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Emerging Corporate Debt Fundamentals - How High Is The Risk?

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Executive Summary

The financial press has given much attention to the rise in corporate debt in emerging countries. The conventional narrative states that abundant liquidity in the aftermath of the Global Financial Crisis (GFC) accompanied an investment boom that led to a significant increase in corporate leverage in the emerging markets. Faced with rising borrowing costs, some of these companies, including quasi-sovereigns, may not generate sufficient earnings to service their debt, which will subsequently lead to rising default rates.

We investigate the impact of these claims on the relevant subset of emerging market (EM) corporates of most interest to GMO emerging debt investors, namely state-owned enterprises (SOEs) or quasi-sovereigns, which make up a little under two-thirds of the EM corporate debt universe.[1] The first part of our research focuses on the direct impact of rising rates on non-financial SOE fundamentals. In the second part, we examine vulnerability of a "sudden stop" possibly precipitated by rising rates or any other myriad uncertainties and how governments may react. Lastly, we make some observations about the government-owned bank fundamentals, because they are one-third of our corporate investment universe and are most likely to serve as government agents to fight against a possible SOE liquidity squeeze.

Using our investment framework, we observe that SOE fundamentals are weak relative to their own history, and this is a concern. Digging deeper, we expect these entities should be able to withstand gradually rising interest rates: The investment cycle is past its peak, and conditions are ripe for deleveraging using free cash flow. We are seeing early positive signs, and if global GDP growth continues to allow for robust revenue growth, de-leveraging can happen fairly quickly. In addition, a key characteristic of the recent borrowing has been that SOEs have extended maturities significantly. Longer borrowing terms imply that the immediate impact of rising rates will be less severe, providing a runway for managements to prepare. Lastly, our deep dive into most troubled SOE credits finds that the balance sheet weakness is a direct function of misguided industrial policies pursued by respective governments, rather than irresponsible management behavior on the face of low borrowing costs.

[1] We note for the benefit of emerging market equity investors that these SOEs comprise about one-third of that universe by market capitalization. Please see Ben Inker's quarterly letter "Emerging Markets – No Reward Without Risk" published in August 2018 for information about GMO's emerging equity positioning.

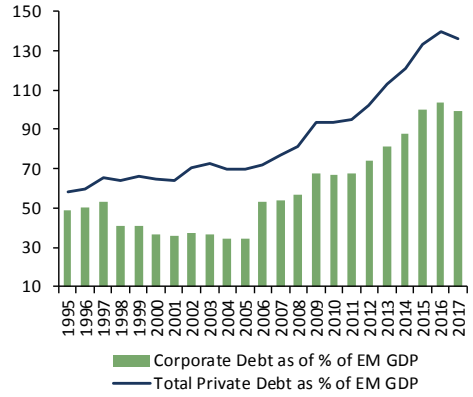
In the second part of our research, we pose the following question: Can the global rising rates bring about a liquidity "sudden stop" (say, as a result of a trade spat turning into a serious global trade war) to otherwise solvent quasi-sovereigns, leaving them bankrupt? On this question, a potential liquidity freeze should be of greater concern than incrementally costlier interest payments, but this is less of a risk for quasi-sovereigns than it is for privately-owned corporates. This is because SOEs are better positioned to withstand liquidity events than their peers, both in the emerging and developed markets, largely owing to their two unique advantages: First, rather than borrowing from occasionally flighty international capital markets, they borrow primarily from local banks that offer a stricter form of financing. Second, they enjoy privileged access to the local state-owned banks where stressful times lead banks to recalibrate their credit risk appetite in favor of SOEs.

Finally, if state-owned banks can cushion against a potential SOE funding "sudden stop," we ask if these financial institutions can withstand financial shocks on their own. On this front, the main take-away is that the credit fundamentals of the state-owned banks are strong, and this is good news both for debt investors who make investments in quasi-sovereign banks and in other SOEs that these banks serve.

Introduction

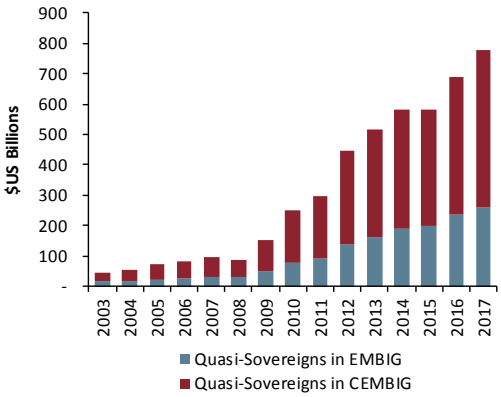
The financial press has given much attention to the rise in corporate debt in emerging countries. The conventional narrative states that abundant liquidity in the aftermath of the GFC accompanied an investment boom that led to a significant increase in corporate leverage in the emerging markets. Faced with rising borrowing costs, some of these companies, including quasi-sovereigns, may not generate sufficient earnings to service their debt, which will subsequently lead to rising default rates. Exhibit 1 shows some of the commonly used charts that advance this hypothesis. It is difficult to dispute that corporate balance sheets in emerging countries are more stretched than before.

Exhibit 1a: EM Corporate Debt as Percent of EM GDP



Source: BIS, GMO

Exhibit 1b: Index-Tracked Quasi-Sovereign Debt Outstanding

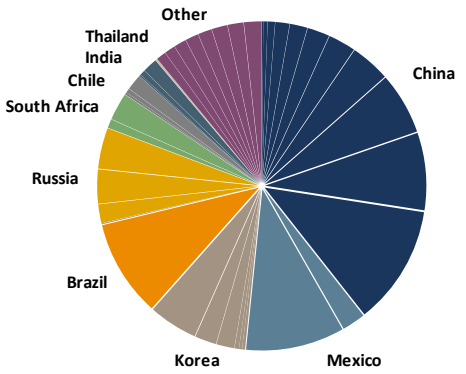


Source: J.P. Morgan, GMO

For our study, we narrowed the focus to those SOEs most relevant to our emerging debt investment portfolios. While not the same totals as the BIS, we believe it's a highly relevant sample: 55 representative SOEs in 25 countries with $1.1 trillion in debt market capitalization and 30 state-owned banks; we considered 30 banks covering about $12 trillion in banking assets across 16 jurisdictions. Exhibit 2 shows the country breakdown.

We use our investment process, a key aspect of which is the stand-alone fundamental credit quality of the issuers to assess their vulnerability to rising interest rates and "sudden stops."[2]

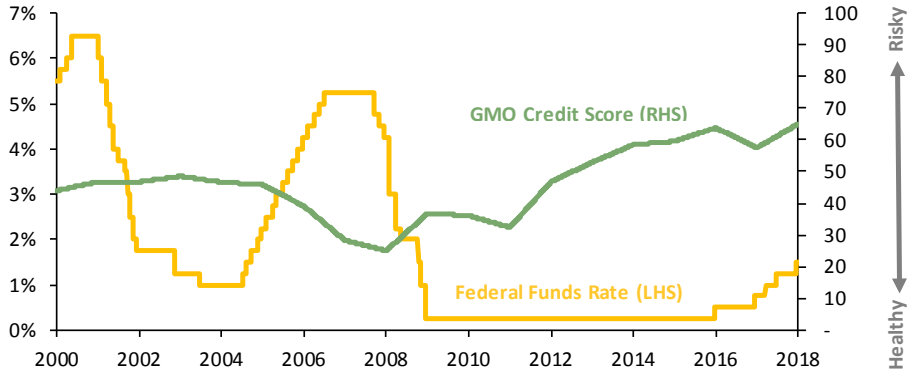
Exhibit 2: GMO's Investment Universe



Source: GMO, Financial Statements

Our process "scores" each company on various credit metrics, and we can aggregate these up to a broad measure of credit quality for our sample weighted by debt market capitalization. In Exhibit 3, we present the aggregate score for our sample of non-financial quasi-sovereigns, alongside the US Federal Funds rate.

Exhibit 3: History of Fed Rate Cycles Against GMO's EM Quasi-Sovereign Fundamental Scores



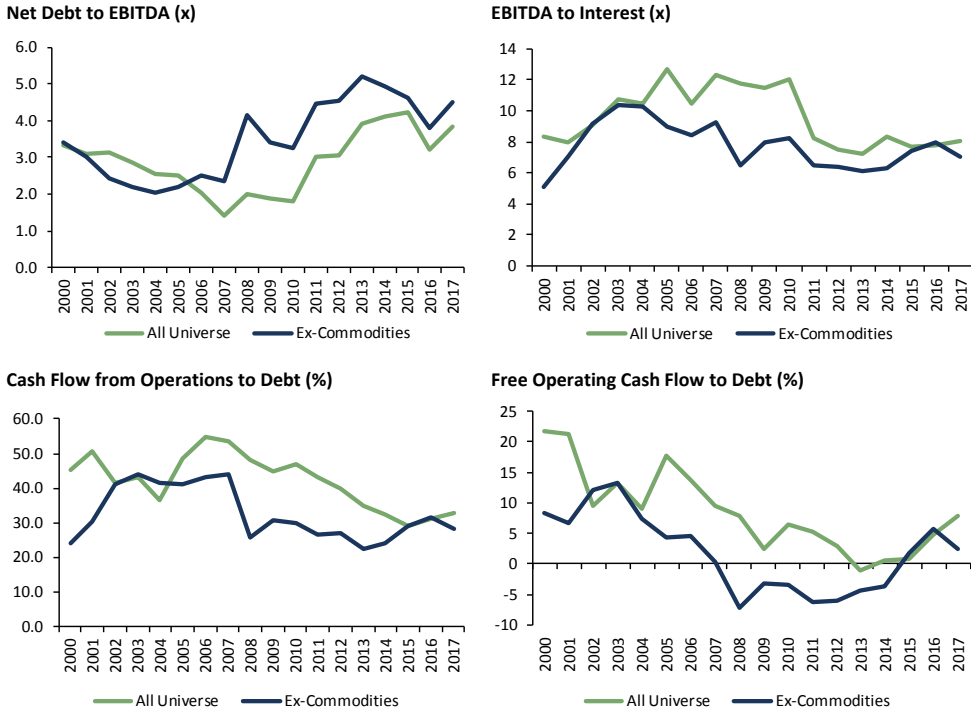
Source: Capital IQ, Company financial statements, GMO calculations

From Exhibit 3, we agree with the broad narrative that aggregate credit fundamentals have weakened in the low rate environment. The charts in Exhibit 4 shed more light on the details of this deterioration, using several ratios that feed into our fundamental credit score. Net debt-to-EBITDA stands at 3.8 times today, compared with 2.9 times in 2005. Nevertheless, net leverage of 3.8 times EBITDA is a very manageable level, consistent with, say, ratings in the BB range in the context of US corporates. During this period, we also observe that the free cash flow metric, which measures the surplus operating cash after investments costs, turned from positive to negative, implying investments

[2] Our investment process for quasi-sovereigns evaluates each name on four main pillars – stand-alone credit quality, ability of a sovereign to provide extraordinary support to a quasi-sovereign in times of stress, the willingness of the sovereign to do so, and the issue documentation. Based in part on Carl Ross' previous research "Emerging Debt in a Rising Interest Rate Environment" published in June 2018, we assume that the sovereign's ability to support, or issue documentation, will not change significantly in a moderately rising interest rate environment.

exceeded operating cash generation, and thus the need to borrow. The coverage ratio (measured by EBITDA-to-interest expense) and the payback ratio (measured by cash flow from operations-to-debt) tell similar stories. The starting points today, while not alarming, are worse than they were in 2005. The year 2007 marks their peak and 2015 generally marks the bottom. The quasi-sovereigns comfortably earn 8 times more than their interest costs and, through internal capital generation, they can pay off their debt in a short 3.5 years.

Exhibit 4: Selected Indicators of Corporate Risk – Quasi-Sovereign Aggregates



Source: Capital IQ, Company financial statements, GMO calculations

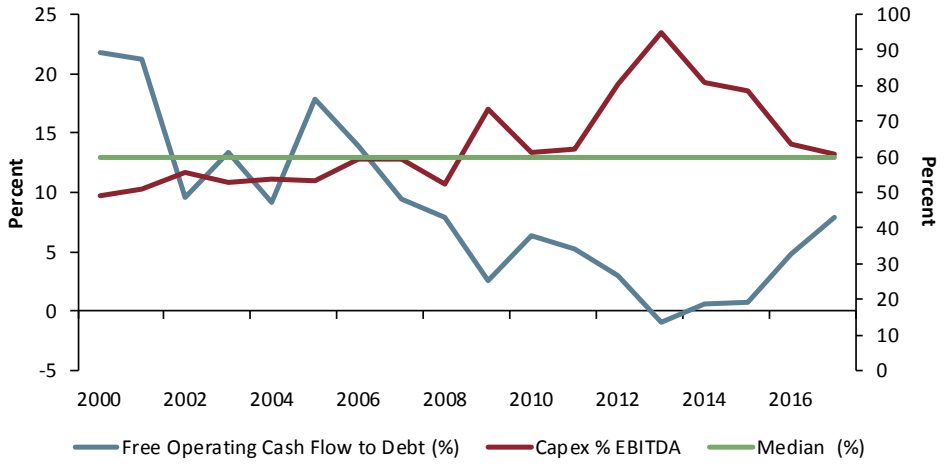
Direct impact of rising rates

With the longer history and the fundamental credit quality metrics from Exhibit 4, we are able to see how these companies managed the 2004 to 2006 cycle and get indications of how they are prepared for the current cycle. First, we note fundamentals improved markedly during the Fed's 2004 to 2006 rate hike cycle. Net debt-to-EBITDA, for example, declined to only 1.4 times by 2007, following over 2 years of Fed rate hikes totaling 400 bps. We think this was due to the fact that global growth was high during those years, and company managements worked proactively to cushion their balance sheets against rising rates. High commodity prices also buoyed those sectors. We see similar trends emerging in the current cycle, based on the available data, and our discussions with company managements. We doubt that company fundamentals will improve at the pace they did from 2004 to 2007, but we see signs of stabilization in the ratios.

Trends in free cash flow generation relative to debt, the blue line in Exhibit 5, a metric that measures excess operating cash after investments costs relative to debt, also confirm the rise in borrowing post-GFC. Since 2013, however, quasi-sovereigns have significantly scaled back their investments, reversing a trend that began post-GFC. These companies today are past the peak of their borrowing and investment cycles, and if global GDP growth allows for robust revenue growth, deleveraging can happen fairly quickly, even in the face of rising rates. This is because they are highly cash-generative

entities. Further, the median quasi-sovereign invested roughly half of its EBITDA in 2000. From 2000 to 2007, the investment ratio gradually ticked up to 60% while taking a breather in the hiking cycle of 2004 to 2006. In 2013, it hit a historic high of 95%, marking the peak of the capital expenditure cycle. Since then, investment rates have declined and the newly completed projects started contributing to EBITDA, bringing the ratio down to 60% in 2017. Notice this is roughly the long-term trend average. Based on forward guidance I receive from management teams, I expect that this ratio will settle at around the current levels over the next 24 to 36 months.

Exhibit 5: Business Investment Peaked in 2013

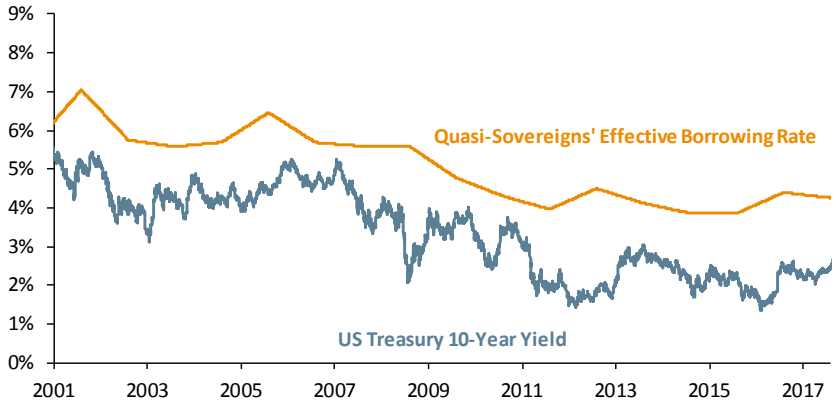


Source: Capital IQ, Company financial statements, GMO calculations

The cushion of longer maturities

A key characteristic of the recent borrowing has been that quasi-sovereign corporates have extended maturities significantly. One indicator of this is the average life of quasi-sovereign bond debt included in the benchmarks, which has risen from 8.9 years in 2010 to 10 years currently. Longer borrowing terms imply that the immediate impact of rising rates will be less severe, providing a runway for managements to prepare. Moreover, the average interest rate on quasi-sovereign debt in our universe is very low relative to history, providing some further cushion for higher rates (see Exhibit 6).

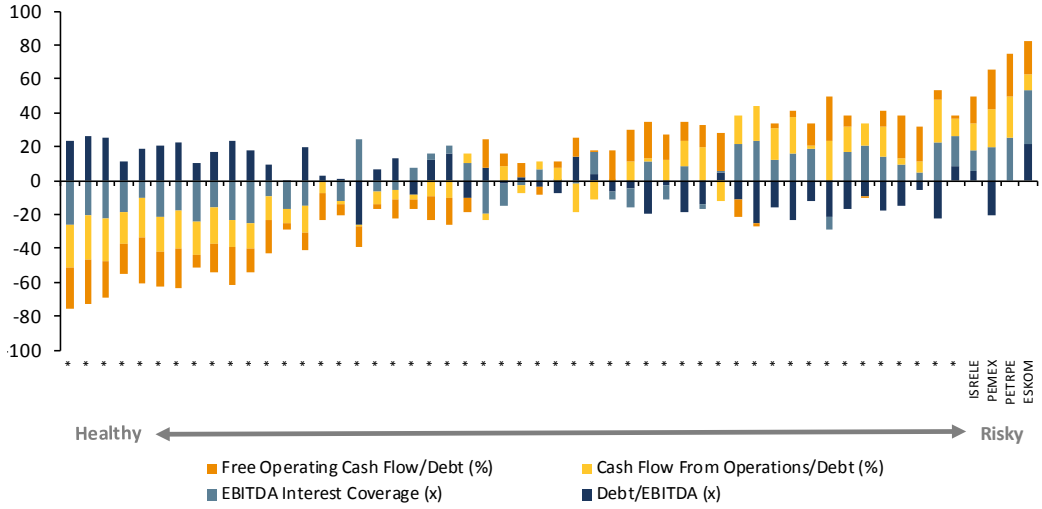
Exhibit 6: Average Borrowing Costs of the Quasi-Sovereigns Against 10-Year USD Rate



Source: Capital IQ, Company financial statements, GMO calculations

Let's drill into some of the riskier stand-alone companies to test how rising rates may further stress these companies. Notwithstanding valuations, the companies listed in Exhibit 7 score the poorest in our process. Recall that the higher the score, the higher the leverage. Our deep dive into the most troubled credits finds that the balance sheet weakness is a direct function of misguided industrial policies pursued by their governments, rather than irresponsible management behavior in the face of cheap financing. For example, Israel Electric has uncomfortable fundamentals because the current domestic electricity market in Israel forces the utility provider to overstretch in generation without much consideration to costs. Only structural reforms, which we are keenly watching, that push decentralization in electricity generation can improve the company's fundamentals. Similar arguments can also be made for Pemex, the national oil and gas producer in Mexico; Petroperu, a refiner in Peru; and Eskom, a utility in South Africa. These companies have easy-to-diagnose challenges such as selling their goods or services at insufficient margins or overstaffing their ranks and paying them generously, even beyond their retirement. Yet, domestic politics are often in the way of sensible industrial policies, making them very hard-to-solve problems. And, unless their operational environments improve through structural policy fixes, they will remain unsustainable companies. In such cases, we turn again to the ability of the relevant sovereign to support such companies. We note that in all but Eskom's case, the sovereign in question is investment grade.

Exhibit 7: These Quasi-Sovereigns Have the Most Worrying Stand-Alone Fundamentals



Source: Capital IQ, GMO calculations

What about liquidity risks?

Could there be a liquidity "sudden stop" (say, as a result of rising rates or a trade spat turning into a serious global trade war) to otherwise solvent quasi-sovereigns that leaves them bankrupt? GMO's quasi-sovereign fundamental score considers various cash-based liquidity metrics and is a reflection of our best guesses of their future state. But these best guesses of the future can miss the realities on the ground, especially in EM countries. When tail events occur, for example, most borrowers, including quasi-sovereigns, become vulnerable to a sudden funding freeze. At these moments, liquidity (i.e., receiving new loans, or extending an existing loan) could determine survival. On this measure, local banks, compared to international capital markets, have a better track record of continuing to provide funds.[3] As proxy for extraordinary liquidity measures, I estimate that bank debt accounts for roughly

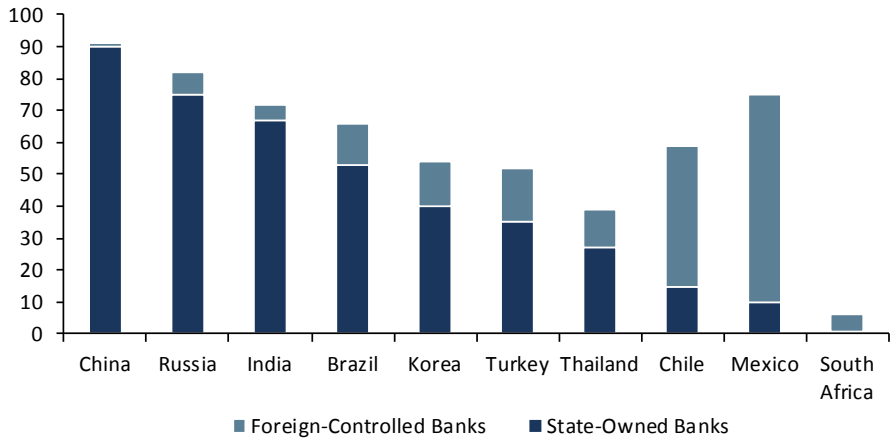
[3] I feel the need to qualify my statement. To the extent that there is an exodus of foreign-based lenders from domestic banking systems, local corporates will suffer. However, because the foreign ownership levels are generally low and are concentrated in a handful of emerging markets, we can ignore this.

half of quasi-sovereign indebtedness, and roughly 75% of this is owed to local banks (see Exhibit 8). This compares favorably to other markets. In the US high yield markets, for example, an average corporate is 25% bank-funded.[4]

Petrobras, a Brazilian oil and gas quasi-sovereign, serves as a helpful test case.

When the company became mired in a multi-billion-dollar bribery scandal in 2014, a handful of local banks, particularly those that are government-owned, came to the rescue by increasing Petrobras' credit limits. The rescue was orchestrated by the government, a shareholder of Petrobras and some of the banks, and by the banking regulator through its forbearance measures on lenders. At the same time, the risk officers of international lenders were reducing exposure to the company. Without the local support, the company would have faced a much more severe liquidity crunch, potentially causing default.

Exhibit 8: State-Owned Banks Are the Leading Lenders in Their Domestic Markets



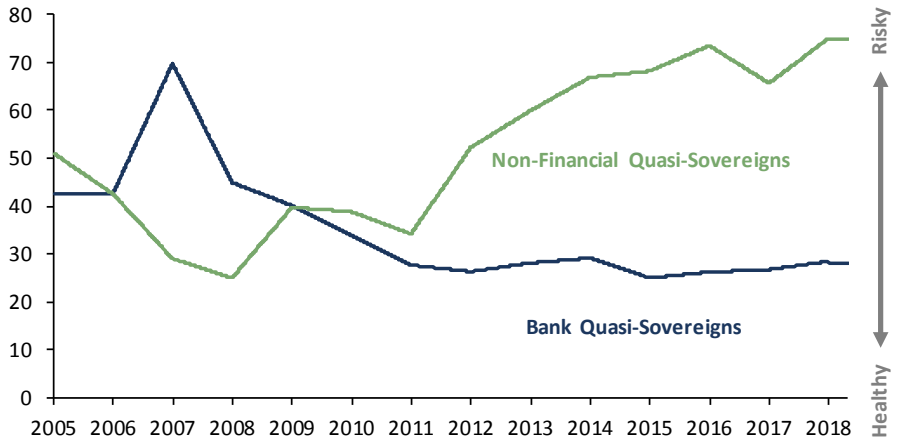
Source: IMF, World Bank, central banks, J.P. Morgan, Rencap

Are quasi-sovereign bank fundamentals healthy?

If state-owned banks can cushion against an SOE funding "sudden stop," let's examine if these financial institutions can withstand financial shocks on their own because these banks' willingness to provide funding is restrained by their balance sheet strength. In Exhibit 9, we present the aggregate score for our sample of government-owned banks (covering about $12 trillion in banking assets across 16 jurisdictions), with a low number signifying strong credit quality and a high number indicating low credit quality.

[4] Bank of America estimates.

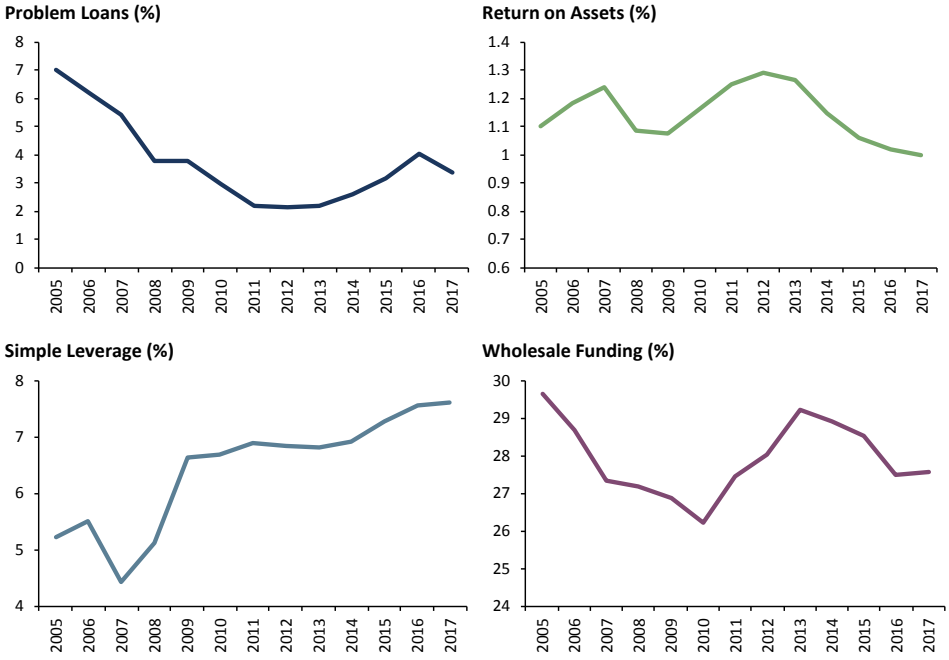
Exhibit 9: GMO Fundamental Credit Score – Quasi-Sovereign Aggregates



Source: Capital IQ, Company financial statements, GMO calculations

The main take-away is that the credit fundamentals of the bank quasi-sovereign universe are strong, relative to their history and relative to SOEs that are already in a decent position to weather any upcoming storm. This is good news for debt investors who make investments in quasi-sovereign banks and in SOEs that these banks serve as clients. The charts in Exhibit 10 shed more light on the details of this improvement, using several ratios that feed into our fundamental bank credit score. Asset quality measured in problem loans, which sum up non-performing and recently restructured loans, stands at a healthy 4% of the lending today, compared with the 7% in 2005. During this period, we also observe that banks have steadily earned above 1% of their assets, reflecting a very high level of profitability. Simple leverage ratio, measured by equity over assets after deducting intangibles, too has shown marked improvement from roughly 5% to 7.6%. The up-tick in equity cushions along with less reliance in wholesale funding are indeed good news.

Exhibit 10: Selected Indicators of Corporate Risk – Quasi-Sovereign Aggregates



Source: Capital IQ, Company financial statements, GMO calculations

Summary

We agree with the headline narrative that emerging market corporates have borrowed heavily in the low rate environment. We observe that the ones of most relevance to sovereign and quasi-sovereign focused emerging debt investors handled the 2004 to 2006 cycle well; that they have taken steps to cushion the impact of the current cycle; and that their domestic banks are healthy and therefore can be an important liquidity backstop if needed.

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