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# Emerging corporate bonds: making the grade

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## In Brief

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- Concerns are growing that emerging market corporate borrowers will find it more costly to service their debts
- But it would be mistaken to suggest emerging corporate debt markets are overvalued
- Several companies and industries can remain insulated from the effects of a higher USD; at the same time, US interest rates are unlikely to be hiked aggressively

**These appear to be testing times for corporate borrowers in the developing world. A strong USD and higher US interest rates could make it more costly for such companies to service their debts. But investors in emerging corporate bonds should not be discouraged. The investment outlook for the asset class remains attractive.**

When Chinese e-commerce company Alibaba made its first foray into the capital markets in November 2014, it could have sold its USD8 billion USD-denominated bond seven times over, such was the level of demand. To some, the deal's overwhelming success was yet more evidence of the advances made by the emerging world's corporate bond market. To others, it was a sign that an asset bubble was forming. The sceptics' voices have since grown louder. But their thesis is not necessarily stronger.

The doubters have accumulated a list of worries. A rising USD, prospective increases in US interest rates and the scandal engulfing Brazilian oil giant Petrobras each threaten to make life less comfortable for corporate borrowers across the developing world. An additional concern is the rate at which Latin American and Asian companies in particular have loaded up on USD debt. Since 2000, the volume of USD denominated liabilities in emerging markets has doubled to USD4.5 billion, thanks in part to increased corporate borrowing in these regions.

Look more closely, however and the investment climate is not as hazardous as it seems. For one thing, the assumption that corporate borrowers in the emerging world will fall victim to lopsided balance sheets – a mismatch of liabilities denominated in USD and revenues and assets largely in local currency – is an oversimplification.

Weak domestic currencies do not automatically mean corporate finances become more precarious. Several emerging market companies actually benefit from a rising USD. Asian-based firms, who make up a large portion of the emerging bond market, look especially well placed. Recent research shows that while some

22 per cent of their debt is denominated in USD, so too are 21 per cent of their earnings.[1]

More broadly, companies operating in mining, sugar, beef, pulp and paper generate revenues in USD but have a cost base which is largely in local currency. For these firms, a rising USD may lead to higher profit margins.

But even those whose revenues are primarily in local currency will not necessarily find it tougher to honour their debts.

Most emerging market companies that tap the USD bond market are investment grade. This means many operate – and have benefited from - conservative and transparent currency hedging policies. What is more, a large number of the firms we invest in are able to pass on higher debt servicing costs to their customers without suffering falls in sales.

Currency troubles aside, bond bears also point to a recent rash of corporate credit rating downgrades and defaults. Yet here too, the evidence is not universally negative. Defaults and ratings reductions have risen but have remained concentrated within countries and industries exposed to weak commodity prices (Brazil, Russia and the energy sector).

Moreover, most of the corporate ratings cuts have been triggered by downgrades of sovereign or quasi-sovereign borrowers. In other words, many Russian corporations have been downgraded simply because Russia has been cut to junk status (For more on this please see *'In Wintry Russia, signs of a thaw'*, March 2015 on www.pictet.com). The same goes for Brazilian firms, some of whom have suffered in the wake of oil giant Petrobras' woes. Stripping out the sovereign effect, credit rating upgrades outnumber downgrades by a ratio of 1.6 to 1.[2] This positive rating trajectory is also borne out by credit metrics. As Fig. 1 shows, emerging market corporate borrowers have a lower gross leverage ratio[3] than their US counterparts in nearly every rating category. Partly for these reasons, default rates among emerging corporate borrowers are expected to remain at 3.9 per cent this year.

**FIG 1 - EM VS. DM LEVERAGE COMPARISON BY RATING BUCKET**

| | A | BBB | BB | B | CCC |
|---|---|---|---|---|---|
| EM Corporate | 2.1x | 2.4x | 3.0x | 4.6x | 2.0x |
| US Corporate | 2.1x | 2.8x | 3.1x | 4.1x | 8.1x |

Source: JP Morgan

[1] Source: Morgan Stanley, cited in The Economist, March 20, 2015
[2] On a 12-month basis. Source: JPMorgan, Moody's, Standard and Poor's, Fitch Ratings as of 31.01.2015
[3] The proportion of a company's debt to equity

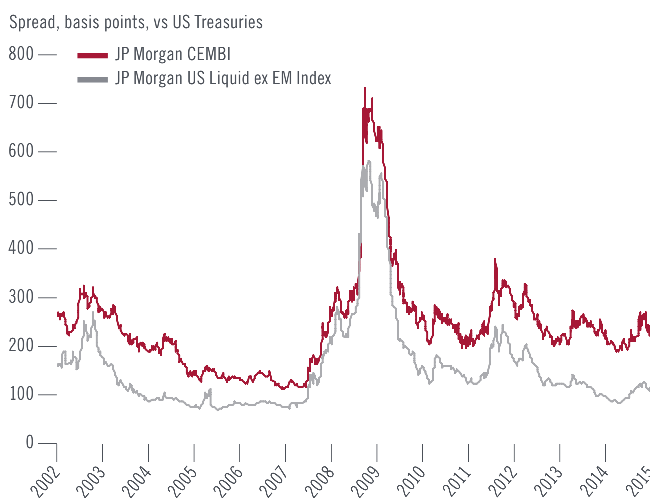
A major stress test for the asset class could well emerge when the US Federal Reserve begins raising interest rates. When that happens, corporate borrowing costs are certain to rise worldwide, particularly in the developing world.

However, the rhetoric emanating from the Fed suggests the central bank is in no hurry to raise rates. Its dot plot graph – which maps official interest rate forecasts – indicates a more gradual tightening of monetary policy than was envisaged just a few months ago. Rate rises will come but they won't come quickly.

Also in the asset class's favour is the stability of its investor base. Unlike other high-income bonds, emerging corporate debt is not at the mercy of unpredictable retail investment flows.

Domestic institutional investors such as sovereign wealth funds, insurance companies or pension funds currently make up two thirds of the investor base, which has lent the market a considerable degree of stability during previous periods of market turbulence, such as the Fed-inspired "taper tantrum" in the spring and summer of 2013.

**FIG 2 - EM CORPORATE BONDS: A SUBSTANTIAL YIELD PICK-UP**




Source: JP Morgan

All this is not to say that investors can afford to be complacent. Business conditions are not as favourable as they have been in recent years, which means some companies could see a weakening of their credit profiles. However, with emerging corporate bonds trading at a yield spread that is more than twice that of similarly-rated US counterparts (see Fig. 2) market participants appear to be sufficiently compensated for these risks.

**Alain Nsiona Defise, Head of Emerging Corporate Bonds**

Alain Nsiona Defise joined Pictet Asset Management in 2012 as head of the emerging corporate bond team. Previously, Alain was at JP Morgan in London where he managed the emerging corporate business, worth over USD 2 billion. Prior to that, he worked for nine years at Fortis Investments where he started as a senior credit analyst focusing on the high yield market and later worked as a senior emerging fixed income portfolio manager building the emerging corporate business.

Alain holds a Master's degree in Business Engineering from Solvay Business School, Brussels and a Diploma in Financial Analysis from the European Federation of Financial Analysts Societies.

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- **In-depth local knowledge:** within the team, dedicated EM credit analysts perform fundamental research to identify the strongest investment opportunities. They possess strong local knowledge, including a thorough understanding of operational risks and corporate governance in the markets covered.

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