WHY CONSIDER ALLOCATING TO EM ILLIQUID CREDIT

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Introduction

Events in 2020 have brought uncertainty and price dispersion to many corners of global markets – how can investors gain conviction in this environment? One theme which has gained consensus is the view that core rates will remain low for the foreseeable future as policymakers aim to provide buffers against potential economic and financial instability. In that environment, fixed income investors will likely continue to face the key challenge of the last 10 years – finding appropriate strategies to enhance the yield in their portfolios.

Since the global financial crisis of 2007-2009, many developed market investors have turned to alternative investment strategies, such as private credit[1], to achieve this, while others have broadened their geographic reach to include emerging markets (EM) assets, focusing primarily on liquid, public-market strategies. Most recently, following the Covid-related market dislocations, there has been a wave of new capital raised anticipating a surge of distressed opportunities in the developed markets (DM) corporate sector.

We believe there is an alternative, attractive approach available, which remains largely untapped: performing hard-currency loans to large, healthy EM corporates. These loans can offer potential advantages for an investor looking to enhance portfolio yield without compromising on robust legal documentation or having to venture into higher leveraged, distressed opportunities.

Through income-paying, drawdown structures, investors have the potential to capitalise on the illiquidity premium the secondary loan market offers compared to liquid instruments, through high-quality corporate credit in EM countries. Indeed, these structures have the potential to achieve double-digit returns that, given their longer-term investment horizon, are not susceptible to the shorter-term risk dynamics of potential market volatility and flow fluctuations in the EM asset class.

While the opportunity set is deep, navigating it successfully requires extensive regional and sectoral expertise, as well as experience with the legal and documentation framework of the underlying assets.

In this note, we outline the key parameters of the opportunity set and why we believe it represents a compelling alternative for EM and DM investors alike. We also describe the investment framework we believe is necessary for approaching this market, combining resources and expertise for extensive bottom-up fundamental analysis with structural and transactional capabilities to evaluate the idiosyncratic features of specific investment opportunities.

We believe there is an attractive, alternative approach available, which remains largely untapped: performing hard-currency loans to large, healthy EM corporates.

Attractive opportunity set

For the purposes of this paper, we refer to the secondary loan segment of the EM market as 'private credit', given that access to these instruments is not readily available to most investors and the number of participants in any given transaction is generally limited. While primary lending opportunities are also possible, the scope of the discussion will focus on bank loans trading in the secondary market – which we believe provides a deep and diversified opportunity set. The lock-up nature of the vehicle we would recommend would place such a strategy in the illiquid bucket of a portfolio.

A review of the competitive landscape of this market shows that the alignment of several key elements can result in a potentially powerful investment case.

[1] Private credit refers mainly to loans and other illiquid instruments and is defined as direct lending, distressed debt, mezzanine financing, special situations and venture debt.

Below we summarise the components that can be leveraged to access high-quality performing credits to shape a favourable investment risk/return profile.

Market characteristics

Deep opportunity set

Corporate external hard currency market estimated at USD2.5+ trillion with tradable hard currency primary syndicated loans issuance between USD100-200 billion annually.

Less competition for EM assets

Since the global financial crisis, there have been a large number of new managers coming to the market with direct lending strategies (mainly focusing on the European market). This has eroded both the return potential and documentation protections. Within the EM space, we have seen substantially smaller amounts of capital raised (both in absolute and relative terms), which has preserved significant influence for existing managers over underlying returns.

Better default and recovery rates

EM corporates have historically had better default and recovery rates versus their DM counterparts. We expect EM corporates default rates to peak in the mid-to-high single-digit range with US high yield to be in the lower double digits. Moreover, EM recovery rates have been consistently above DM for both bonds and senior loans.

Attractive supply/demand dynamics

Continuous bank capital and balance sheet management mean the supply of quality loan paper should remain solid. Moreover, in today's Covid-19 driven market, we are seeing a number of international banks selling performing EM risk in order to release capital needed in their home markets. Coupled with a limited number of dedicated buyers, this reduces potential competition for attractive investments.

Robust credit metrics

Credit risk

EM corporates have lower EBITDA leverage (on average this is 2-4x) when compared with the target corporates for DM private credit strategies (5x+).

Documentation protection

A large majority of DM loans are now 'covenant-lite', while in EM, lenders benefit from financial covenants and borrower restrictions which, in the right jurisdictions, can translate into better recoveries should the underlying corporate enter a distressed period.

Compelling return potential

Double-digit returns

We believe investors can potentially achieve double-digit returns in this asset class, comparable with distressed strategies in DM and substantially above what similar senior direct lending strategies are currently achieving. For example, direct lending strategies in DM (senior, uni-tranche and even mezzanine) are achieving mid-to-high single-digit returns for corporates with 5-7x leverage ratios.

Diversification

Private credit strategies offer potential diversification for both EM liquid credit (e.g. by accessing credits without public securities or instruments more senior in the capital structure) and DM private credit portfolios (by offering a different risk/reward balance), presenting a yield pick-up with less volatility.

ESG integration

Within EM, even more than in DM, integrating ESG factors in credit selection, due diligence and engagement, by following a pragmatic and tailored approach, is critical to investment outcomes and typically leads to a better risk/reward balance. In addition, the lack of alternative sources of capital for many of these corporates paves the way for lenders to be more influential when engaging on ESG issues.

Investment vehicle

Illiquidity premium

Locked-up capital allows for an illiquidity premium to be harvested versus public markets by deploying capital into compelling stories that require time to play out.

Economic cycle agnostic

By carefully selecting the right approach for EM illiquid credit with multiple sleeves, the deployment of capital should not be dependent on where we are in the cycle. Likewise, the supply of paper from global and regional banks can stem from a host of regulatory and commercial reasons, many of which are unrelated to the economic backdrop at the time of balance sheet reduction.

Capital deployment pace

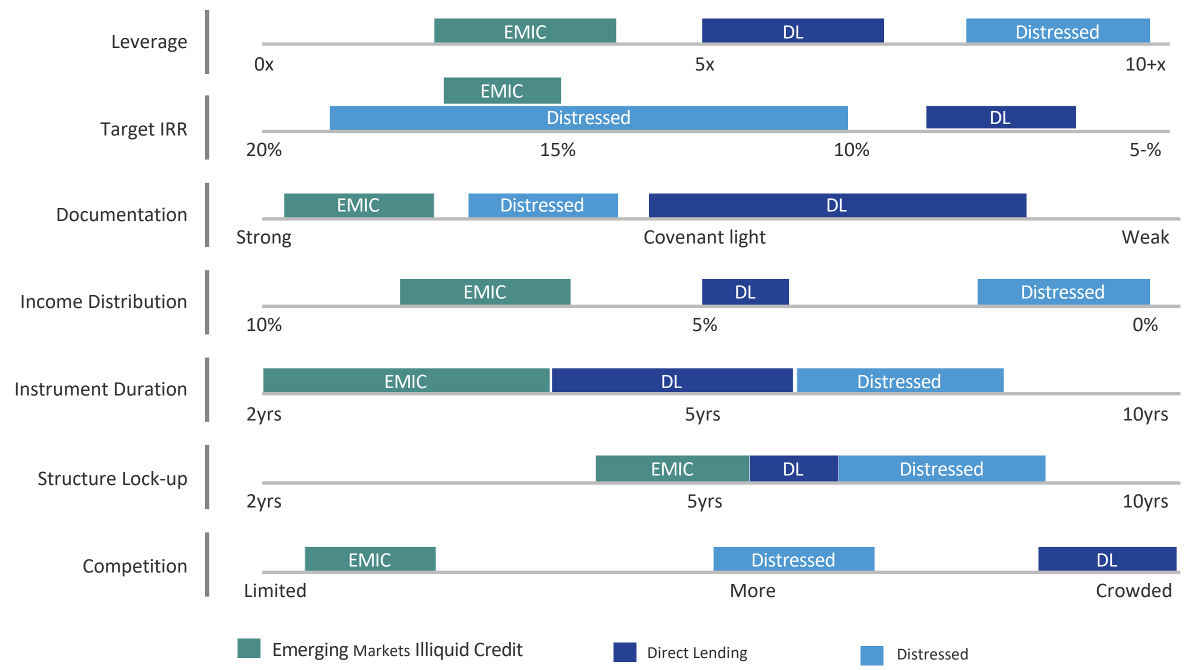
Given the opportunities available, we have found that capital can be deployed immediately and continuously without the need to wait for the right market conditions. For example, the distressed wave expected in DM for the past 3-4 years and the capital committed is likely to depress the money-multiple even in today's environment.

Positioning EM illiquid credit strategies

We believe an EM senior performing loan strategy accessed through a locked-up vehicle scores favourably on the key strategy metrics when compared to DM-focused direct lending and distressed strategies, as outlined in chart 1. Here we can see that an EM portfolio invested in performing loans can deliver returns comparable with distressed strategies in DM but with lower underlying leverage and duration exposure. These strategies also benefit from stronger lender documentation for the underlying loans and less competition for attractive investment opportunities than direct lending and distressed funds focused on DM markets.

While liquid strategies in equity and fixed income have been available to investors for some time, access to private markets and private capital (comprising of private equity and private credit) has been more limited.

CHART 1: EM ILLIQUID CREDIT COMPARED TO PRIVATE CREDIT STRATEGIES IN DM



Source: BlueBay Asset Management, October 2020

Private capital: equity vs credit

While liquid strategies in equity and fixed income have been available to investors for some time, access to private markets and private capital (comprising of private equity and private credit) has been more limited. This has been driven mainly by the natural evolution of these markets on a global basis.

Because the pools of capital in private equity (PE) funds have traditionally been larger and broad-based, this asset class was the first area investors naturally turned to when looking at EM. However, we believe private equity investing in EM, with a few exceptions, comes with a number of challenges:

a) **Leveraged buyouts:** there is generally a lack of leveraged loans available in EM for a PE investor to complement its equity check. As such, compared to DM-focused strategies, underlying companies in EM will need to grow much faster for PE firms to achieve a similar level of return.

b) **FX:** because the currency markets in EM tend to be shallow and short term, it is difficult for PE managers to hedge FX exposure, especially given the irregular cashflows and long-term horizon of PE strategies. Moreover, we have seen that over long time periods, EM currencies can suffer bouts of substantial depreciation, causing USD returns to be further depressed compared to DM strategies, where investors either don't take FX risks or are fully hedged.

c) **Exits:** in DM, a PE manager has a multitude of exit alternatives available: deep stock markets, large numbers of strategic buyers or other PE managers keen to acquire assets. In EM, these alternatives are substantially muted and are also susceptible to swings in global sentiment related to the outlook toward EM equities.

Overall, we believe that within EM private markets investors in private credit are rewarded with compelling returns on a risk-adjusted basis relative to PE, with more stable returns in substantially shorter time frames and with less uncertainty. Moreover, according to Preqin data, outside certain country-specific PE strategies, we have seen PE in EM consistently underperforming on a three, five and 10-year horizon when compared to similar DM strategies.

Focus on high-quality opportunities

While the opportunity set is deep, we believe the key to successful investing in secondary loans within EM lies in three key criteria. In combination, these set the stage for maximising the potential risk/return balance and avoiding some of the pitfalls that can present themselves in EM.

Considering the development in local legal frameworks, FX risks and the enforcement track-record across regions, we believe investors in EM private credit should focus on investments with the following characteristics:

1. Performing credits

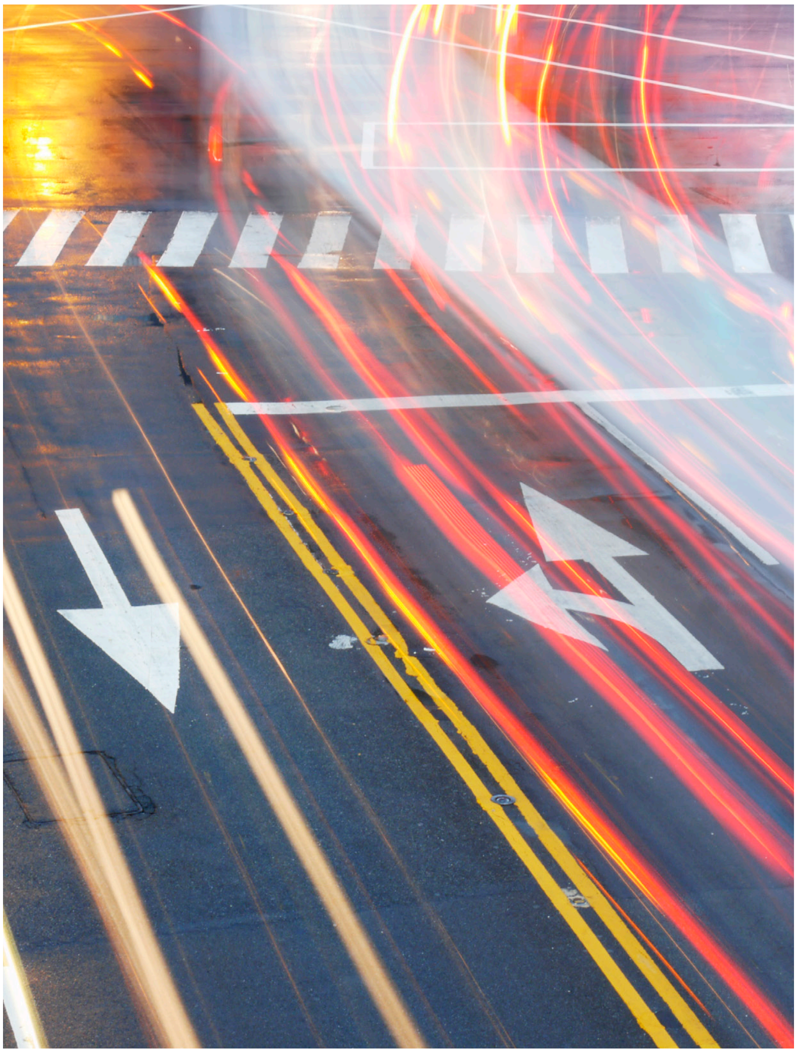
Given banks' capital constraints and their move towards a more originate-to-distribute model, there are many high-quality credits trading in the secondary market at notable discounts for short-to-medium term paper, offering compelling returns per turn of leverage. Focusing on the performing spectrum rather than deeply distressed names provides a much larger investable universe without the need to dedicate excessive time, resource and undue risk to distressed opportunities. Moreover, our observation is that, given the longer timeframe that is often required for distressed stories to play out, dedicated EM distressed strategies have struggled to deliver on their return targets, let alone within their expected timeframes.

2. Hard currency

One of the main default risks we have seen for EM corporates is related to foreign exchange (FX) mismatches between their sources of cash and their liabilities, especially when they have a medium-to-high leverage ratio. As such, we believe investors should focus on underlying borrowers that generate hard currency revenues or situations where the financing is hedged into the local currency, eliminating the FX mismatch.

3. English/US law documentation

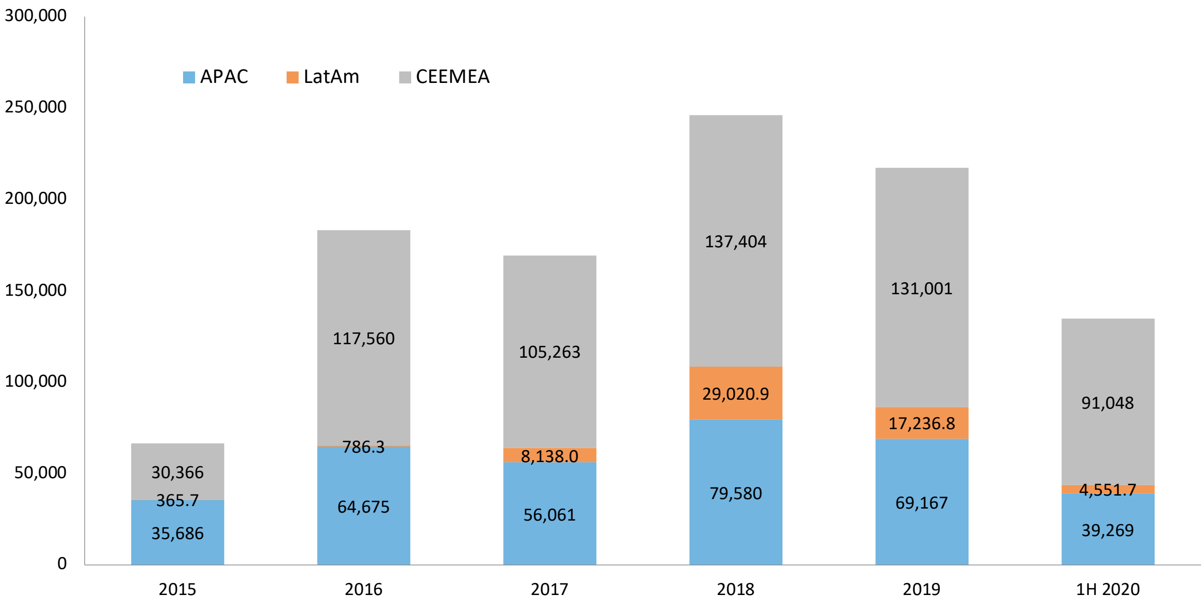
While we believe legal rights in certain EM jurisdictions are stronger than in some Southern European countries, overall, they are weaker than in the UK and US, with a shorter track-record on enforcing contracts and underlying collateral and security. For this reason, we believe investors should focus on instruments with documentation under UK or US law, which allows a speedier and 'cleaner' contract enforcement, even in local courts. We believe this documentation, coupled with the investment team's knowledge and experience within individual local jurisdictions, is key to mitigating legal risks that can often be associated with EM investments.



Large universe of opportunities

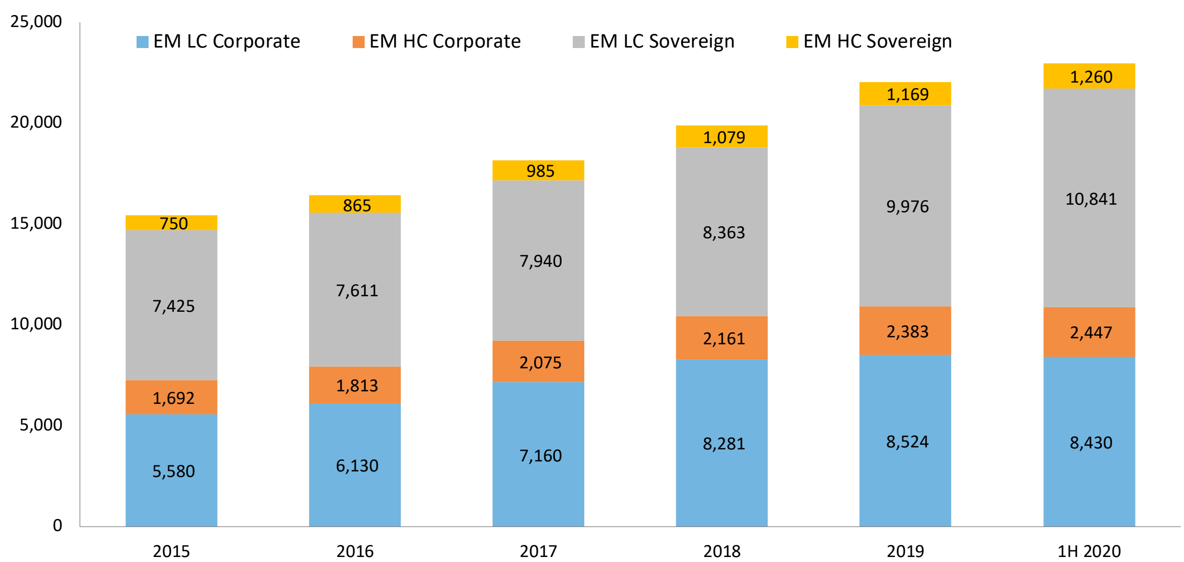
Limiting the scope of investments to the three criteria mentioned previously implies focusing primarily on internationally syndicated loans and Eurobonds. Even then, the size of the investible universe remains meaningfully large and diverse. As can be seen in charts 2 and 3, the stock of debt is over USD1.2 trillion with an annual volume of new syndicated loans to the tune of USD130+ billion.

CHART 2: EM TOTAL SYNDICATED LOAN VOLUMES (USD M)



Source: Debtwire, as at July 2020

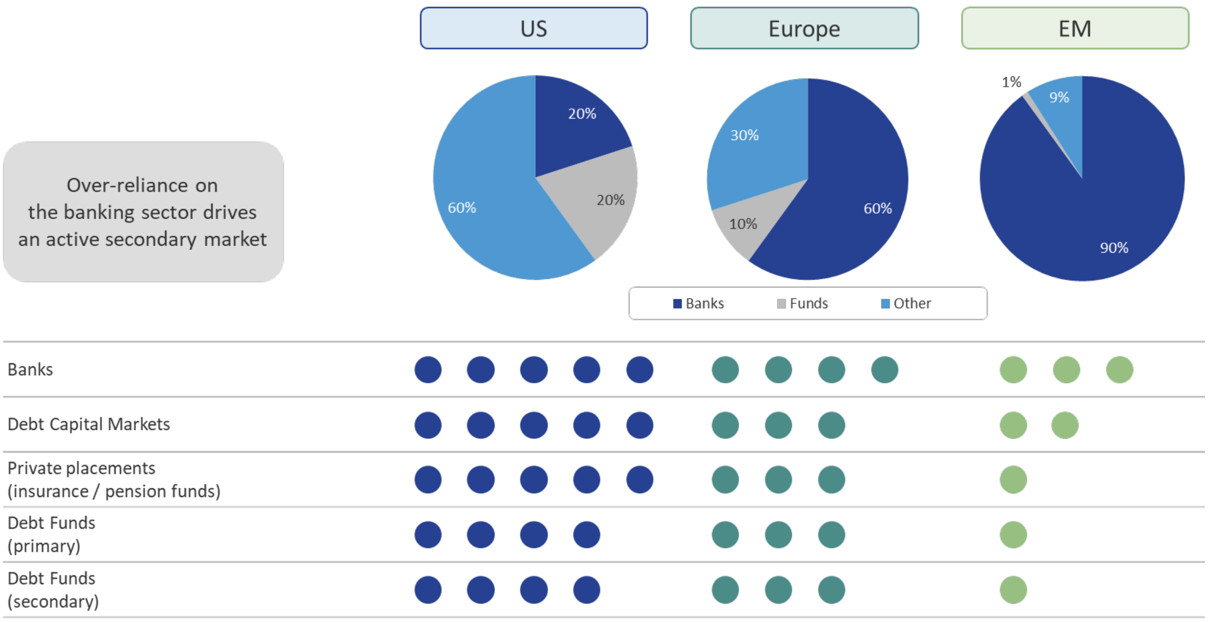
CHART 3: SIGNIFICANT GROWTH OF TOTAL DEBT STOCK OVER THE PAST FIVE YEARS (USD BN)



Source: JP Morgan, as at July 2020

Not only is the opportunity set large, but trends within EM credit markets suggest to us that it will remain a structural opportunity for the foreseeable future. Underpenetrated corporate credit markets will likely continue to distinguish EM from DM due to the inefficient and illiquid debt capital markets in these regions, coupled with over-reliance on the banking sector and lack of alternative pools of capital, as illustrated in chart 4.

CHART 4: AVAILABILITY AND ACCESS TO CREDIT FOR CORPORATES ACROSS DM AND EM



Source: AIMA, IIF and own estimates. Note: denotes various markets segments activity and appetite

Managing risk

As credit investors, we focus first and foremost on downside protection before considering the potential return of an investment. This risk assessment has four main dimensions:

1. Credit risk

Focusing on the underlying borrower or issuer leverage ratio. This is a standard credit ratio looking at the underlying (net) debt versus EBITDA (the ability for the company to generate earnings from operations). The leverage ratio drives both the underlying implied equity cushion and the ability of the corporate to afford interest payments. In the current global environment, with ultra-low rates coupled with substantial amounts of liquidity and dry powder available, we have seen an increase in both the enterprise value multiple and ability of corporates to service higher levels of indebtedness. This leaves the corporate sector vulnerable, not so much to the changes in the underlying rates (which we expect to remain low for the foreseeable future), but to macro and sectorial shocks.

In DM, we have seen leverage ratios being stretched to record levels, making the underlying corporate more susceptible to stressed and distressed situations driven by macro (e.g. Covid-19 lockdowns) or market (e.g. market access and ability to refinance) shocks.

EM corporates have much lower levels of leverage when compared with similar DM counterparts, making them more robust when dealing with external shocks. Moreover, with higher returns in absolute terms, investors in EM corporates are receiving a notable pick-up in yield per turn of leverage.

2. Legal risk

Currently, 80-90% of all DM corporate leverage and investment-grade loans are extended under ‘covenant-lite’ documentation. Documentation standards have eroded continually for the past 10 years in the developed world with borrowers facing fewer restrictions, including financial covenants as well as restrictions on asset disposals, acquisitions or dividend payments. The relaxation of these restrictions has meant that lenders have less control and influence over the underlying corporate. This, in turn, has the effect of delaying required restructurings for distressed borrowers and, ultimately, lower recovery rates. For example, according to Moody’s, in DM high yield, average recovery rates for the past five years have been around 30%, while in EM high yield these are around 40%. When looking at senior secured 1st lien loans, recovery rates in DM have been around 60% while in EM these are closer to 70%.

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EM corporates are still borrowing in the international markets (via loans or bonds), largely using full-covenanted documentation. Outside the highest-quality, investment-grade names in EM, most of the corporates are subject to a full set of financial covenants, typically maintenance covenants such as maximum net leverage, minimum asset coverage and minimum debt service coverage. They also face tight restrictions on asset disposals and value leakages, either via an M&A transaction or dividends payments. We expect this substantial differential between recovery rates for EM corporates versus similar DM counterparties to continue over the coming years.

3. Enforcement and restructuring risk

Should an underlying credit deteriorate and subsequently default, creditors will need to ensure their rights are protected and the restructuring or enforcement follows a well-defined process. This allows the creditors to maximise their recovery and ensure a fair and speedy process. Legal environments in DM, especially in the US and UK, have been thoroughly tested for decades and are well understood by market participants. This is less the case in EM, making certain factors such as having the appropriate underlying security package, avoiding certain jurisdictions, mitigating against local factors and having an experienced investment team all the more important.

Loans for EM corporates have largely preserved important security features helping to protect and enhance recovery and enabling additional creditors' leverage in restructuring negotiations. Asset security, both onshore and offshore (where available) that focuses on strategic operating assets would have similar enforcement routes across both EM and DM (e.g. shipping, oil & gas). Moreover, share security structured in both local and offshore holding companies in well-tested jurisdictions provides multiple enforcement options. Additional security elements include personal guarantees from controlling shareholders, cashflow and receivables collection accounts in offshore and debt service reserve accounts.

English law documentation enables EM creditors and borrowers to bypass local restructuring regimes. Notwithstanding this, we see a growing number of EM jurisdictions pushing through new insolvency laws modelled upon English & US frameworks:

- **CEE:** EU directive on preventative restructuring passed in 2020 would enable further harmonising for CEE restructuring regimes to best standards and enlarge the restructuring toolkit for creditors.

- **MENA:** UAE (2016), Bahrain (2018) and Saudi Arabia (2018) passed a wave of restructuring-law reforms, borrowing the framework from US Chapter 11 and UK Restructuring Proceedings.

- **India:** passed reforms to corporate legislation and introduced a new bankruptcy code, making the process faster and more streamlined.

4. ESG risk

Integrating ESG factors into the investment process isn't just about doing the right thing for our planet and society; it is also about managing risks which affect the potential risk/return balance. We believe investors should view ESG as an alpha opportunity, not just a risk-management tool. Sometimes due to laxer local regulation, we have seen EM corporates being more exposed to all three risks within the ESG complex: environmental (deforestation, mining practices etc), social (community access to energy and clean water, workers' rights etc) and governance (majority shareholder actions, stakeholders' involvement etc). We believe investors need to rely on an ESG evaluation framework designed to overcome challenges specific to fixed income credit with a focus on value-add engagement and research capabilities.

Moreover, in EM we have seen an inverse relationship between access to capital and ESG adherence – the lower the access to capital, the higher the willingness to engage on ESG matters. In our view, this opens up opportunities for creditors to have a more influential role when engaging with EM borrowers than might be the case in other markets.

We believe investors need to rely on an ESG evaluation framework designed to overcome challenges specific to fixed income credit with a focus on value-add engagement and research capabilities.

Extracting a premium through multiple avenues

When looking for investments, we focus on certain themes that drive our approach to sourcing:

- **Illiquidity premium**: for corporates with both loans and bonds outstanding, one can frequently source the loans at a meaningful spread to the bonds.

- **Place in the capital structure:** within the capital structure of corporates there can be opportunities to buy loans that are senior secured, rather than senior unsecured bonds. In some instances, the senior paper can be sourced at the same or higher spread than the junior bonds.

- **Forced sellers:** banks periodically are required to reduce their balance sheets for reasons that are unrelated to the quality of the underlying credit. Their need to sell a given position quickly means they may be willing to do so at an attractive discount.

- **Financing not suited for traditional corporate banking:** borrowers periodically seek funding for a project within a timeframe that is too short compared to the decision-making time banks require. Likewise, sometimes the underlying financing and security package structures are too complex for traditional local corporate banking activity.

- **Unusual structures:** cross-border acquisitions and holding-company loans for which local banks have little appetite given their preference for vanilla corporate structures.

- **Stressed situations:** instances where high-quality corporates are facing temporary stress despite having robust credit metrics and not being at risk of imminent default. This can happen, for example, when the corporate loses temporary access to working capital or there are macro events which are not expected to affect the corporate in the medium term, or temporary sector shocks affecting even the strongest corporates.

We believe the need for a clear, well-defined investment process with enhanced ESG screening to analyse and execute opportunities cannot be underestimated.

Platform & team are critical to investor success in EM illiquid credit

While we believe the investment proposition for EM loans is compelling, the universe's sheer size and the need to effectively mitigate key risks requires in-depth knowledge of the local markets (legal system, corporates' access to financing, government policy framework), as well as sector and macro expertise. A team with this breadth and depth can identify market themes and opportunities that present interesting investment potential. They can also draw on relationships with a wide network of global, regional and local banks and other credit providers for sourcing investment proposals and conducting due diligence. Last but not least, we believe the need for a clear, well-defined investment process with enhanced ESG screening to analyse and execute opportunities cannot be underestimated.

The table below summarises what we believe to be the key components that an experienced investment team should cover within the sourcing and investment process:

Sourcing and investment process

Local knowledge and connectivity
- Market knowledge for investment due diligence
- Large sourcing network

Clearly defined investment process
- Sector and credit expertise using key risk criteria
- Expertise in instruments and legal structures

ESG screening and integration
- Product-based screening
- Conduct-based screening
- ESG systematically considered at different levels
- Dedicated in-house ESG resource
- ESG engagement and stewardship

For further details on the key parameters of the investment process, please refer to our prior publication [‘Accessing dislocated corporate credit in emerging markets’, July 2020.]

Conclusion

In today's market, characterised by macro-driven volatility, political and economic uncertainty with low core rates, we believe an approach focusing on high-quality performing EM credits in an illiquid loan format offers an attractive risk/reward balance.

EM private credit offers an exciting opportunity for investors to potentially earn compelling returns without needing to extend the leverage and documentation risk in their portfolios, as could be required for the DM alternatives.

The high barriers to entry for such a strategy mean that competition on the demand side in this market will likely continue to be outweighed by supply. At the same time, the diversity and depth of the market provides those with relevant expertise and experience an attractive opportunity to potentially achieve compelling risk-adjusted returns.

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Senior Portfolio Manager

Mihai is a Senior Portfolio Manager within the Emerging Markets Team. He joined BlueBay in January 2020 and his primary portfolio management responsibilities include the illiquid strategy covering loans, illiquid instruments, special situations and distressed. Prior to joining BlueBay, Mihai was a Founding Partner for the credit strategies at Helios Investment Partners. Mihai has 19 years' experience including on the sell-side where his last role was heading the emerging markets structuring team across fixed income, currencies and commodities. Mihai holds a Master's Degree (MSc) in Economics and Finance from Warwick University.

Global Asset Management

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