

# Emerging markets private credit: why now?



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**“In our judgement, an effective approach has a dual track approach, considering both primary and secondary loans from emerging market (EM) corporates.”**

Fundamental changes in the banking sector, coupled with periodic bouts of market dislocation and a lack of alternatives, have resulted in a multitude of emerging market private credit opportunities. Mihai Florian, Senior Portfolio Manager, highlights why it’s a timely moment to invest.

### Structural changes in the banking sector

Fundamentally, changes in the banking industry following the financial crisis have meant that banks are under regulatory and capital constraints. This has profoundly impacted their behaviour and their capacity as direct providers of long-term credit. Furthermore, banks act largely in an arranger capacity, exacerbating volatility and credit dislocation.

In our judgement, an effective approach has a dual track approach, considering both primary and secondary loans from emerging market (EM) corporates. This allows a manager to tap into market opportunities at different points in the cycle. For example, when the market was experiencing volatility in the first half of 2023, we saw more opportunities in the secondary market, purchasing syndicated loans from the banks looking to de-risk their balance sheets. On the other hand, as witnessed in the last few months when a considerable amount of liquidity came back to the market, there has been a substantial pick-up on new money, primary loan opportunities.

### Underpenetrated markets

In EM, approximately 90% of corporates’ funding needs come from the banking sector, versus 20-40% in the US and 50-60% in Europe. EM local capital markets lack depth, and alternative sources of capital, such as insurance company capital, are limited.

This lack of capital markets alternatives for borrowers and low demand for bank loan paper pave the way for investors to focus on lending to high quality, low leveraged corporates and still achieve double digit returns.

In developed markets (DM), leverage loans and direct lending transactions in recent years have exceeded 5x leverage ratios that could put substantial pressures on coverage ratios and recoveries, especially given the prevalent covenant-lite structures in today’s high-rate environment.

### Attractive risk/reward balance

EM corporates typically experience lower default and higher recovery rates than their DM counterparts. We focus on healthy and growing companies with substantially lower levels of leverage, while in DM, achieving similar returns requires meaningfully greater risks (i.e. distressed) and weaker documentation.

Strong documentation, with English-law standards, helps put EM corporates in a stronger position than their DM peers. Typically, loans are executed under ‘old style’ documentation, with a full financial covenant package, restrictions on disposals, moving assets and dividend payments to shareholders, and enhanced protection from a creditor’s perspective.

### “We focus on healthy and growing companies with substantially lower levels of leverage.”

In DM, for example, where around 90% of deals are under covenant-lite structures, we’ve seen a number of situations where companies move assets away from the existing borrowing perimeter and raise new money, priming in effect the existing creditors which substantially reduces recoveries for the “old” creditors. That is not a situation that arises in EM.

### Less competition versus DM strategies

EM private credit strategies are a rarity, and the lack of managers and competition in the market means that many underlying loan terms can be dictated.

In Europe alone, there are 200+ managers, and it is a fully developed, sponsor-driven market, which most of the time comes with ‘pre-baked’ terms. In EM, the vast majority – 90+% – of our potential opportunities are sponsor-less transactions, family owned, and sometimes listed companies. The shrinking banking sector means that there aren’t a plethora of alternatives coming into a market trying to lend, and that is important in driving the terms.

### Investment opportunities

For us, the biggest markets are the larger countries with established legal systems, for example Brazil and Mexico, while within Europe, Turkey is where we have exposure and continue to see investment opportunities. Clearly, Turkey has been undergoing hyperinflation, however we are ultimately looking for mitigants, for example by focusing only on exporters. For hard currency earners, in the history of Turkey there hasn’t been a situation where the government has put in capital controls nor restricted the flows of hard currency for debt service.

#### Summary

We believe high quality EM corporate private debt investments, generating 500+bps per turn of leverage, can make a significant contribution to investment returns while improving the overall credit characteristics and diversification of risk exposure.

We employ a selective approach within a closed-end structure that seeks to provide the optimal approach for accessing outsized excess returns, while protecting against market volatility and downside risk. We believe that focusing on high quality performing EM credits and enhanced by a small allocation to select stressed names, is a very compelling strategy for navigating current markets.



### Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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