. Less cyclical sectors (TMT, Utilities, Healthcare) would benefit less from the recovery of the cycle linked to the resolution of the conflict as they are more sensitive to the evolution of interest rates
- **From a geographical point of view,** the European HY markets would catch up with the US market. The same is true for issuers in Europe and Central Asia compared to other emerging markets.

The « **Base case** » scenario of a conflict that remains as it is (does not spread to other regions and does not cause a dramatic humanitarian situation) but that lasts a few weeks before considering a diplomatic solution that could satisfy the various stakeholders. The sanctions on Russia would be lifted very gradually. **This is the scenario that seems the most likely today.**

The economic and financial impacts of this scenario would be as follows:

- Commodity prices gradually adjust downwards
- Defaults on Russian companies increase but would be less widespread and stress in the banking and financial system would not be as significant as in the "Worst case" scenario
- HY market spreads increase by 50-100bps vs current level @ 415bps
- Contraction of economic activity in Europe and globally but risk of recession would be avoided
- Default rates increase @ 4.5% at the end of 2022 and 4% in 2023 (vs 2% at the end of 2021)
- Central banks, after a "pause", gradually resume their roadmap for an exit (admittedly less aggressive than in “Best Case scenario”).
- **From a sectoral point of view,** cyclical sectors (industry, consumer discretionary) and financials are recovering some of their underperformance, but without returning to their pre-conflict spread levels, and the adjustment would be gradual. The less cyclical sectors (TMT, Utilities, Healthcare) would continue to be the main beneficiaries for a while
- **Geographically,** European HY markets would catch up with the US market. European and Central Asian issuers would be impacted for some time (the adjustment would be very gradual) vs other emerging markets.

SIMULATIONS OF THE IMPACT OF THESE SCENARIOS ON LF RG 2025 AND LF RG 2028 FUNDS

Based on the above scenarios, we have tried to assess the impact on the portfolio by considering:

- **The evolution of market default assumptions**. Although the exposure of our portfolios to European and Central Asian issuers is 0% (Russia, Ukraine, Turkey), we have conservatively assumed that our portfolios take 1/3 of the default rates of the global HY market
- We have also conservatively assumed an **average recovery rate** in case of default of **30%** even if a significant part of our exposures are senior and/or secured bonds which often benefit from a higher recovery rate (between 50 and 70%)
- **We have retained a degressive reinvestment rate** (calls, coupons, redemptions, and others) of around -50bps/year for LF RG 2025 and -30bps/year for LF RG 2028 until the respective maturity of the 2 funds. The initial rate is the current YTW of each fund net of the hedging cost for R and I share classes in euro and net of the current fees for all R and I share classes in euro and in $.
- For the cost of hedging (Euro/$ and Eur/£) we use the current monthly cost (annualised) over the whole simulation period.

➢ The **assumptions for the global HY market default rates** in each scenario are as follows:

Year	« Worst case » Scenario	« Best case » Scenario	« Base case » Scenario
2022	6.5%	2.5%	4.5%
2023	6.0%	2.5%	4.0%
2024	1.7%	1.7%	1.7%
2025	1.7%	1.7%	1.7%
2026	1.7%	1.7%	1.7%
2027	1.7%	1.7%	1.7%
2028	1.7%	1.7%	1.7%

➢ **The reinvestment assumptions** (net of ongoing charges and hedging costs) for each fund are as follows:

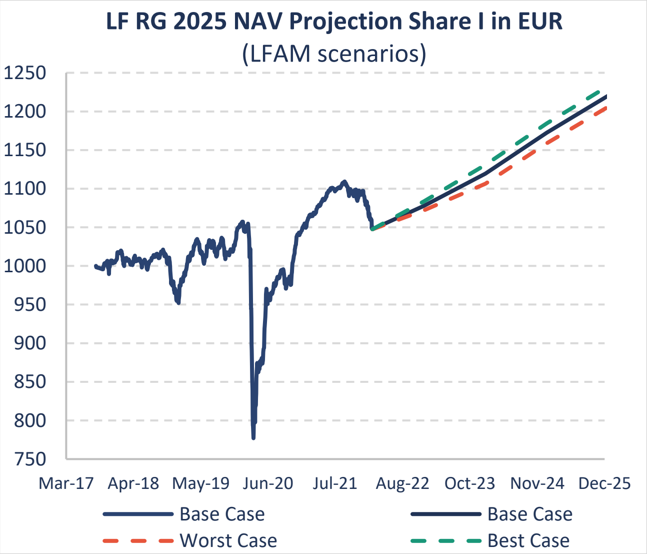
LF RG 2025

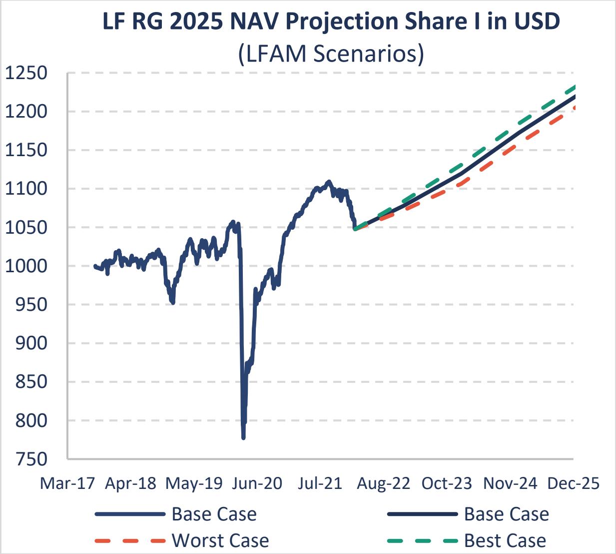
	I EUR	I USD	R EUR	R USD
YTW Gross as at 28/02/2022	6.0%	6.0%	6.0%	6.0%
Fees	-0.59%	-0.59%	-1.19%	-1.19%
Hedging costs	-0.33%	0.51%	-0.33%	0.51%
YTW Net	5.09%	5.92%	4.49%	5.32%
NAV 28/02/2022	1 047.45	1 138.76	102.03	109.76
Roll-down	**50bps**	**50bps**	**50bps**	**50bps**
	Reinv. net	Reinv. net	Reinv. net	Reinv. net
2022	5.09%	5.92%	4.49%	5.32%
2023	4.59%	5.42%	3.99%	4.82%
2024	4.09%	4.92%	3.49%	4.32%
2025	3.59%	4.42%	2.99%	3.82%

LF RG 2028

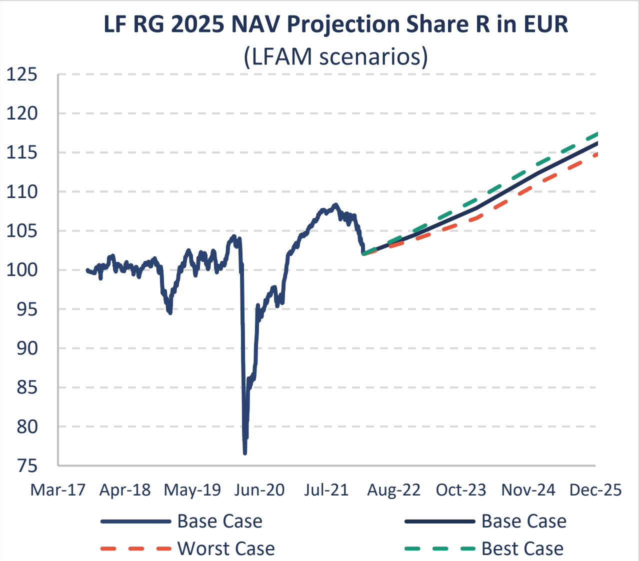
	I EUR	I USD	R EUR	R USD
Growth YTW as at 28/02/2022	6.18%	6.18%	6.18%	6.18%
Fees	-0.75%	-0.75%	-1.19%	-1.19%
Hedging costs	-0.39%	0.45%	-0.39%	0.45%
Net YTW	5.02%	5.86%	4.58%	5.42%
NAV 28/02/2022	1 027.35	983.19	101.32	100.00
Roll-down	**30bps**	**30bps**	**30bps**	**30bps**
	Reinv. net	Reinv. net	Reinv. net	Reinv. net
2022	5.05%	5.88%	4.61%	5.45%
2023	4.75%	5.58%	4.31%	5.15%
2024	4.45%	5.28%	4.01%	4.85%
2025	4.15%	4.98%	3.71%	4.55%
2026	3.85%	4.68%	3.41%	4.25%
2027	3.55%	4.38%	3.11%	3.95%
2028	3.25%	4.08%	2.81%	3.65%

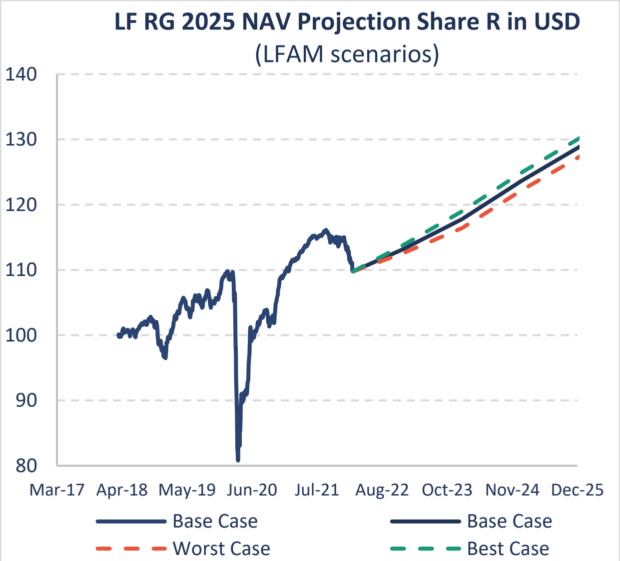
The results of the simulations are as follows (RG 2025 Share Class I in EUR & in USD)



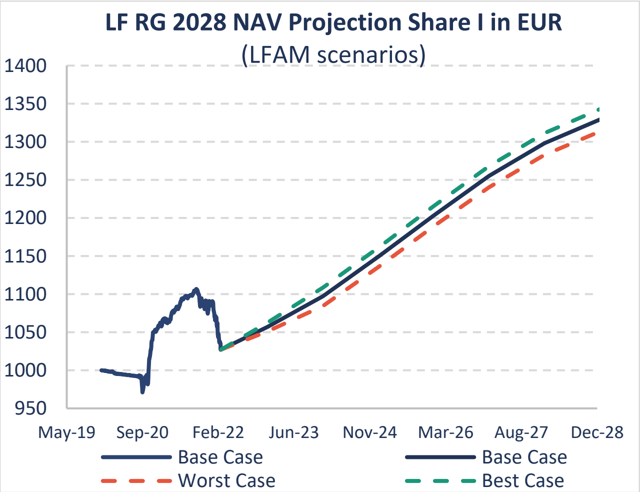


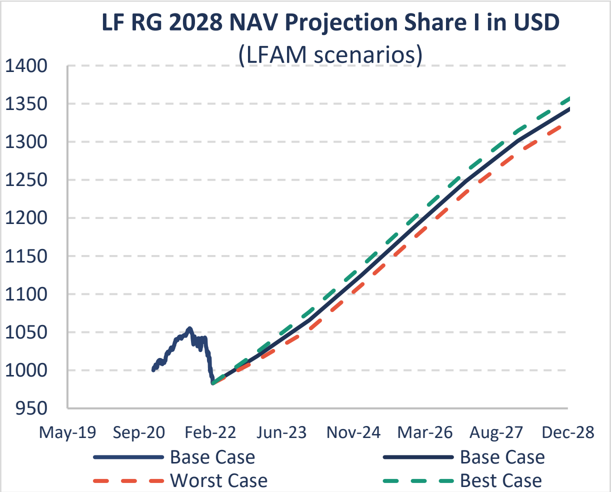
The results of the simulations are as follows (RG 2025 Share Class R in EUR & in USD)



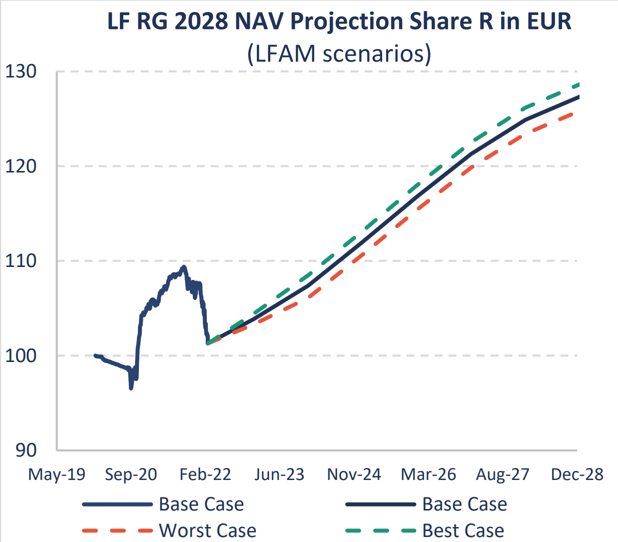


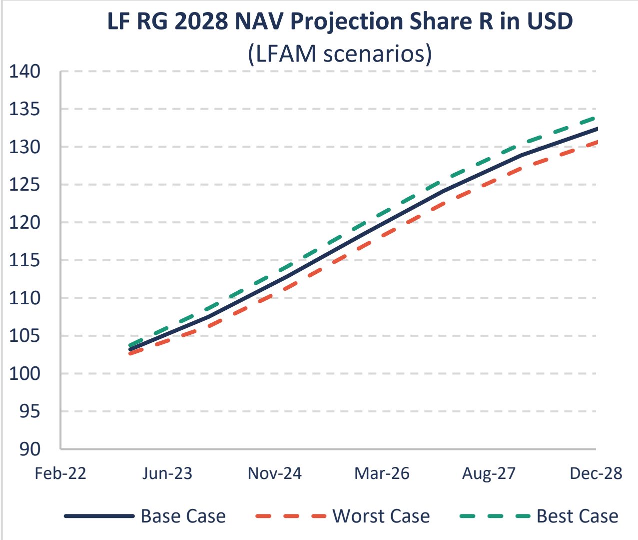
The results of the simulations are as follows (RG 2028 Share Class I in EUR & in USD)





The results of the simulations are as follows (RG 2028 Share Class R in EUR & in USD)





Simulations carried out on La Française Rendement Global 2025, R share (current charges at 30/06/2021 of 1.29%), I share (current charges at 30/06/2021 of 0.70%). Simulations carried out on La Française Rendement Global 2028, R share (current fees on 22/09/2021 of 1.21%), I share (current fees on 22/09/2021 of 0.75%. ***Simulated performance is not a reliable indication of future results.*** *These estimates are provided for information purposes only and should not be considered as a recommendation to buy or sell any security or as investment advice. Please use the information provided by these simulations with caution. In essence, this information does not reflect the actual performance generated. The data displayed above is based on various factors and assumptions and involves significant subjective views and analysis. Such assumptions, views, and analyses may be incorrect or may change without notice.*

CONCLUSION AND POSITIONING OF PORTFOLIOS

At this stage, it is difficult to know the outcome of this conflict and the economic and financial consequences that will follow. Thus, market volatility is likely to remain high in the short term.

The simulations presented here are based on several hypothesis and then does not constitute a guarantee of the final NAVs of our portfolios but it allows us to understand the potential impact of these different scenarios on the HY market and on the future performance of our portfolios.

Our priority objective is to get through this crisis in the best possible conditions by paying attention to portfolio positioning and by effectively managing country and sector risks.

It should be noted that:

- The credit fundamentals (leverage and interest coverage ratios in particular) of European and US high yield issuers have returned to particularly comfortable levels post-Covid period, allowing them to partially absorb the expected negative impact of higher input costs (negative effect on margins) as well as the likely deterioration of consumer demand (negative effect on growth). Similarly, the maturities of HY bonds to be refinanced in 2022 and 2023 are relatively limited (9% on Euro HY, 4% on US HY, mainly composed of "BB" rated issues) and the level of cash on the balance sheet is at historical levels (more than 25% of the total debt on Euro HY and more than 15% on US HY), which gives us confidence in the liquidity profile of the vast majority of European and US HY issuers.

- We have no exposure to Russian and Ukrainian private, sovereign, or quasi-sovereign issuers. Our exposure to the Eastern European and Central Asian credit market (including Turkey) is 0% (even before the start of the conflict) in line with what we indicated in our credit outlook published earlier this year

- Our exposure to emerging issuers (12%) is limited to: Asia (India, China including Hong Kong, Singapore, and Indonesia), Africa (Egypt for the sovereign and IHS for private issuers) and Balkans/Greece (Media TMT company "United Group")

- Our most significant indirect exposures to Russia and Ukraine are linked to two pharmaceutical companies: the German group Stada (0.5% in the portfolios) which generates 15% of its revenues in Russia and the Italian group Recordati (0.4% in the portfolios) which generates 7% of its revenues in Russia. For these two groups, we believe that the current situation is not likely to endanger their business model or their solvability.

- The geographical and sectoral diversification of our portfolios is important. In addition, we maintain a strict risk management policy (classification of issuers[1] as Tier 1, 2 and 3 with a risk budget allocated to Tier 1 issuers of up to 1.25%, those with the best credit quality, and up to 0.5% for Tier 3 issuers). The granularity of our portfolios and this ex-ante risk management allow us to limit the impact of a default shock on the HY market (significant increase in defaults following an economic and/or financial crisis).

La Française Rendement Global 2025

- The objective of the fund is to achieve, over the recommended investment period of 7 years from the date of creation of the fund until 31 December 2025, a performance net of fees higher than that of bonds maturing in 2025 issued by the French government and denominated in EUR.
- **Risks: loss of capital, interest rates, credit, defaults, investment in speculative high yield securities, emerging markets, convertible bonds, counterparty, subordinated debt securities, derivatives, liquidity linked to temporary purchases and sales of securities and/or total return swaps.** For more information, please refer to the section "Description of risks" of the prospectus available on the website www.la-francaise.com
- FCP fund approved on 13/07/2017, transformed into a La Française SICAV, sub-fund La Française Rendement Global 2025 on 14/08/2018

La Française Rendement Global 2028

- The fund's objective is to achieve, over the recommended investment period of 9 years from the date of creation of the fund until 31 December 2028, a performance net of fees that exceeds that of bonds maturing in 2028 issued by the French government and denominated in EUR.
- **Risks: loss of capital, interest rates, credit, defaults, investment in speculative high yield securities, emerging markets, convertible bonds, counterparty, subordinated debt securities, derivatives, liquidity linked to temporary purchases and sales of securities and/or total return swaps. For more information, please refer to the section "Description of risks" of the prospectus available at www.la-francaise.com**
- La Française Rendement Global 2028, approved by the AMF on 30 August 2019, is a sub-fund of the French SICAV "La Française", approved by the AMF on 14 August 2018

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[1] Internal limits that could evolve over time

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