Ashmore

CD CORPORATE DEBT

Growing opportunities in Emerging Markets corporate bonds

By Alexis De Mones

Executive summary

- The Emerging Markets corporate bond debt universe is much larger and much more diverse than investors commonly assume
- This market offers investors opportunities to invest in less leveraged companies trading at wider spreads in comparison to its better known developed markets counterpart
- This market has delivered very strong returns for investors since taking off a decade ago
- Its higher spread and lower duration characteristics in comparison to developed market credit indices offer one of the most compelling opportunities in global fixed income markets today

A rapidly growing, deepening market

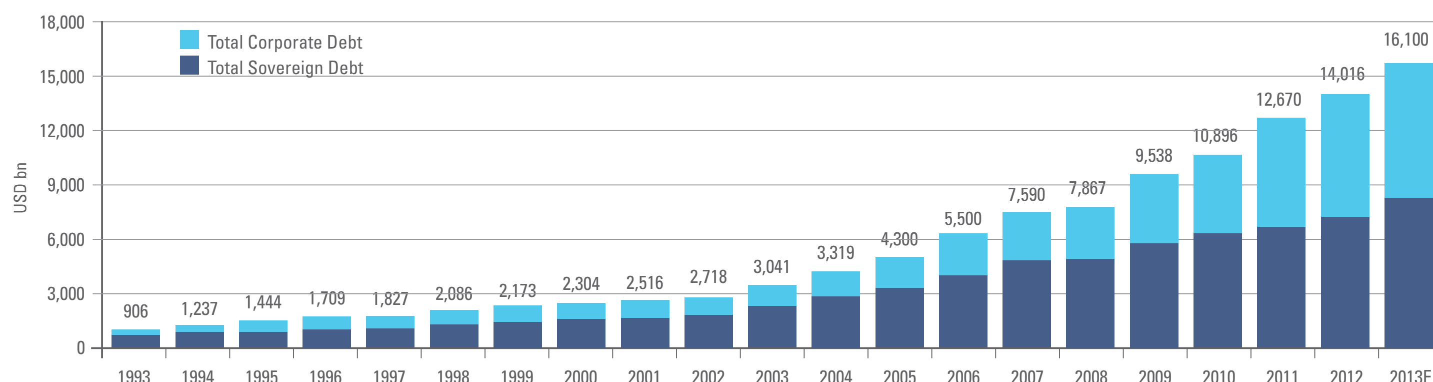
Over the past decade, the Emerging Markets (EM) corporate bond market has changed beyond recognition: it has gone from a small, often overlooked corner of the Emerging Markets debt universe to a fully-fledged asset class. This market has grown in size and breadth as new issuers have tapped it and have issued a growing number of bonds in larger sizes and longer maturities. Over time, we have seen more asset managers and bank trading desks have become involved, helping to deepen liquidity, develop research coverage, and facilitating the participation of more investors into the universe.

Like its sovereign cousin, the EM corporate debt market is divided into hard currency and local currency denominated instruments. Taken together, we estimate that they amount to over USD 7.5trn in total tradable bonds outstanding.[1]

Whilst many investors are more familiar with the USD denominated part of the market, the local currency denominated part is far larger in absolute size and now benefits from a dedicated global index launched in 2013 by BoA Merrill Lynch. This should generate increasing investor interest in 2014 and beyond.

Corporate debt is the fastest growing part of the EM debt universe. According to latest available data, outstanding bonds grew over 10% in USD terms in 2012 to USD 6.8trn from USD 6.1trn. In the hard currency space, the corporate debt market grew over 13% in 2012 to USD 941bn from USD 828bn. Primary issuance in hard currency corporate debt first surpassed sovereign issuance in 2003 and it has continued to do so in each subsequent year: in 2012, total issuance was nearly three times larger for corporate debt than for sovereigns. 2012 also saw the size of the hard currency EM corporate debt market surpass the US high yield market for the first time. Issuance in 2013 suggests that growth in the EM corporate debt market is continuing to keep pace with this trend.

Fig 1: **Size of the EM corporate and EM sovereign debt universe (all currencies)**



Source: BIS and BoAML, July 2013. 2013 forecast based on Ashmore estimates.

[1] Source: BIS and BoAML, July 2013.

In the hard currency space, the most widely followed EM corporate debt is covered by the JP Morgan Corporate Emerging Market Bond family of indices (CEMBI), whose main characteristics are described in the table below. Whilst this index family covers a large number of issuers, close to 500 in total, it does a pretty poor job at reflecting the size of the opportunity in EM credit markets. Indeed, it only includes fixed-rate USD-denominated bonds issued in USD 300 million minimum size and excludes a large number of bonds issued in other currencies or in different structures. Because so many Emerging Markets have become investment grade rated and their companies are conservatively managed, the index family also features a notably high proportion of investment grade rated bonds.

Fig 2: **CEMBI Broad/Diversified statistics**

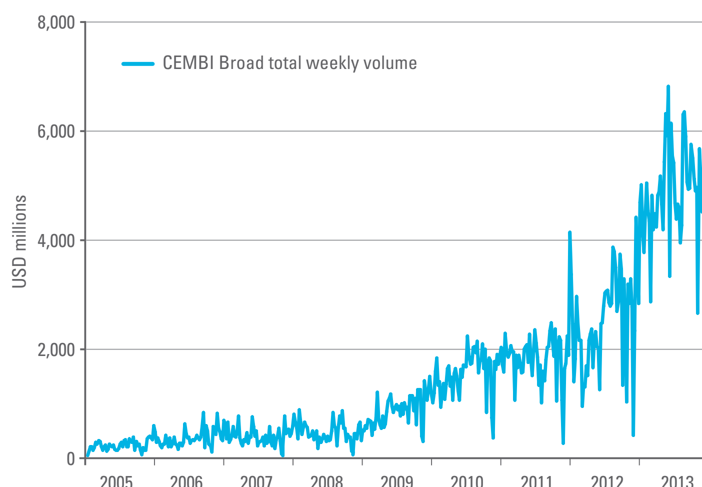
General information	
Total market cap (USD billions)	727
Investment grade	497
High yield	231
Number of issues/issuers	1045/497

Statistics			
	Spread (over. UST)	**Yield-to-maturity**	**Duration**
CEMBI Broad/ Diversified	323	5.48	5.12
Investment grade	233	4.57	5.30
High yield	511	7.11	4.76

Source: JP Morgan index, End February 2014.

The growth in the asset class has led to a substantial growth in trading volume in EM corporate bonds. Despite data limitations, the table below which only covers smaller trades and CEMBI index constituents illustrates the dramatic rise in weekly trading volumes in EM corporate bonds.

Fig 3: **CEMBI broad total weekly volume traded**

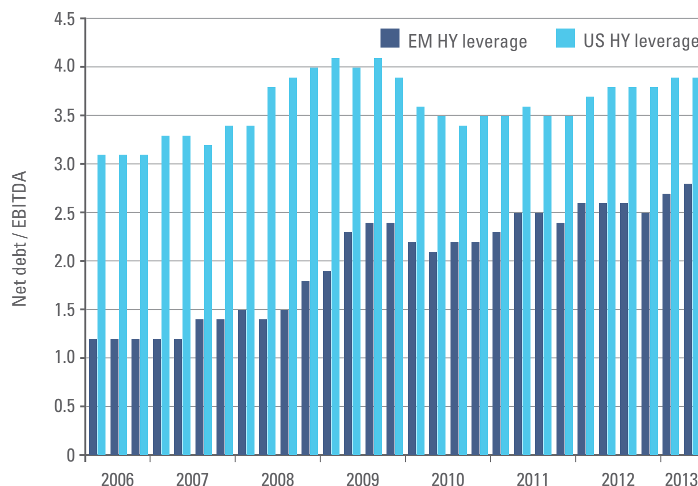


Source: JP Morgan index, January 2014.

Attractive leverage: adjusted credit spreads

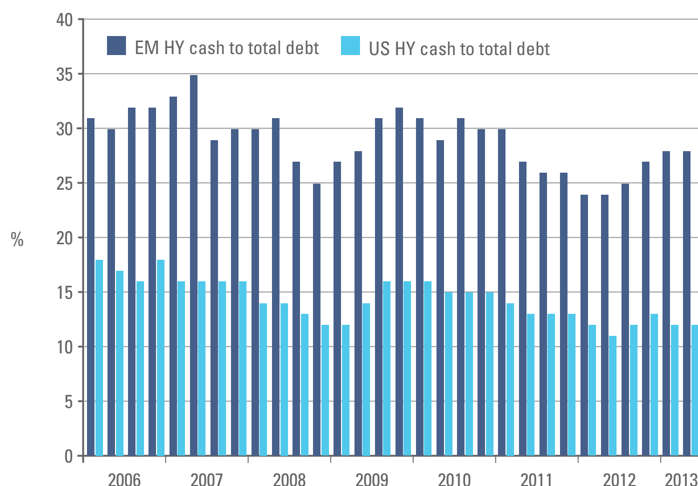
The first key attraction of the EM corporate debt market is the average quality of the issuers' balance sheets. In a historical comparison of EM high yield corporate debt with its developed markets counterpart (using the US HY market as a proxy), EM high yield corporates exhibit significantly less financial leverage, and more cash on their balance sheets, as illustrated in figures 4 and 5 below.

Fig 4: **Net leverage as per NET DEBT/EBITBA (EM HY vs. US)**



Source: BoA Merrill Lynch, June 2013, based on universe of reporting companies tracked by the firm.

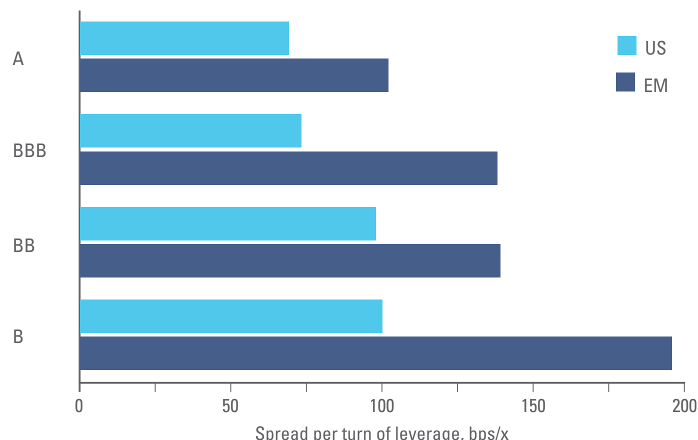
Fig 5: **Cash on balance sheet as a percentage of total debt (EM HY vs. US HY)**



Source: BoA Merrill Lynch, June 2013, based on universe of reporting companies tracked by the firm.

The second key attraction of this market has been the greater credit spread premium offered by EM corporate bonds in comparison to developed markets (DM) corporate paper: For the same amount of issuer leverage, EM corporate debt investors are much better compensated. The chart below illustrates this concept and shows the number of basis points of credit spread compensation divided by the issuer 'turn of leverage' (i.e. Net Debt/EBITDA here).

Fig 6: **Spread compensation per 'turn of leverage'**



Source: BoA Merrill Lynch, June 2013, based on universe of reporting companies tracked by the firm.

The spread collected per 'turn of credit leverage' by an investor in a BBB-rated corporate in Emerging Markets is typically double the equivalent in the US corporate bond market. This relation is also true for non-investment grade single B rated credits.

Diversified exposure across a large set of countries

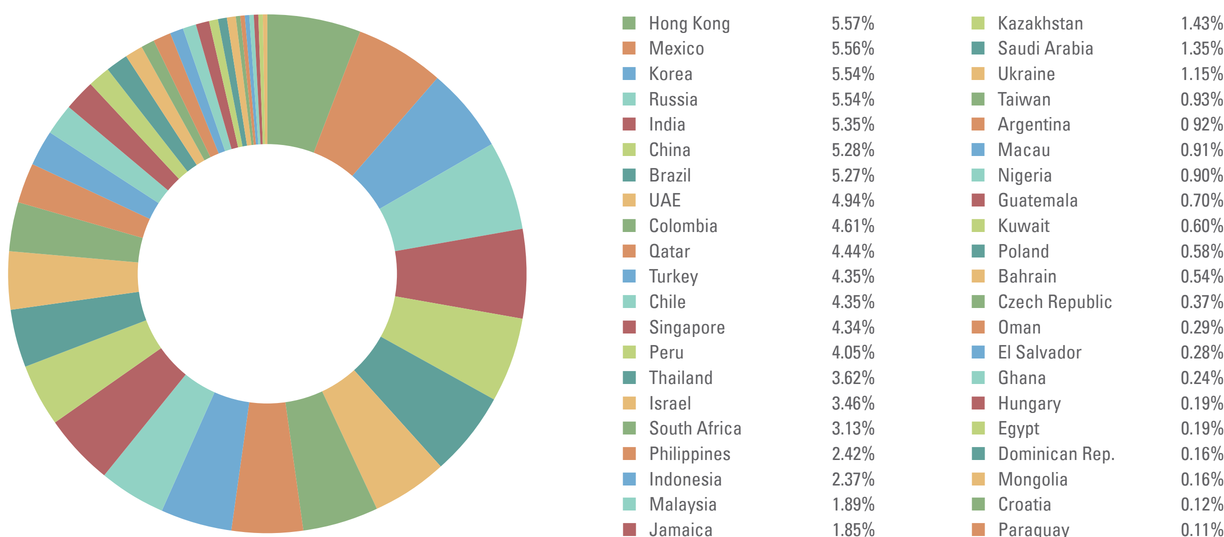
The third key attraction of the EM corporate debt market is country diversification. Unlike the US corporate debt market, where all the credits are exposed to one macro-economic cycle, investors in EM gain exposure to a multitude of macro-economic environments, many of them completely un-correlated with each other. The most widely followed index, the JP Morgan Corporate Emerging Market Bond index (CEMBI) includes bonds issued by companies operating in 42 countries across an increasing variety of industries.

Demand and supply dynamics remain favourable

We believe that the continued growth and development of the EM corporate debt market will be driven by both supply and demand factors:

- On the supply side, EM corporate issuers are taking advantage of the low all-in yields available to fund growth and expansion plans but also to improve balance sheet flexibility by refinancing older, more expensive debt, terming out liabilities and increasing their cash buffers (Figure 5). 2013 equalled 2012's record EM corporate debt issuance of around USD 330bn. During 2013, EM corporates have routinely issued in benchmark sizes of USD 500m to USD 1bn and in maturities of 10-years and above. Whilst local currency corporate debt issuance continues to develop, access to the international USD denominated market remains a significant source of long-term funding for EM corporates
- On the demand side, relative spreads, robust fundamentals and the increased depth and breadth of the market are attracting new investors to the asset class. Many investors see EM corporate debt as an extension of their existing global credit allocation and an attractive way to gain exposure to the secular growth story offered by Emerging Markets. A growing number of investors are also coming from Emerging Markets themselves, where pension funds and insurance companies have become more sophisticated and are comfortable investing in corporate credit on a regional or a global basis, in Latin America and Asia in particular. Participation in this market is shared broadly between allocations to 'blended' EM debt funds, direct investment in EM corporate securities, and the funding of dedicated EM corporate debt mandates. The relative outperformance of EM corporate bonds vs. other EM bonds in 2013 suggest that investors' allocation to EM corporate debt is treated as a structural, long term holding in many portfolios. And whilst investors in this asset class are today largely institutional, there is increasing interest from retail investors as well.

Fig 7: **Country weights in the JP Morgan CEMBI BD index**



Source JP Morgan. End February 2014.

Attractive relative value and performance in comparison to DM credit assets

Emerging Markets corporate spreads are higher than similarly rated US paper, and the lower the rating the larger the difference tends to be. The spread pick up achievable in high yield is higher than in the investment grade space; investors can pick up around 275 bps by investing in high yield EM corporates compared to high yield US corporates.

Furthermore, since credit rating agencies have always been more conservative with their ratings for EM corporates, this spread pick up actually understates the risk-adjusted difference. In addition, corporate credits tend to be rated at or below their sovereign credit ratings. This ensures that the yield of EM corporate credits includes compensation for the sovereign credit risk, which is not always the case in developed markets, where the sovereign risk is simply assumed away.

Fig 8: **Spread differential EM vs. US credit (in bps, for IG and HY)**

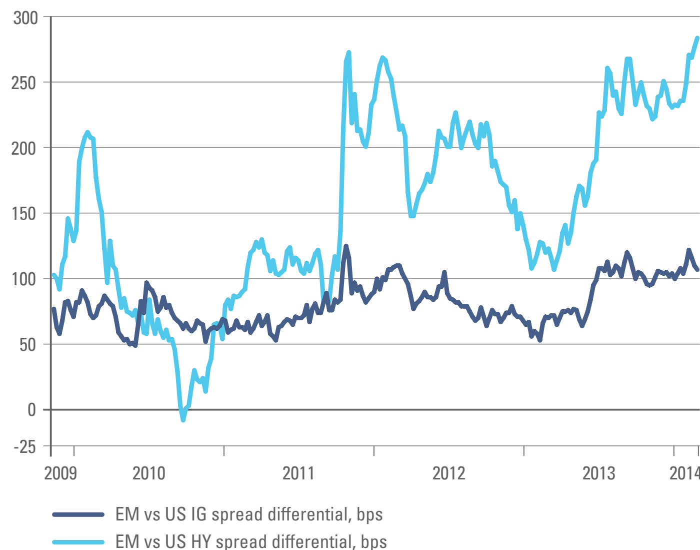
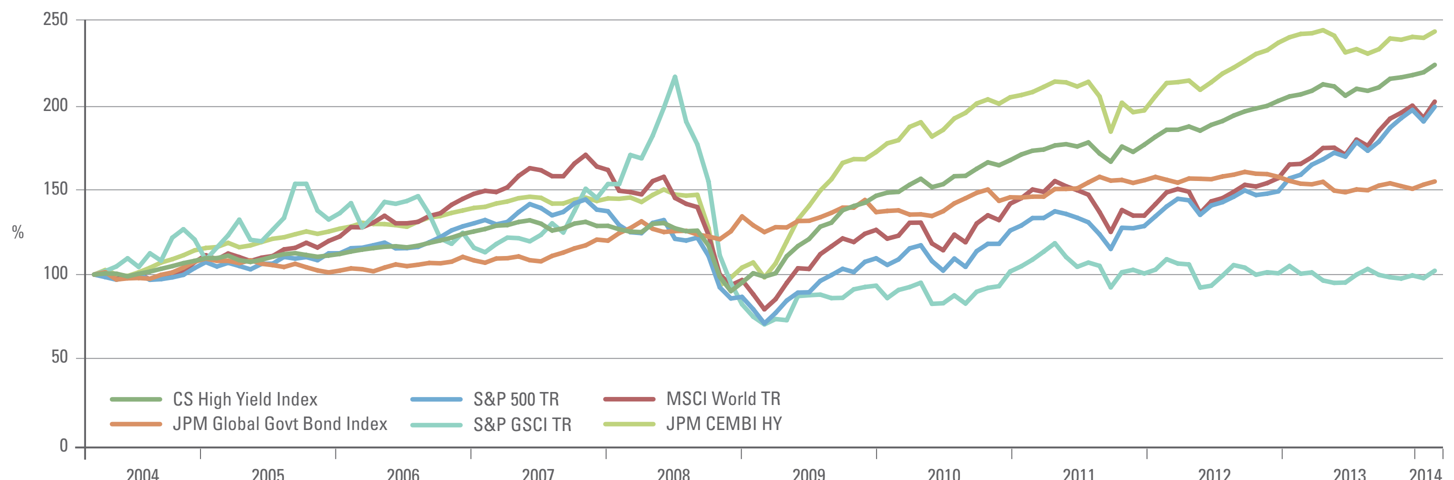


Fig 9: **Ratio of spreads between US and EM credits – near historic highs**

Source: BoA Merrill Lynch, February 2014, based on universe of reporting companies tracked by the firm.

This has led to higher historical returns than that available from developed corporate credit markets. This can be seen in figure 10 which plots the performance of the HY index against other asset classes.

Fig 10: **Comparative performance over 10 years, rebased**



Source: Various indices. Total return basis, February 2004 to February 2014.

On a risk-adjusted basis the JP Morgan CEMBI BD index has performed very well over the last 10 years, delivering an annualised return of 7.6% for annualised volatility of 9% or a Sharpe ratio of 0.50. The high yield subset of the index has delivered an annualised return or 11.3% for an annualised volatility of 14%, or a slightly higher Sharpe ratio of 0.58.

The asset class has low interest rate sensitivity. The CEMBI HY has recorded a negative correlation of 0.06 with the US treasury 10-year index over the last decade, and a very small correlation of 0.14 with the Global Aggregate strategy. Based on this historical data, simple 'mean variance' optimisation models typically assign a high weight to EM corporate debt in diversified portfolio of fixed income securities.

Why now?

We believe that Emerging Markets corporate debt provides a very good solution to two of the most pressing questions for global investors:

- How do I maintain an adequate yield in my portfolio in an environment of low global yields?
- How do I manage portfolio duration in a rising interest rate environment?

Both these factors are likely to remain high on the agenda for global fixed income investors and will continue to support increasing capital allocations to Emerging Markets corporate debt, in our view.

1. **EM corporate bond yields are very attractive in comparison to most other global fixed income and credit products.** Figure 8 illustrates that the asset class has rarely been as cheap in comparison to US corporate credit since the financial crisis in 2008. US high grade and US high yield did widen a little bit during the 'Taper tantrum' in the spring of 2013, but have recouped all their spread widening and more, which is not the case for EM corporate bonds, that have continued to be unloved.
2. **The losses suffered by fixed income portfolios in 2013 were a stark reminder of the dangers of duration in an interest rate tightening environment.** Many investors today are seeking to reduce the average duration of their fixed income portfolios. However, with the US yield curve steepening, the roll down the curve can make reducing duration very costly in terms of running yield. An allocation to a fixed income product with much shorter duration, such as EM corporates, can be a very effective way to reduce duration without bringing the portfolio's yield to maturity too far below the target yield/return.

The right investment approach to capture the opportunity

Ashmore has been investing in Emerging Markets credit across the whole spectrum of corporate debt since 1992 and established a dedicated theme for corporate debt in 2007.

As at 31 December 2013, across all of Ashmore's funds which invest in corporate debt, Ashmore managed around USD 14.7bn in corporate debt assets. These assets are managed across a number of funds and accounts, including some which specifically focus on high yield opportunities and others which invest only in investment grade corporate credit.

Our dedicated corporate credit investment team follows Ashmore's proven investment committee-led process, and uses a bottom-up credit selection approach combined with a macro, top-down overlay.

The Emerging Markets corporate bond debt universe is large, diverse and growing fast. Its higher spread and lower duration characteristics in comparison to developed market credit indices offer one of the most compelling opportunities in global fixed income markets today.

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