Investment Insight

Emerging market corporate debt: A once-in-a-generation opportunity

Now that the great interest rate reset has revitalised fixed income as an asset class, the higher-return potential of emerging market corporate debt is particularly compelling.

Our Emerging Markets Debt Stars strategy successfully navigated a challenging environment in 2023. The strategy returned 7.5% in US dollar terms, driven primarily by income yield. It was a year of uncertainty for global growth and geopolitics, but one that was dominated by central banks' hawkish interest rate policy to control persistent inflation. The continuation of this 'great interest rate reset' meant that bonds finally offered investors, starved of yields for so long, attractive levels of income. We believe that a revitalised fixed-income asset class now has the potential to generate returns not seen since before the 2008 Financial Crisis.

Company fundamentals matter most

When it comes to emerging market debt, many investors think of sovereign debt (bonds issued by governments of emerging market countries). It is easy to see why. Sovereign debt accounts for the lion's share of the emerging debt universe. However, the risk/return profile of emerging market sovereign debt is very different to that of emerging market corporate debt. The risk of sovereign bond defaults rests on the economic health of the country, while the risk of corporate debt is primarily dependent on the quality of a company's fundamentals.

The difference is key. Debt issued by companies in less developed areas has an altogether different risk profile. It is why the perceived risks of emerging market debt are in our view greater than the actual risks associated with the underlying corporates. Local risks, including economic, social or political are more than offset by the underlying fundamentals of quality companies. Investing in hard currency emerging market debt (US dollar, euro, sterling) lowers currency-exchange risk. Additionally, investing in corporates enables us to gain exposure to specific themes we identify as opportunities.

Over the past two years, the perfect storm of rising inflation and higher interest rates has seen many developing countries grappling with worsening debt and meeting their bond obligations. In late 2022 Ghana defaulted on its external debt as its economic crisis deepened, while Argentina's balance of payments deficit worsened further.

Sovereigns must also contend with social, geopolitical and conflict risks. The ongoing Russian conflict, for example, still weighs on Ukraine. President Recep Tayyip Erdogan's re-election last May caused a sudden change in Turkey's monetary policy that had considerable ramifications for its bond market.

Reviewing the performance of our emerging debt strategy, many companies based in countries facing economic and political turmoil were our biggest success stories of 2023.

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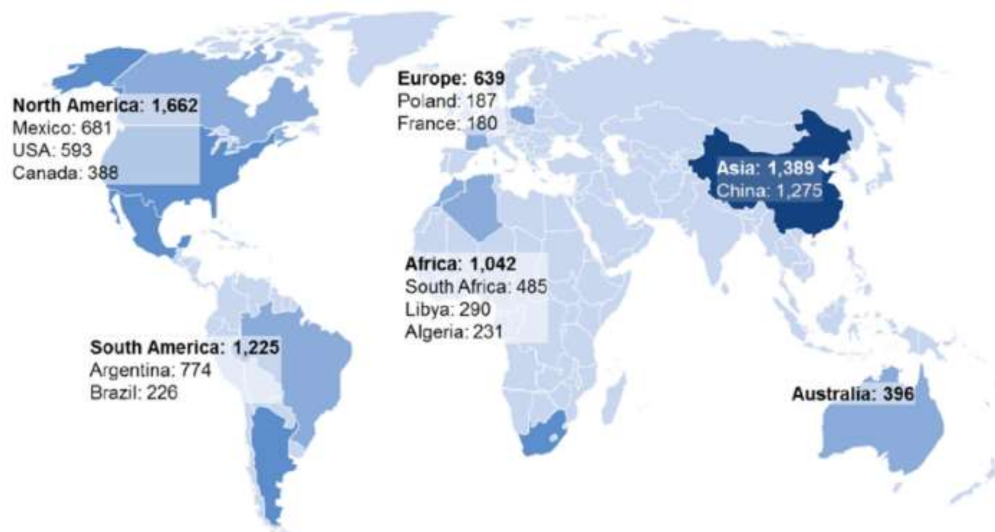
Argentina: Energy provider YPF to double production

YPF is a long-term holding whose bonds were up 36% despite the country's balance of payments concerns and a presidential election in 2023, which led to heightened uncertainty following the victory of Javier Milei, a radical reformist. The company is the largest energy producer in Argentina and strategically important to the government. Not only is YPF critical to the country but it could help reverse Argentina's energy deficit by becoming a net energy exporter for the first time in more than a decade. Such an event is key to any future economic recovery and could provide an important source of US dollars. YPF has announced plans to double production over the next five years and export 35% of oil production by 2027. Production growth at Vaca Muerta, one of the world's largest undeveloped shale formations, will also play a key role in its quest to become a net exporter of energy. Its management team view balance sheet health as a priority – keeping leverage under control, maintaining liquidity and minimising local currency exposure.

Estimates of recoverable global shale gas resources (in trillion cubic feet)



Source: US Energy Information Administration

Ghana: Tullow Oil finances on strong ground

Tullow Oil's bonds rose 21% with most of its production coming from Ghana. Last year, the company announced new assets coming online that will materially increase production and support free cash flow generation. Importantly, the company also raised a new USD 400 million five-year debt facility with Glencore and subsequently launched a tender to buy back bonds maturing in 2025. This efficient capital allocation by the company eliminated near-term refinancing risk.

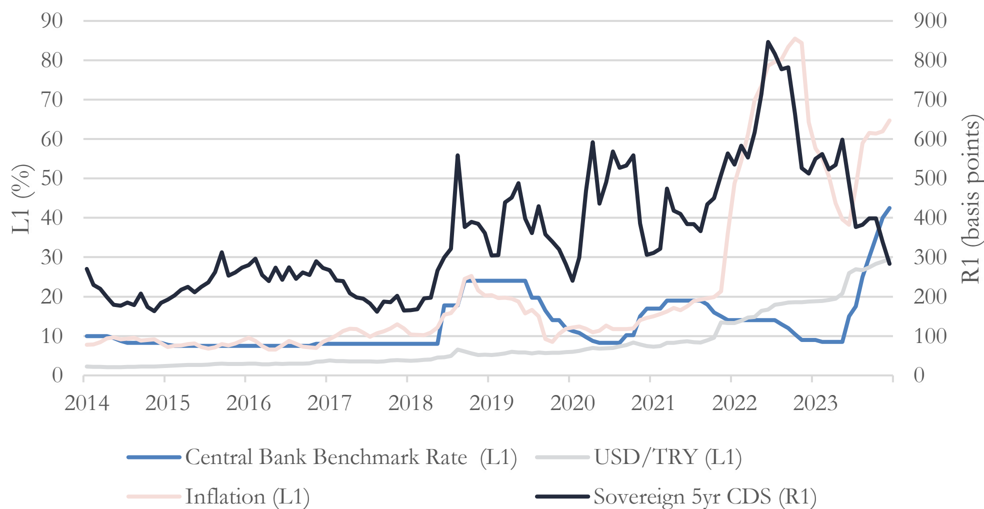
Ukraine: MHP proves its resilience

MHP, the leading agro-industrial company in Ukraine, showed a high degree of resilience with poultry production volumes and most exports continuing despite war-related logistical challenges. Following an extension of bank loan maturities and management's commitment to fully service Eurobond coupons, credit rating agencies upgraded the company. The company's hard currency bonds rose 79% over the year. MHP also announced a tender offer to buy back bonds maturing in 2024 and raised USD 480 million from a group of international financial institutions (including the International Finance Corporation and the European Bank for Reconstruction and Development) to do so. This reinforced our thesis that the business would be supported given its importance to global food security. Our other Ukrainian holding also benefited indirectly as investors drew comparisons to MHP. *Kernel*, the largest producer and exporter of sunflower oil globally and the largest grain exporter in the country saw its bonds climb 99%.

Turkey: Exports provide Sisecam with a balance sheet hedge

Macro-driven volatility can be a compelling source of opportunity for investors who focus on company fundamentals rather than the wider economy – as events last year in Turkey highlight. President Erdogan shocked markets shortly after his re-election in May by abandoning his long-held lower interest rates policy. A series of rate rises caused significant volatility for Turkey's sovereign bond yields and credit default swaps. The move also had a direct impact on corporate bond yields, which closely track sovereign yields, despite many companies' fundamentals being in better shape.

Inflation and currency volatility impact on sovereign risk



Source: Bloomberg

High-quality Turkish corporates have been a core component of our strategy since its inception and have demonstrated their ability to operate successfully in a challenging environment. They represented up to 15% of total exposure and generated returns averaging

10% in 2023. This resilience reflects the quality of their management, the geographic diversification of their operations and the strength of their balance sheets.

The bonds of one such company, *Sisecam*, were up 10% last year. A leading glass manufacturer in Europe, the company's international operations and growing exports provide an important source of hard currency and a natural hedge for its balance sheet. It has been able to implement dynamic pricing models to achieve margin targets given cost efficiencies and pricing power.

Liquidity and refinancing in the crosshairs

Corporate liquidity and refinancing risks were a major source of volatility in 2023, particularly for sub-investment grade issuers, as the great rate reset continued. For example, 10-year US Treasury yields rose from 0.5% in March 2020 to a peak of 5.0% in October 2023 – a move that had a negative impact on credit availability as the primary market remained subdued.

Some of the main detractors of our performance in 2023 were our Latin American technology and media companies. The bonds of *Total Play,* the Mexican telecoms company were down 15% and those of *WOM*, the Chilean mobile phone company fell 27%. Despite generating impressive revenue and earnings growth, both companies were free cash flow negative given high growth capital expenditure related to network rollout and subscriber acquisition costs. This put pressure on liquidity and raised questions as to how they will address upcoming debt maturities in the coming years.

Crucially, the viability of their business models is not in doubt and we remain positive on their long-term outlook. That is why we took the opportunity to add to our positions at low cash prices and very attractive yields. As expected, both Total Play and WOM are taking measures to shift focus from growth to cash flow and liquidity. Heavy capital expenditures programmes are coming to an end, margin-driving penetration rates are improving and non-core asset sales are forthcoming. Further evidence of these trends will help refinancing efforts and will support asset prices going forward.

WOM: economies of scale leading to growth in profitability

Source: Company presentation Sept 2023

Liquidity also became an issue for *Unigel* (-72%), one of the largest chemical companies in Latin America. A simultaneous trough in the petrochemical cycle and a decline in fertiliser prices put pressure on cash flow and leverage. The timing was difficult given a heavy capital expenditure programme as the company expanded in the fertiliser sector and started the construction of Brazil's first green hydrogen plant.

Longer term, Unigel is expected to be particularly important to Brazil given that agriculture is a key component of the economy. The country is one of the largest consumers of fertilisers and imports nearly 100% of its requirements. President Lula da Silva has been vocal about his desire to reduce import dependency and strengthen domestic production. This has already seen Petrobras, the state-owned oil and gas company, sign agreements with the company for future production. A normalisation in fertiliser prices and petrochemical spreads will be supportive.

Income is back

Companies that have gone through refinancing programmes offer three positive lessons for investors. First, good companies will always attract capital. Second, the depth of some local markets has improved and provided a critical alternative source of funding. Third, companies that successfully accessed US dollar bond markets in 2023 did so at much higher coupons given the repricing in underlying rates. This means that not only is income back and rolling into longer maturities, but it also provides greater visibility on future returns.

The global building materials group *Cemex* is a prime example. Key geographies performed well with stimulus-driven industrial activity in the US and near-shoring trends in Mexico. This accelerated the deleveraging path with leverage reaching its lowest level in history and firmly put the company on a path towards an investment-grade credit rating. In March, the company issued a first-of-its-kind USD 1 billion green bond to finance projects such as pollution prevention and clean transportation. The bond was issued with a 9.125% coupon. Rewind 18 months and a similar bond was issued at a coupon of 5.125% when its credit profile was weaker.

2024: A record election year and political uncertainty provide opportunity

After strong performance in 2023, most asset classes are exposed to volatile economic data as markets absorb the impact of higher interest rates and policy tightening.

A busy election calendar awaits in emerging markets with 24 major elections scheduled for 2024. Countries home to more than 50% of the world's population and more than 60% of global economic output will go to the polls. Presidential elections, as those last year in Argentina and Turkey highlighted, often lead to bouts of volatility. Of course, the biggest election of all in 2024, the presidential election in the US in November, is certain to contribute further to a fractious political climate and fuel volatility.

Elections in various emerging markets will generate more uncertainty than others. Key markets where we have exposure include South Africa (10% of strategy), India (8%) and Mexico (14%). Elections are inherently unpredictable, and we may see fiscal discipline loosen against a backdrop of higher US rates and a stronger US dollar. For example, Mexico's 2024 budget includes a significant increase in social spending intended to benefit the incumbent administration.

Upcoming emerging market elections

Source: Reuters

Our emerging market corporate debt strategy focuses on quality and aims to provide lower volatility and generate attractive medium-term returns, with high-income generation acting as a volatility buffer. As the tables below show, the expected gross returns at the end of last year (7.6% income yield and 11.0% yield to maturity per annum for the next 3.1 years) are still in line with the expected returns a year ago despite delivering 8.5% (before management fee) in 2023.

Strategy Characteristics	31/12/2022	31/12/2023
Income yield	7.4%	7.6%
Yield to Maturity	11.2%	11.0%
Duration	3.8	3.1
Average Credit Spread	768	605

Source: J. Stern & Co.

Importantly, we remain true to our investment process. We will continue to focus on the fundamentals of high-quality companies with a track record of operating in challenging environments. We will actively manage the risk exposure depending on what we believe is priced into credit spreads. Any sovereign-induced selloff may be seen as another opportunity to buy at even more attractive yields.

Charles Gélinet & Jean-Yves Chereau

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The Value of Long-Term Investing

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