

The potential advantages of investing in EM private credit



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We look at why it might be time for investors to consider previously overlooked private credit opportunities in emerging markets.

Key takeaways:

- The rapid growth of private credit has so far been largely confined to developed alternative asset markets such as the US and Europe.
- However, many investors are now turning their attentions to emerging markets (EM) to make the most of new opportunities in overlooked regions.
- We believe that EM investments have previously been subject to misconceptions and believe that – with the right research – some of these opportunities can outshine those in more developed markets (DM).

Why we believe EM private credit has the edge over DM

For the most part, the drivers for EM private credit are very similar to what we have seen in DM. What is different is the over-reliance by EM corporates on the banking sector. In the US, the medium-to-large corporates are approximately 20-40% funded by the banking sector. Conversely, in EM, you are looking at 80-90% of funding is coming from the banking sector. Historically, EM countries have been much less developed in terms of debt capital markets, and the same options simply don't exist in the former.

Although news-flow around some parts of the private credit market (or specific vehicles) has been on the negative side of late, there are some key differences that active managers can employ across a few themes that can distinguish EM private credit approaches from typical private credit strategies in DM:

- 1. Software and AI:** some EM private credit strategies focus on “old economy” sectors such as infrastructure, utilities, industrials, oil & gas, and TMT, rather than more volatile areas like software or AI-related investments.
- 2. Seniority:** many EM private credit portfolios emphasize senior secured loans, which can provide better downside protection compared to junior or mezzanine debt structures common in some DM strategies.
- 3. Low leverage:** EM borrowers often have lower leverage ratios (typically in the 3x net debt/EBITDA range) versus DM direct lending borrowers, which generally carry 5x leverage on the senior side and up to 7x on a junior/mezzanine basis.
- 4. Duration:** EM private credit loans tend to be amortizing in nature, with shorter average lives compared to many DM structures.

5. **Exits:** given the amortizing nature of these loans, exit strategies typically rely on borrower cash flows rather than refinancings or secondary market sales.
6. **Current income:** lower leverage levels enable many EM borrowers to pay cash interest, reducing the need for payment-in-kind (PIK) structures that have become more common among some DM borrowers.
7. **Deployment:** the EM private credit market continues to offer attractive investment opportunities.

EM private credit: the myths versus the realities

There are plenty of misconceptions around EM private credit.

- The most obvious is the misconception that there is no rule of law. We do, of course, need to accept the reality that EM countries' legislative and legal environments are not as developed and sophisticated as places like the US or UK. However, the larger markets – like Brazil, Poland and Turkey – are places that have been developing these areas over the past few decades.

As an example, Brazil's bankruptcy legislation is fairly similar to that of the US. It has a Chapter 11 equivalent and the ability to provide deep debtor repossession financing that is recognised by the court as super senior. There are a number of cases over the past 15 years that have gone through the Brazilian courts to establish precedents that can be used. It may take a little longer to go through the courts, but the process is there.

- Another misconception is that the underlying credit risk of EM countries, which are driven by local currencies, are prone to devaluation. Currencies can devalue, but many overlook the fact EM corporates have been living with local currency devaluation for a very long time. This means they have adapted to this reality and often have underlying contracts rooted in harder currencies.
- The last misconception worth mentioning is the lack of information around EM corporates. The vast majority of these corporates are private or family-owned, and if they are looking to borrow internationally, they understand that the threshold for them is much higher, for example, in terms of disclosure and who sits on their board.

EM corporates can offer more attractive opportunities than DM counterparts

Firstly, the DM private credit space has been booming for the past 15 years with substantial amounts of capital being raised. The broadly syndicated markets are becoming more institutionalised, which has implications for the underlying documentation. We've seen a lot of deals in DM that are covenant-lite or with 4-5x leverage, and with a unitranche on top, that rises to 6-7x leverage.

When we look at EM, we see that underlying documentation has not materially changed. As these are not P/E-driven deals, there can be restrictions in place in terms of payments to shareholders. There is less of a chance for a shareholder or private equity firm to play games or make attempts to 'juniorise' current lenders.

DM were more impacted than their EM counterparts when interest rates went up a few years ago, and companies involved in several deals had to make last-minute decisions to switch to PIK. In contrast, the lower leverage of EM corporates means that even if rates rise significantly, they're still often able to pay interest in cash.

Compelling regions for EM private credit opportunities

EM countries are full of idiosyncratic stories. Some might argue that Poland is not an EM because it's an A-rated country, yet the risk profile and the returns are very different just across the border in Germany.

Each country has specific drivers. For instance, we have seen a lot of commodity-driven financing in Latin America. Brazil is home to large lithium mining, and electric vehicles have been a huge driver of that trend. The bottom line is a lot of these countries have seen substantial macro growth and that drives demand for funding.

It is worth noting that Asia presents a very different offering to other EM countries. Asian private markets can generally be divided into three – China, India and the rest of the continent. China is an extremely difficult market to enter due to geopolitical issues and language barriers, while India is a very competitive market because due to its vast size. A considerable local presence is needed to play in these spaces.

Accessing the opportunity set in EM

In a developed market P/E-driven transaction, the lender is presented with a full information pack and everything is ready for them to start the process immediately. Due diligence material is freely available, as that is how the space ultimately operates. Unfortunately, that's not yet the case in EM countries, which is evident in our hit ratio. Comparing the opportunities we see to those we ultimately execute on, the total is lower than one would see in DM.

A lot more work is necessary to be successful in EM, and more people are needed on the ground, with both local and global perspectives. This huge universe needs more than just a few people sitting in an office, but it is ultimately worth the extra effort to capitalise on those opportunities.



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