Evaluating EM Corporates

A misunderstood asset class

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HSBC
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Management

Introduction

Emerging Markets Corporate Debt

Historically, many investors have viewed emerging markets corporate debt as a niche segment of EMD that was risky, volatile and illiquid. However, over the past ten years the size of the EM corporates universe (JPM CEMBI Broad) has increased from $159 billion to $943 billion — surpassing the market value of its equivalent hard currency sovereign index (JPM EMBI Global) in 2012. EM corporate debt is now a large and diverse asset class spanning 50 EM countries and 644 issuers. Very simply – the EM corporate asset class can no longer be considered “niche”. (See figure 1.)

In the last few years, improving business practices in EM corporates and stronger fundamental measures such as net leverage, interest coverage, and capital expenditure to EBITDA (earnings before interest, taxes, depreciation, and amortization), have resulted in more expensive valuations. While 2018 has been a challenging year for the wider EMD universe, EM corporates have shown resilience, reflecting the strength of their balance sheets and a generally more positive technical supply environment than its sovereign counterparts.

Today, EM corporates are broadly more expensive than sovereign spreads, however concerns regarding their liquidity remain valid. With higher bid-ask spreads and smaller, less frequent trading patterns defining the marketplace, EM corporates can be more price sensitive to sustained outflows. In this type of environment, we believe investors must discriminate and apply a rigorous evaluation framework to ensure that valuations accurately reflect the underlying risks.

In this article, we articulate how we apply such a framework to the asset class, how we differentiate between issuers as well as identifying the drivers of risk and return. We also discuss today’s market context, why valuations are challenging and what risks we should look out for going forward.

Figure 1: Emerging Markets Debt Returns and Characteristics *(as of October 31, 2018)*

Index	YTD Return	YTD Std Dev.	Market Cap	Countries	Issuers	Credit Rating	*IG % HY %*	Yield-to-Maturity (%)	Duration (Years)
CEMBI Broad (EM corporate debt)	-2.19%	2.87	$943 Bn	50	644	BBB-	IG = 56.6 HY = 43.4	6.33	4.51
EMBI Global (EM sovereign debt)	-5.61%	5.31	$855 Bn	68	152	BB+	IG = 58.6 HY = 41.4	7.08	6.65
GBI-EM Global Diversified (EM local debt)	-9.95%	11.85	$1106 Bn	19	19	BBB	IG = 81.0 HY = 19.0	6.76	5.05

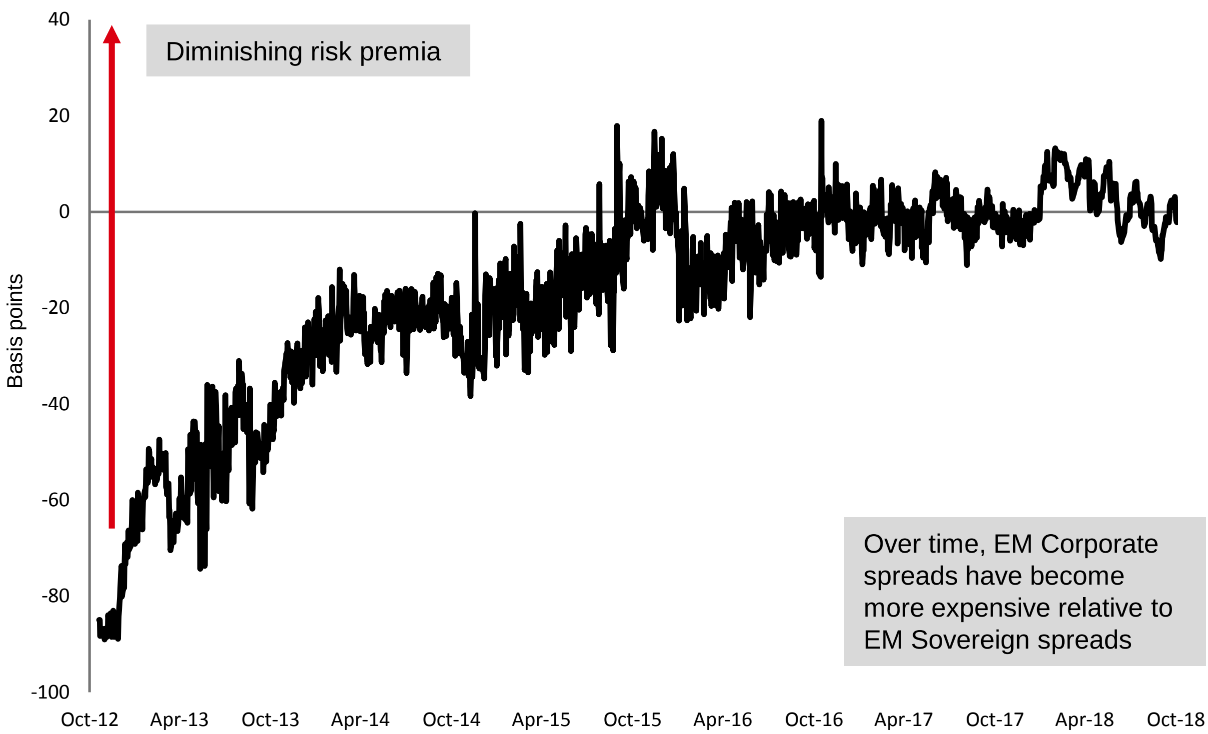
Source: JPMorgan Emerging Markets Bond Index Monitor, data as of October 31, 2018.

How do we identify opportunities when valuations seem challenging?

EM corporates are trading at more expensive levels than EM sovereigns and investors must examine whether current valuations for EM corporates compensate for the underlying risks.

Over this year, we have seen valuations for EM corporates compress relative to EM sovereigns. For example, the investment grade corporate bond index once required anywhere from 50-100 basis points of premium over the EM sovereign investment grade index; however, more recently, the EM corporate index is trading at similar spread levels, if not tighter levels than the respective sovereign index. (See figure 2.)

Figure 2: EM Sovereign IG versus EM Corp IG: Spread differentials ***(October 2012 - October 2018)***



Source: HSBC Global Asset Management, data as of October 31, 2018

To properly analyze EM corporates and identify potential investment opportunities in the current environment, it is important to categorize them to account for some of the divergence we see in their fundamentals and risk characteristics.

We group EM corporates and quasi-sovereigns into the following 5 categories:

1) Corporates with strong fundamentals tied to local economies
2) Global corporates with developed markets risk
3) Corporates that have higher beta than their respective sovereigns
4) Quasi-sovereigns (corporates that are partially and/or fully-owned by governments) with strong balance sheets
5) Quasi-sovereigns with weaker balance sheets but critical to the EM country

A taxonomy of EM corporate debt

EM corporates: 5 categories		Examples
EM corporates with strong fundaments, solid balance sheets and that are linked to local GDP growth tend to have defensive characteristics in periods of macroeconomic uncertainty.	**Corporates exposed to local EM economies, but with solid fundamentals**	A Brazilian railroad company with a monopoly in its region; an Argentinean pipeline company with net leverage of just 0.1x—this issuer did not default when Argentina did.
Global EM corporates with risk characteristics similar to those of developed markets often show greater resilience than their sovereign counterparts--primarily due to their large overseas operations or foreign currency revenues. In fact, global EM corporates are often punished unfairly for being domiciled in EM countries of risk.	**Global corporates with an EM zip code, but DM risk attributes**	Global companies often engaged in the metals & mining, chemicals, and pulp and paper industries. During EM market sell-offs driven by idiosyncratic country risk, this category can maintain positive fundamentals and offer investment opportunity.
EM corporates with higher betas than their respective sovereigns are often closely linked to their country's GDP growth rate; however, they tend to have less liquidity relative to this sovereign debt. This category (small subset of the EM corporate universe) may be familiar to investors — as it includes airlines, industrials, banks and infrastructure companies.	**Corporates with higher beta than their sovereigns**	Turkish banks exhibited a much higher beta than Turkey's sovereign debt when Turkish assets sold off in earlier 2018.
Quasi-sovereigns (corporates partially-to-fully owned by governments) with strong balance sheets are important to the sovereign and often represent solid investment opportunities. Quasi-sovereign bonds typically outperform their sovereign counterparts because they issue less debt and avoid "flooding the market" with bonds.	**Quasi-sovereigns with strong balance sheets**	The Brazilian oil and gas quasi-sovereign, Petrobras, has been able to consistently reduce its hard currency bonds.
Quasi-sovereigns with weaker balance sheets and fundamentals, but represent critical assets for the country.	**Quasi-sovereigns with weaker balance sheets, but important to the country**	Mexico's electric company, Comisión Federal de Electricidad (CFE). While CFE's balance sheet is not entirely robust, the government's support is very reliable. After all, a stable source of electricity is a prerequisite for running the country in good political order.

Source: HSBC Global Asset Management.

A framework in action - Vale

Developed markets risk with emerging markets zip code

Over the last few years as Brazil's economy has struggled to overcome a deep recession, its fortunes have contrasted with those of one its largest mining companies - Vale. While the Brazilian government has run a large fiscal deficit, Vale has been deleveraging and today, its spread levels trade inside its sovereign counterpart. (See figure 3.)

Is this valuation justified? As the Brazilian real has depreciated relative to the US dollar, Vale has been a large beneficiary of this currency dispersion. Since Vale's revenues are denominated in USD and its costs in Brazilian real, the company has improved its profitability and undergone a large deleveraging exercise moving from x4 net leverage in 2015 to x1 today.

An additional factor stems from developments in China. China's drive to implement environmental reform and drive down its air pollution has changed its approach to its resource-based industries. China moved to a higher quality iron-ore, to reduce coal consumption when smelting. As the producer of the world's highest quality ore, Vale has been able to drive a large price premium for its exports (at about $30 per ton). This has contributed to significant spread compression relative to its developed markets peers. (See figure 4.)

Figure 3: Brazil sovereign spreads versus Vale spreads (December 31, 2014 – October 31, 2018)

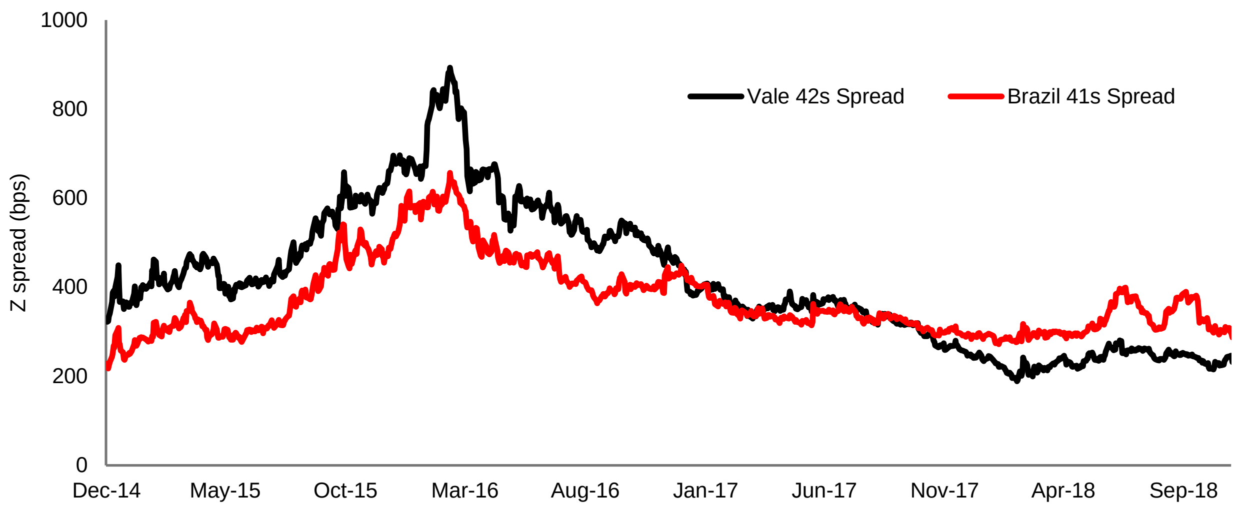
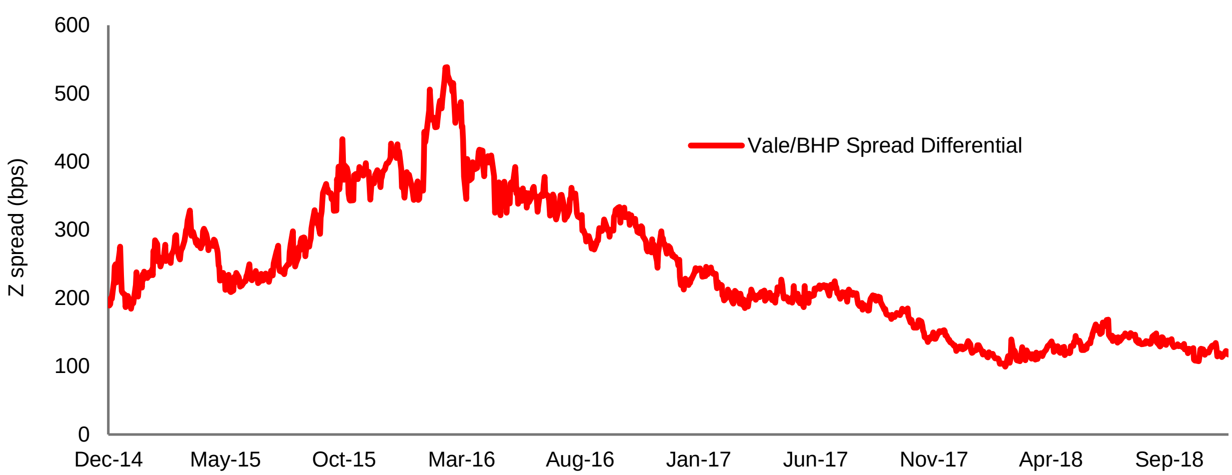


Figure 4: Vale spreads versus BHP Billiton spreads (December 31, 2014 – October 2018)



Source: JP Morgan as of October 31, 2018.

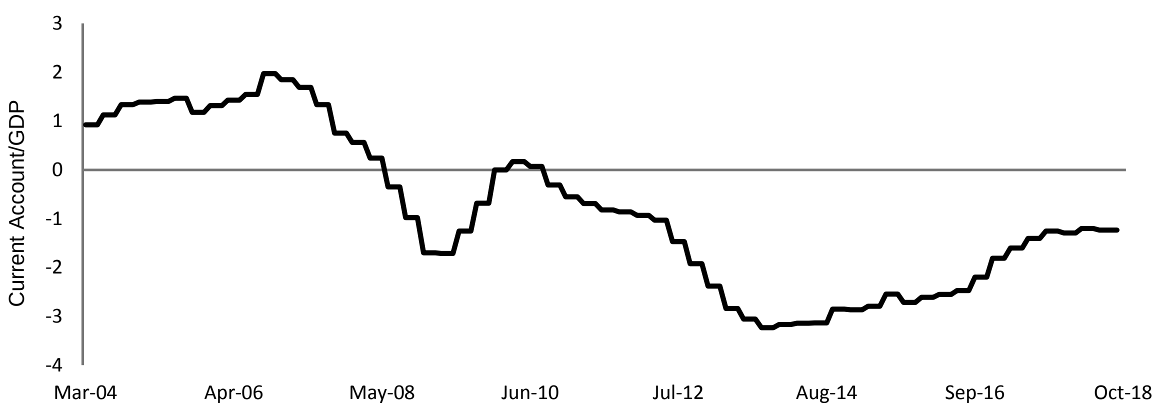
Why have corporate valuations become more expensive?

Corporate fundamentals improve while sovereigns plateau

Following the commodity collapse of 2014-2016, many EM economies underwent the painful, but necessary, structural adjustments to repair their current account balances and terms of trade, resulting in meaningful currency depreciation, particularly in commodity exporting countries. While this improving fundamental story contributed to record investor flows in 2016 and 2017, more recently, a moderation in economic data combined with upticks in inflation have contributed to stagnating fundamentals in EM sovereign debt. Unless we see higher-than-expected export demand together with higher commodity prices, we expect the pace of current account adjustments to slow. (See figure 5.)

EM corporates, on the other hand, have continued to reduce capital expenditures and strengthen their balance sheets over the same period. Net leverage has declined since 2016 across all EM regions while capital expenditures have also fallen. (See figures 6 & 7.) Corporate management teams have grown more conservative due to lowered outlooks for global growth, specifically for China. In addition, the concern over the impacts of US Fed rate hikes on EM local currencies and economies has delayed new projects, leading to a reduction in capital expenditures and net leverage.

Figure 5: EM current account balances - top 8 EM exporters



Source: HSBC Global Asset Management, Bloomberg as of October 31, 2018.

Figure 6: EM corporates: net leverage (x)

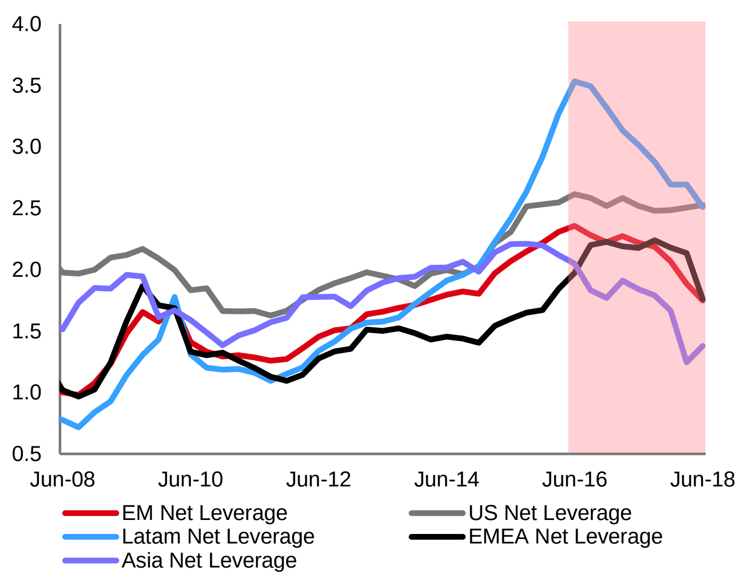
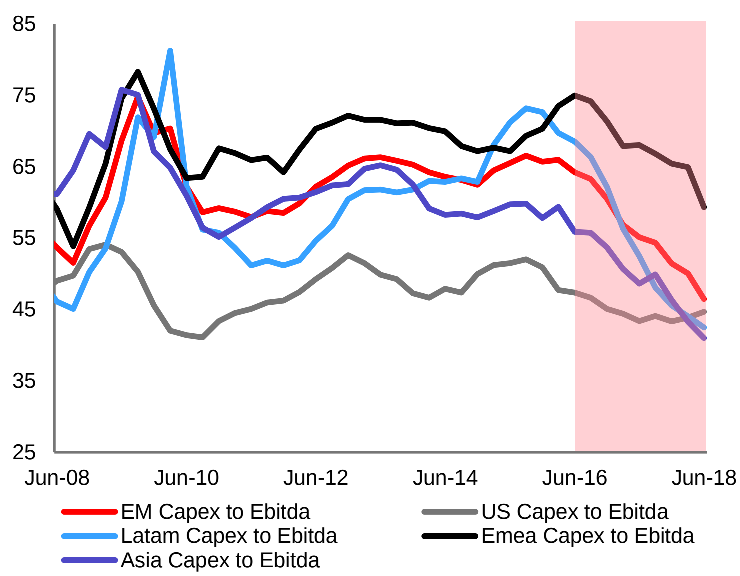


Figure 7: EM corporates: CapEx to EBITDA* (%)



*CapEx: capital expenditure. EBITDA: earnings before interest, taxes, depreciation, and amortization.
Source: Bank of America as of 31 August 2018. The views expressed were held at the time of preparation and are subject to change without notice.

Different sovereign and corporate supply characteristics have contributed to price action

Another trend which has supported tighter valuations for EM corporates is that much of the new issuance has been dominated by Asia, which overall is higher quality and lower volatility. (See figure 8.)

Moreover, issuance has been driven by more stable, resilient sectors such as consumer staples, real estate and utilities which tend to be higher quality than more cyclical corporates in the oil & gas, industrials and infrastructure sectors.

In contrast, sovereign new issuance (see figure 9) has come primarily from higher volatility countries in MENA (Middle East and North Africa region) and Latin America. Furthermore, over the past 3 years, the volume of sovereign net issuance has been well above historical averages, creating an over-supply dynamic. EM corporate debt supply has been more constrained. Consequently, high quality, low levels of supply in a less liquid environment has applied upwards pressure to corporate valuations.

Figure 8: Net corporate issuance by region ***(January 1, 2010 –July 31, 2018)***

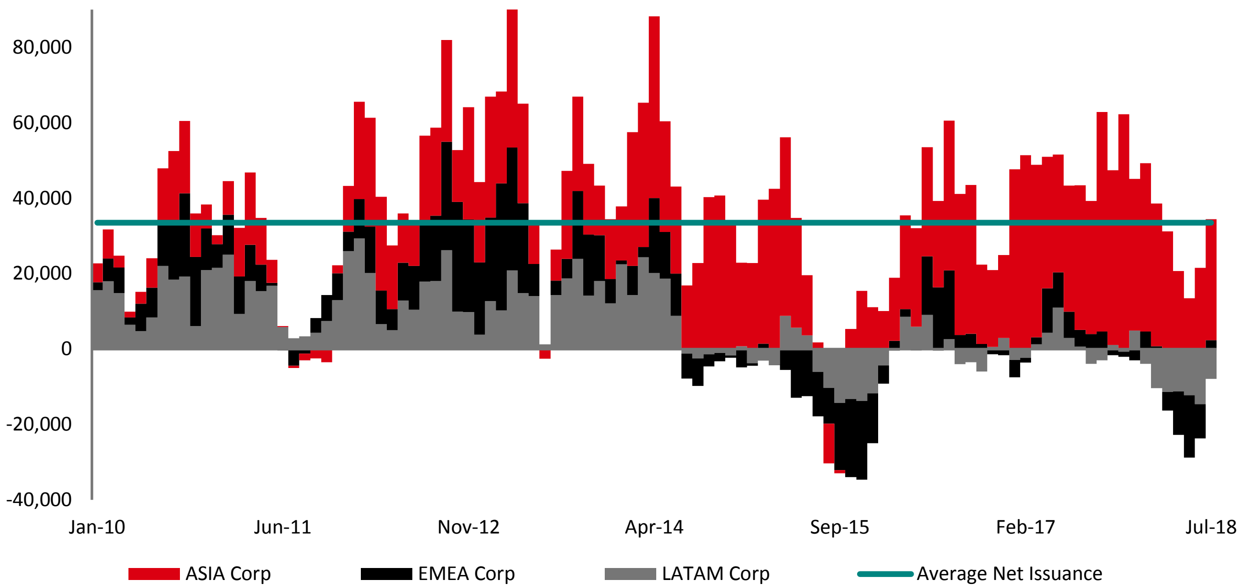
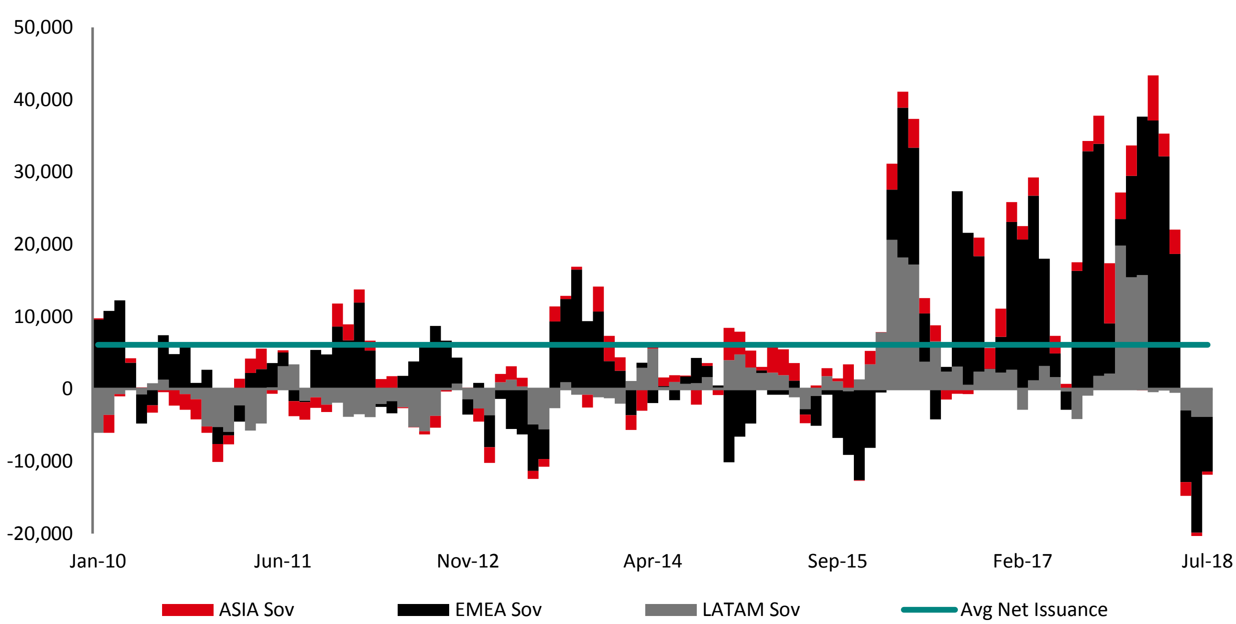


Figure 9: Net sovereign issuance by region ***(January 1, 2010 –July 31, 2018)***

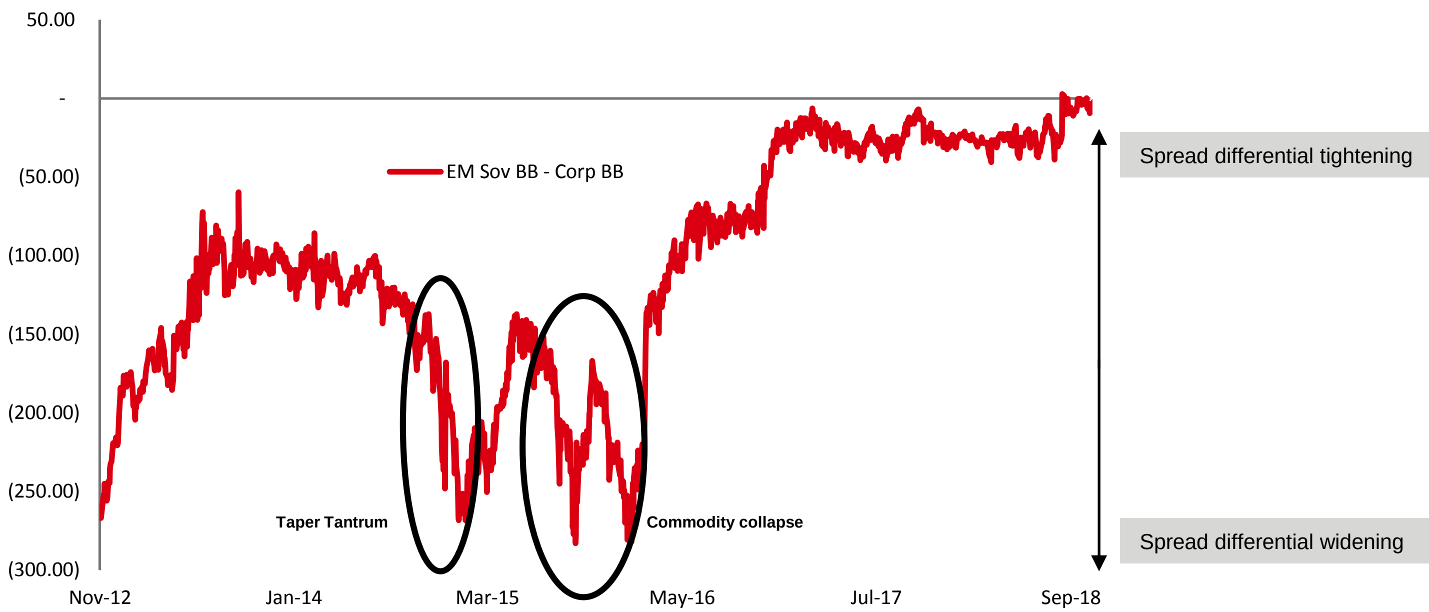


Source: BofA ML as of July 31, 2018.

Improving trends may mask risks in EM corporates

EM corporates have shown substantial improvements in fundamentals and composition; but, in general, they are less liquid relative to EM sovereigns. Wide bid-ask spreads and lower trading volumes put them at risk in market downturns—especially during bouts of sustained outflows. Typically, EMD portfolio managers sell their more liquid names in a market downturn, but this can have the effect of increasing the concentration of less liquid names in an EMD portfolio. Consequently, to manage risks, they may be forced to sell EM corporate holdings leading to wide sell-offs and large price actions. For example, in the 2013 taper tantrum and in the commodity collapse of 2014-16, EM corporates—particularly high yield—exhibited substantial price gap risk. (See figure 10.)

Figure 10: EM Sovereign BB vs EM Corporate BB Spread Differential



Source: Bloomberg as at October 31, 2018.

Other considerations for EMD portfolio managers are the changes to bid/offer spreads in challenging environments. In more benign periods of gradual spread compression and two-way flows, large investment grade sovereigns can trade with bid/offers of 0.25 bases points or less and higher yielding sovereigns trade with bid/offers of 0.50 to 1.00 basis points on average. Corporates on the other hand, depending on the yield and issue size, will typically trade with bid/offer spreads of 0.75 to 1.00 with some of the larger, more developed investment grade corporates issues trading in line with their sovereign peers.

However, in periods of risk-off sentiment, bid/offer spreads on higher yielding corporates, for example, can widen to as much as 3 to 5 points. Sovereigns, on the other hand, typically only widen 1 to 2 points in this type of scenario, depending on the issue size and yield.

Risks highlight the importance of differentiation within corporates

We believe the potential for price action as described above presents both risks and opportunities. Price actions may lead to an indiscriminate widening in valuations and simultaneously present investment opportunities to add in credits that we have identified as attractive.

Conclusion

EM corporates have evolved and matured from a niche segment of emerging markets fixed income to a diverse stand-alone asset class that has undergone improvements in terms of fundamentals and composition. Our strategies seek to identify areas where the market has incorrectly priced risk as a result of misinformation, or misunderstanding by the sell side, or simply lack of research. For example, in sovereign sell-offs, a strong EM corporate that generates 100% of its revenue outside of its country can suffer unjustly due to the overall risk-off sentiment even though that corporate could in fact benefit from its weaker local currency. However, the asset class forces investors to be diligent in differentiating between corporate entities to assess their fair premiums and identify attractive opportunities.

Key Risks

There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Fixed income** is subject to credit and interest rate risk. Credit risk refers to the ability of an issuer to make timely payments of interest and principal. Interest rate risk refers to fluctuations in the value of a fixed income security that result from changes in the general level of interest rates. In a declining interest rate environment, a portfolio may generate less income. In a rising interest-rate environment, bond prices fall.
- **Foreign and emerging markets.** Investments in foreign markets involve risks such as currency rate fluctuations, potential differences in accounting and taxation policies, as well as possible political, economic, and market risks. These risks are heightened for investments in emerging markets which are also subject to greater illiquidity and volatility than developed foreign markets.

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