

REFUTING THE TOP 3 MISCONCEPTIONS OF EM CORPORATE CREDIT

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In recent months, several media reports have warned of an impending implosion in emerging market (EM) finance. In many of these reports, journalists have warned that after years of easy money from the [Federal Reserve \(Fed\)](#), emerging market fixed income would soon come under considerable pressure. In response to these reports, we seek to highlight the three most common myths surrounding emerging market [corporate credit](#). Below, we restate their claims and refute their conclusions about emerging market fixed income. In our view, valuations in emerging market corporate debt could represent an attractive entry point for patient investors who are focused on total returns. **Myth #1: Rapid Growth in EM Corporate Issuance Implies Higher Default Risk** A similar concern surrounds not only the serviceability of the debt, but also the massive increase in the EM corporate bond market over the past eight years. In fact, the amount of debt outstanding has increased tenfold over this period!¹ For some journalists, this increase points to an increased likelihood of default. However, what many fail to realize can be distilled into a few key points: **1. Composition of emerging market financing has evolved**

a. Historically, emerging market corporations have borrowed money from European banks in the form of loans.

- i. As European banks have sought to reduce risk and de-lever, they have retreated from new loan issuance to EM corporations.²
- ii. As more EM corporations developed a longer [credit](#) history, they sought to extend the [maturity](#) profile of their borrowing by issuing more bonds.
- iii. While net [leverage](#) levels have increased for some issuers, most emerging market corporations remain much less leveraged across the ratings spectrum than their competitors in developed markets.³

b. Access to global credit markets is a testament to the development of EM economies and the emergence of many EM corporations as global industry leaders. **2. Leverage in emerging markets was, and still is, considerably lower than in developed markets.**

- a. Emerging markets currently account for over 40% of global economic output⁴ but only 12% of the bond market⁵.
- b. Therefore, even though the market has increased by a significant multiple, it has been increasing from an extremely low base.
- c. EM corporate debt has grown at about the same pace as the European high yield market over this period. However, EM corporate issuance has been dominated by investment-grade borrowers.⁶
- d. By gaining access to longer and more diverse sources of capital through the global fixed income markets, EM corporates may now actually pose less risk to investors, given that they do not need to constantly tap or roll over credit lines to continue to grow their businesses.

Myth #2: EM Corporations Are in Trouble Due to U.S. Dollar Strength Currency investing is hot right now. The premise for concern about “King Dollar” isn’t wrong, but its focus may be misplaced. Critics believe that since EM corporations have borrowed in U.S. dollars, they have an [asset-liability mismatch](#). Since the U.S. dollar is stronger than most emerging market currencies, the cost of EM corporations’ debt in local currency terms prompts concern about their ability to repay. While a mismatch might exist for some domestically focused operated companies, the investable universe of emerging market corporate debt is quite broad, and it includes many industries that generate hard currency revenues.⁷ In our view, dollar strength is less of a concern because a majority of these large, EM issuers, such as commodity producers, have dollar-denominated revenues that will be used to service their debt. While these businesses inevitably sell a portion of their oil, copper, steel, or gold domestically, they are actually producing these goods for sale

on the global markets. Today, most international commodity markets use the U.S. dollar as their principal settlement currency. As long as these companies can generate revenues in excess of their costs, they should be able to continue to service their U.S.-dollar-denominated debt. In fact, for companies with considerable local-currency costs and dollar-based revenues, [margins](#) could actually increase, since dollar revenues rise relative to local costs, which decline along with the local currency. For example, JB Y Compañia, S.A. de C.V., the owner of Jose Cuervo Tequila, derives over 60% of its revenue from exports to developed markets outside of its operations in Mexico.⁸ Additionally, the maturity profile of the debt is what really matters. Issuers that have debt maturing in the next year have essentially two options: roll over the debt with a new issuance or set aside cash to pay off bond-holders. If a management team is going to require a large pool of dollars, the company will often seek to currency-match the assets and liabilities on its [balance sheet](#) in order to avoid fluctuations that could result from changes in currency rates near maturity. Also, after the last several years of low global interest rates, many companies have fully extended the maturity profiles of their debt, further reducing [roll-over risk](#).

Myth #3: Investors Aren't Committed to EM Corporate Credit Among the major concerns, we find this one the least compelling, in light of reported under-weight exposure to emerging markets via the latest investor surveys.⁹ The argument goes that in searching for income around the world, U.S. and European investors have recklessly invested in anything with higher [yields](#). As a result, risky borrowers in emerging markets have had too much access to cheap funding, and investors are exposed to increasing defaults once these flows subside. While U.S. dollar borrowing costs have fallen in emerging as well as developed markets (as global bond yields fell), a sizable premium still exists among comparable businesses operating in each region.¹⁰ Additionally, just because bond yields rise, that does not immediately mean that a borrower is likely to default. In most instances, leverage remains manageable for these businesses. While a rise in rates may be painful for some hot-money investors, dedicated emerging market investors, along with regional players from emerging markets (such as pension funds or insurance companies), would likely step in when other investors lose their heads. As we have seen several times, private banks, sovereign wealth funds, and insurance companies in Asia and the Middle East appear willing to deploy capital in other emerging markets as the asset class continues to evolve. Although inflows to emerging market dedicated strategies have slowed, we believe that current fundamentals from select issuers represent an attractive opportunity for nimble, active managers. As in any other credit market, we could see negative surprises that challenge our outlook. But for investors who stay focused on fundamentals, many issuers with strong core franchises and well-established business models may represent attractive entry points near current levels.

¹Source: Barclays, 3/24/15. ²Source: Barclays, 3/24/15. ³Source: J.P. Morgan, 3/31/15. ⁴Source: IMF, as of 3/31/15. ⁵Source: Barclays, as of 3/24/15. ⁶Source: J.P. Morgan, 3/31/15. ⁷Source: J.P. Morgan, 4/30/15. ⁸Source: Corporate disclosures, Fitch, 12/31/14. ⁹Source: EPFR, 3/31/15. ¹⁰Source: J.P. Morgan CEMBI Broad Index versus J.P. Morgan JULI, as of 3/31/15.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Corporate Credit : compensation associated with the risk of lending to a corporation.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Maturity : The amount of time until a loan is repaid.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Asset-Liability Mismatch : refers to a situation when a company's assets do not earn enough revenue to service their liabilities, especially debt.

Margins : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new positions.

Roll-over risk : occurs when a debt issuing entity has debt that will mature soon and must be "rolled over" into new debt, with the risk that the new debt will be at a higher interest rate.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.