

Private credit opportunities in emerging markets



April 2024



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We address the misperceptions around EM private credit and make the case that, within global portfolios, select EM exposure can reduce risk in investor portfolios, dampen volatility and materially enhance returns.

EM private credit – uncovering the opportunity set

Uncertain and volatile markets in recent years have led many investors to retreat and wait for clarity, before allocating capital. In this context, assets with stronger credit metrics have been the natural area of focus, whilst private markets have also offered a haven from volatility. We believe that those looking at traditional developed markets (“DM”) opportunities could benefit from incorporating select emerging markets (“EM”) private debt in their portfolios, in order to take advantage of higher yields for comparatively stronger credit exposure.

As it is not broadly covered, the biggest hurdle in the EM private credit space is that investing in EM assets equates to higher risk, both on the credit and documentation side. In this paper, we look at this misperception and others, take a deep dive into the opportunities in this space, and discuss the potential risk-reward in the context of the current market backdrop.

Uncertainty in global markets will likely persist

Global markets in the last year have largely revolved around a few key themes. Central banks across the globe have been battling inflation by raising rates aggressively, while geopolitical concerns and prospects for economic growth have featured strongly in asset allocation decisions. The next 12-18 months will undoubtedly bring additional political and economic uncertainty to many corners of global markets, particularly heading into US elections, and this could trigger further economic and financial stress. The pressure could potentially be felt most severely amongst corporates, some of which have been cut off from the capital markets, possibly resulting in financial difficulties. These range from covenant breaches to outright default on their financial obligations.

Market dislocations in pricing and capital availability have, indeed, been felt acutely within EM, where outflows in public debt markets exceeded USD120 billion in the last two years¹. Indeed, some sectors, such as Chinese real estate, have experienced severe stress. As we look ahead, the dearth of available capital could remain an important feature, given that investors have a general bias in favour of DM. In particular, this is an issue in the private credit segment portion of the asset class, where corporate newsflow or simply de-risking amongst banks can result in forced selling at prices not observed in liquid bond markets. Moreover, high dependence of EM corporates on funding through the banking sector and lack of dedicated pools of capital to absorb supply can exacerbate these moves further.

A targeted approach can achieve an attractive risk-reward balance

We believe a targeted investment approach, largely focusing on high quality performing EM credits, but enhanced by a small allocation to select stressed names, is a very compelling strategy for navigating current markets. This allows investors to capitalise on a diversified pool of higher quality investment opportunities that offer asymmetric return profiles and can generate outsized returns, often enhanced even further if acquired opportunistically at a discount during periods of market dislocation.

The upshot is that the distinct attributes of the EM private market allow investors to enhance the yield in their portfolios by capturing the illiquidity premium compared to liquid EM markets. This is done while improving the credit and documentation profile of their underlying investment, compared to DM private credits.

Inevitably, with such opportunities come potential pitfalls. Misunderstanding the credit risks is first and foremost on the list, but other factors come into play within EM, such as execution and enforcement risk, given the global scope of the opportunity set. We believe that implementing a successful strategy in this context requires four critical elements:

1. **Deep sourcing and origination channels** to source high quality, attractive opportunities.
2. **Rigorous bottom-up fundamental analysis capabilities** that can be employed in a timely manner.
3. **Strong documentation and legal environment** with thorough due diligence.
4. **Ability to deploy capital opportunistically** in compelling stories that may require time to play out.

The investment case for EM corporates through the lens of a lock-capital, drawn down vehicle can be outlined as follows.

“Although it can seem counterintuitive, EM corporates are currently in a stronger position than their DM peers.”



¹ JPMorgan.

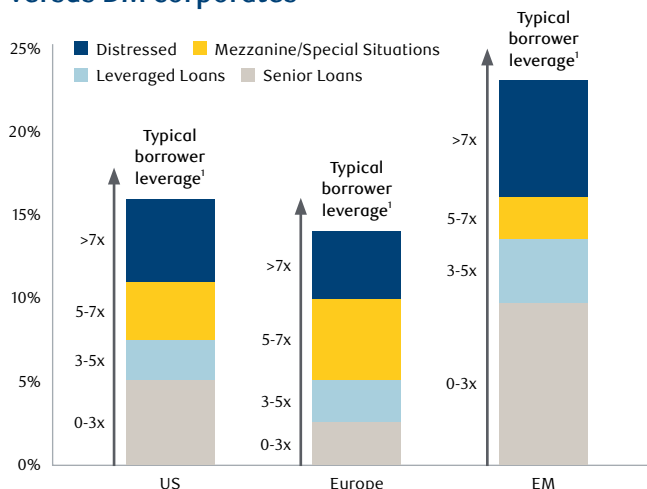
The EM universe offers a multitude of opportunities with superior credit and commercial metrics

Although it can seem counterintuitive, EM corporates are currently in a stronger position than their DM peers and, in many jurisdictions, can offer investors better protection on both financial and documentation fronts. The contrasts, many of which strengthen the position of creditors, are even more evident within the private credit universe.

Lower leverage and higher interest cover: most EM corporates have leverage ratios below 3x, materially lower than that of DM counterparties, at 5-6x. Moreover, this also translates into a higher interest coverage (typically north of 2x) in EM, versus 1-1.5x in DM even in the current higher rate environment. It is particularly noteworthy that the yields on these EM corporates, in comparison to their DM counterparts in the US and Europe, are also higher (Figure 1). Even when looking at corporates' ability to service their debt, we have seen a divergence over the past few years between DM and EM, as cash levels relative to total debt in US companies, for example, have declined since 2020 while growing across the EM corporates (Figure 2).

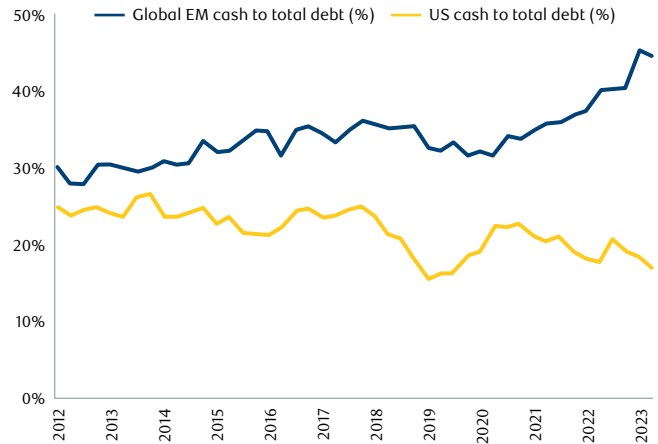
Better documentation protection: overall, financings for EM corporates in scope for foreign investors continue to be executed under international law, with full covenant protection and borrowers' restrictions that are more robust than financings in the DM universe. In the majority of transactions, we target enhancements through tested European or US governed security packages, thus allowing the bypass of local jurisdictions' legal frameworks in case of enforcement.

Figure 1: EM corporates risk-reward balance versus DM corporates



Source: US Senior Loans and High Yield, S&P Global, GEM Blended Sovereign and GBI-EM JPMorgan indices. ¹ Estimates are based on market information and historical investment experience. Distressed and Mezzanine returns are global. Data and estimates as at December 2023.

Figure 2: Cash to total debt – EM versus US corporates



Source: BAML, as at 2023.

Banking sector more restricted: while healthier than in the past, local EM banks don't have the same access to liquidity levers as their counterparts in DM, limiting their lending capacity. Moreover, we expect some of the DM banks, as part of their de-risking measures, to further pull their risk appetite away from EM regions. This continuing re-orientation of the global banks is being driven primarily by capital requirements they face in their core DM markets but also by the increasing costs of doing business locally in EM countries. As such, we have seen these regulatory constraints on capital and leverage profoundly impact the behaviour of the banks and their capacity as direct providers of long-term credit. Furthermore, banks are generally opting to act largely in an arranger capacity, a trend which has also exacerbated volatility and dislocation within the credit market.

Illiquid and shallow local capital markets: unlike DM, where deep debt capital markets provide liquidity to corporates (for example, corporate-issued bonds represent approximately 40-50% of GDP in the US and Germany), we see local corporate debt capital markets providing much smaller pools of capital in EM (where corporate bonds represent around 10-20% of GDP in large EM countries like South Africa, Turkey and Brazil).

Low amounts of dry powder available: despite the significant inflows into direct lending and other private credit opportunities in DM, it is unclear whether additional liquidity will be extended to EM borrowers in the foreseeable future. The implications of this could be material for investors who are in a position to provide liquidity for high quality credits or pick up secondary EM loans sold by forced sellers.

Access to meaningful yield pick-up through the illiquidity premium

The EM investment universe offers a variety of choices across liquid benchmark strategies (CEMBI-based or the underlying investment grade or high yield sub-asset classes) as well as the option of investing through total return and long/short funds. The illiquid assets within the opportunity set have historically been held by the sub-set of investors who are able to forego liquidity in order to garner higher yields, often from the same underlying issuer (Figure 3).

“The EM investment universe offers a variety of choices across liquid benchmark strategies.”

The EM illiquid credit strategy offers a compelling return, even when compared to the broader fixed income universe (Figure 4).

The drivers for capturing this illiquidity premium include:

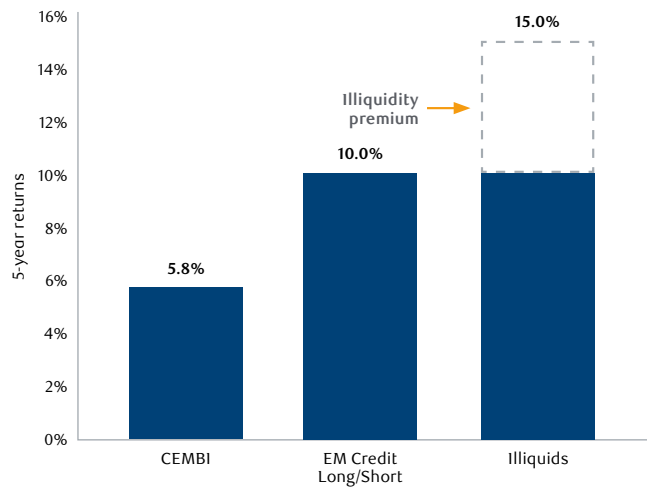
Lack of competition for EM illiquid assets: there are fewer asset managers and substantially lower amounts of dry powder available.

Lack of alternatives: the EM borrowers over-rely on the banking sector, the local debt capital markets are shallow (relative to DM), and there are a lack of other alternatives pools of capital existing in DM.

Deep sourcing channels: covering illiquids requires long-standing relationships and market access, which relies on being part of a larger organisation.

Ability to act fast: being the first port of call when opportunities arise (particularly in instances of forced selling) and having deep sector and country knowledge to permit quick decision making.

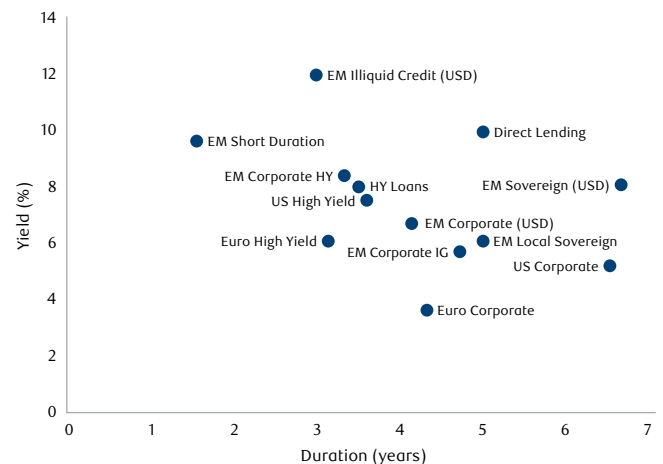
Figure 3: Capturing the illiquidity premium



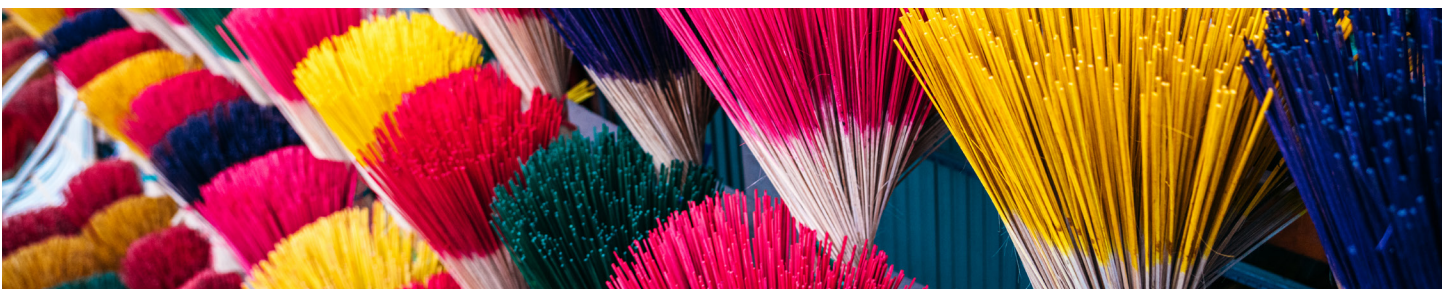
Source: RBC GAM, as at 29 February 2024.

Note: returns for CEMBI (JPMorgan’s Corporate Emerging Markets Bond Index) are for the past 5 years. For EM Credit Long/Short and BlueBay Emerging Markets Illiquid Credit strategy the returns are target gross returns.

Figure 4: EM Illiquid Credit strategy performance versus other fixed income strategies



Source: JPMorgan, BofA and Bloomberg, as at 31 January 2024. Returns are net. Note: EM Corporate (USD) = JPM CEMBI Diversified Index; EM Sovereign (USD) = JPM EMBI Global Diversified Index; EM Local Sovereign = JPM GBI-EM Global Diversified USD unhedged Index; US High Yield = BofA US High Yield Master II Index; US Corporate = BofA US Corporate Master Index; Euro High Yield = BofA Euro HY Index; Euro Corporate = BofA Euro Corporate Index; EM Corporate HY = JPM CEMBI Diversified HY Index; EM Corporate IG = JPM CEMBI Diversified IG Index.



Why EM private credit, and why now?

The 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. 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 (Figure 5).

A robust investment framework is essential

Over the last four years, we have built a tried-and-tested framework for investing in EM private credit based on several key underlying principles, with fundamental analysis as the key starting point.

In-depth due diligence by specialists: financial and commercial due diligence leveraging a deep bench of sectors and macro specialists within the team; analysis includes testing the range of potential stress scenarios with a focus on cashflow generation, debt sustainability, leverage trends, refinancing risks and FX risk. Technical and ESG factors are integrated within the decision-making process.

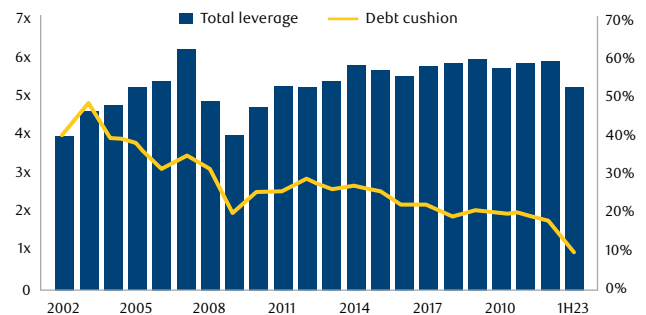
Active monitoring and engagement: ongoing monitoring of the borrower’s financial conditions and the respective local markets; use of lender information, disclosure rights and engagement with company’s management to ensure on-going operational and financial performance remain consistent with initial underwriting thesis.

Strong and credible sourcing network: proprietary sourcing from direct, long-term relationships, which materially de-risks the investment process and provides a constant flow of potential investments across geographies and sectors.

Seamless execution resources: working within a purpose-built platform that incorporates robust risk management, operations and compliance.

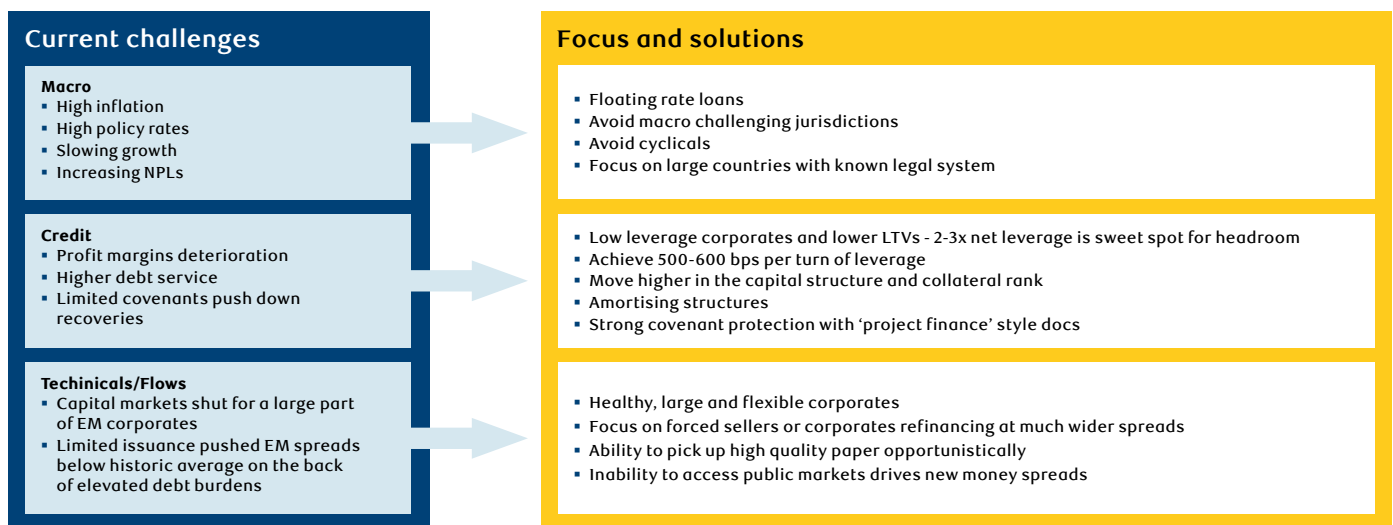
Familiarity with legal architectures: focusing on downside protection from a legal perspective, drawing on restructuring expertise and in-depth knowledge of local bankruptcy laws to allow for more accurate analysis of enforceability of creditors’ rights and monetisation of collateral in a worst-case scenario.

Figure 5: LBO leverage and LTV ratios saw gradual increases



Source: Data as at 30 June 2023, based on issuers with EBITDA of USD50 million or greater.

Current challenges – and the solutions



Source: RBC GAM, as at 31 December 2023.

Risks & misperceptions versus mitigants & reality

While the EM credit asset class is large and global, there are several key (mis)perceptions that have historically held investors back. It is important to examine these more closely, to separate out the perceived risks from real ones and understand how to best mitigate them in the investment process:

FX risks

Limiting portfolio investments to hard currency instruments is the first step in mitigating the impact of FX movements within an issuer's local macro backdrop. However, equally vital is the position of the underlying corporates with respect to fulfilling hard currency obligations. The borrower is already in a strong position to access foreign currency, either through earning sufficient hard currency revenues or having low enough levels of leverage such that access will be possible, even in worst case scenarios. Alternatively, the borrower would be expected to have hedging in place to secure this access.

Legal environment and enforcement

Many EM countries are operating under relatively new legal frameworks which can translate into the absence of a long-term track record with respect to enforcing contracts and gauging underlying financing security. Mitigants against these concerns include:

- Most external EM corporate debt is issued under English or NY law documentation and contains comprehensive security packages. With a few exceptions (as highlighted below), there is a long track record of enforcing English (or NY) law contracts in EM.
- Most of the legal systems related to credit and financings have been drafted with strong creditors' rights and there is a lack of debtor rights protection (i.e. Chapter 11-like).
- On a relative basis, in a large numbers of EM countries, creditor's legal rights can be weaker than in the US and UK but notably stronger than some Southern European countries.
- A substantial track record; there have been a large number of successes in collateral enforcement.
- Avoiding difficult jurisdictions: ultimately, as credit investors, we look at protecting the downside risks, and in certain jurisdictions this is more difficult, particularly when considering enforcement scenarios, as well as the length and ability of stakeholders to interfere with the process

“While the EM credit asset class is large and global, there are several key (mis)perceptions that have historically held investors back.”



Higher risk-adjusted returns compared to DM provide an important buffer

On a like-for-like comparison, EM corporates have lower levels of leverage and better documentation protection (e.g. covenants, restrictions) than their DM counterparts. In DM, to achieve comparable returns, investors would need to shift to the lower end of the credit spectrum (i.e. distressed) and be willing to accept weaker documentation protection.

- When considering secured loans, the security packages in EM generally contain very conservative Loan-to-Value (“LTV”) ratios and the secured assets provide cover well in excess of the loan amount.
- Higher debt service coverage ratios crucially enable target EM corps to afford principal repayment over 3-5 years, thus not relying on market conditions and refinancing risk prevalent in the DM universe.

Reputational risk

There are a number of factors that are important to cover, including Know-Your-Customer (“KYC”), ESG risks and ensuring adequate transparency and due diligence related to the management team and main shareholders. In our view, the most effective way of mitigating the risks surrounding these issues is to:

- Focus on the larger corporates with management teams that have a proven track record. Such corporates usually have a long history and public markets-level of disclosure and are accustomed to addressing investor requirements in this area.
- Conduct in-depth due diligence using a multitude of local and independent sources.
- Most EM corporates that have raised financing (or anticipate doing so) in the international markets already have substantial policies around ESG, or are working to augment their existing programmes. As investors, we actively engage with them on these topics to ensure that they are aligned with our own ESG framework and moving in the right direction.

The case for a drawdown vehicle: distinguishing between mark-to-market and default risk

Given the speed and the severity of recent market dislocations, investors in liquid strategies were subject to substantial mark-to-market losses, some of which were crystallised in actual losses due to redemption and rebalancing needs. This can be counterproductive for investment returns, especially as, ultimately, investors' risk analysis within fixed income assets should be focused primarily on default risk and the potential for permanent impairment of capital. A longer-term investment horizon is more suitable for investors wishing to isolate this credit risk from technical factors and short-term market volatility. Indeed, for these investors, market volatility translates into an opportunity to acquire high quality assets at discounted levels.

When operating in environments that potentially experience dislocated credit markets, we believe the optimal approach would incorporate the following:

Investment vehicle and structure permitting opportunistic investing for maximising returns:

- Ability to **draw capital** when opportunities arise, rather than being forced to deploy it immediately.
- Smoother volatility profile with **locked capital**, allowing enough time to harvest the underlying investments.
- **Income distribution** through instruments with relatively high cash interest, which can be passed on to investors on a quarterly or semi-annual basis.

A focused but flexible strategy:

- Targeting **hard currency assets** only (mainly in USD) for underlying corporates that either generate hard currency or can afford it (for example, by having low leverage levels).
- Flexibility to 'look through the cycle' by having **multiple sleeves**, each designed with certain market conditions in mind. For example, whilst the primary holdings in the portfolio could be high quality performing loans, the ability to structure 'new money' investments can be beneficial (such as when lending to a strong corporate that needs to move quickly), as is the option to opportunistically pick up a newly restructured asset in secondary trading at a price below intrinsic value.
- Targeting opportunities where the **risk-return profile** is superior compared to the public markets.
- '**Buy-and-hold**' approach rather than trading in and out of the market.

Platform and team providing rigorous analysis and timely decision making:

- **Strong sourcing capabilities** across the EM spectrum, allowing a selection of the best risk-return opportunities.
- **Experienced team** across sectors and through the credit cycle, drawing on sovereign, sector and structuring expertise throughout the investment process.

High quality risk at mid-teen returns available for investors in EM private credit

Although the market fallout was severe (due to limited market access and elevated yields), issuers in EM countries were nevertheless generally in a relatively strong position entering into the recent global market volatility.

Uncertainty regarding the market outlook and the corresponding risk aversion could remain a theme for the foreseeable future. This is precisely why investors should carefully assess the risk-reward profiles within their portfolios to ensure they have sufficient diversification in their exposure. With this in mind, and considering that credit spreads are at historical lows, investors in DM private and liquid markets could question whether they are being fully compensated for the credit and market risk they currently hold.

We believe high quality EM corporate private debt investments, generating 500bps per turn of leverage, can make a significant contribution to investment returns while improving the overall credit characteristics and diversification of risk exposure. A selective approach within a closed-end structure provides the optimal approach for accessing outsized excess returns, while protecting against market volatility and downside risk.



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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