

# EM Corporate High Yield – The Next Big Investment Opportunity?



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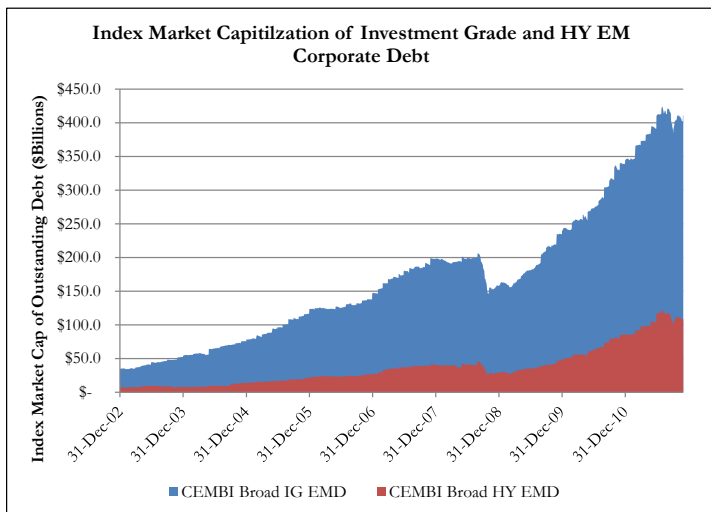
The early 1970s ushered in a period of inflation and high absolute borrowing rates for U.S. capital markets. All but the largest and highest rated borrowers were shut out of the marketplace. Public markets were not available to young, innovative companies and banks stopped lending to riskier credits. Bear Stearns and Drexel revived the market in the late 70s, as they brought a number of below investment credits to market. Michael Milken, often given the title of the King of Junk Bonds, leveraged a study by W. Braddock Hickman which showed that below investment grade bonds offered higher risk adjusted returns than investment grade bonds. The market grew from just over \$10 billion in the early 1980s to a current \$1.8 trillion market cap. Many famous names including MCI, Turner Broadcasting and Wynn Gaming were able to make their start thanks to the U.S. high yield marketplace.

Today's EM corporate market, at \$400 billion in market cap as measured by the index, is considered to be in its infancy when compared to other, more mature asset classes. Even smaller, the EM high yield corporate market has an index market cap of \$109 billion (6% of the size of the U.S. high yield market). The size of the high yield market has grown in recent years as the strength of EM sovereigns has provided great interest for higher yielding investments. The EM corporate high yield index was only \$41 billion at its last peak in 2008 and half that size in 2005. The expansion of high yield corporates has piggybacked on the expansion in the corporate market overall. While the EM corporate market, including high yield, is just over \$400 billion today, it was only \$150 billion three years ago. High yield is poised to grow rapidly, especially if it ushers in a new era of opportunity and return.

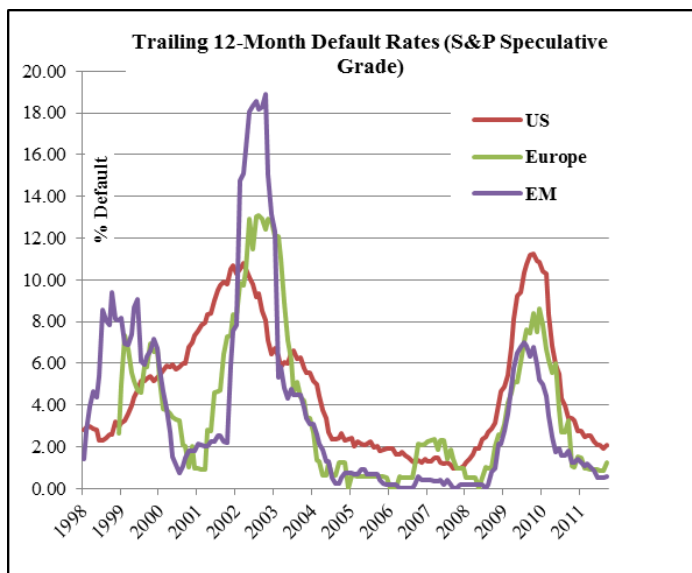
vertically integrated steel producer in Russia, the U.S., Brazil and India. The current period may be a mirror of the Milken era – lower rated companies with high growth prospects (which we currently take for granted) could in the future become investment grade companies.

As mentioned previously, the successful manner in which emerging markets weathered the storm of 2008 has refocused investor interest into the entire asset class, but especially the opportunities in EM corporates. As EM sovereigns no longer have overwhelming issuance needs in USD, they have provided a ripe opportunity for cash starved EM corporations to finally access the market. The end of this crowding out effect and a growing middle class being created in EM countries can provide the opportunity and demand for EM corporates. Additionally, with the evolution of the asset class, investors are now seeking these types of investments to gain additional return in EM portfolios. Even U.S. high yield managers are investing in EM corporate issuers as a way to diversify and/or expand their alpha generation for U.S. high yield funds.

And why? Since 1999, the average trailing 12-month default rate on EM high yield is 3.57%, versus 3.75% for European high yield and 4.87% for U.S. high yield. This attractive number is somewhat mitigated by the higher volatility of EM defaults (at its peak in 2002, EM defaults rates were almost 19% versus peaks of 13% for European high yield and 11% for U.S. high yield in that same year). If we begin the analysis post-2003, not only does the average default rate for EM high yield fall back below that of developed markets, but so too does the volatility. We anticipate that EM high yield default rates will continue to outperform developed markets due to simpler capital structures and lower leverage in the asset class.



EM high yield has already proven itself a fertile ground for the growth of emergent multinationals that migrate from high yield to high grade. For example in the 1990s, Gerdau, a steel producer in Brazil, issued its first unrated external currency bond. The bond achieved a BB-rating in 2005 by S&P and is now a BBB-/Baa3 rated company with operations in North America, Europe and Asia which produce over 25 million metric tons of steel annually. While not yet investment grade, credits like Vimpelcom and Severstal (specializing in telecom and steel, respectively) have used available funding to expand their local Russian presence and are now globally diversified operators. Today, Vimpelcom is operating in 19 countries including developed markets such as Canada and high growth markets in Asia. Severstal has grown into a

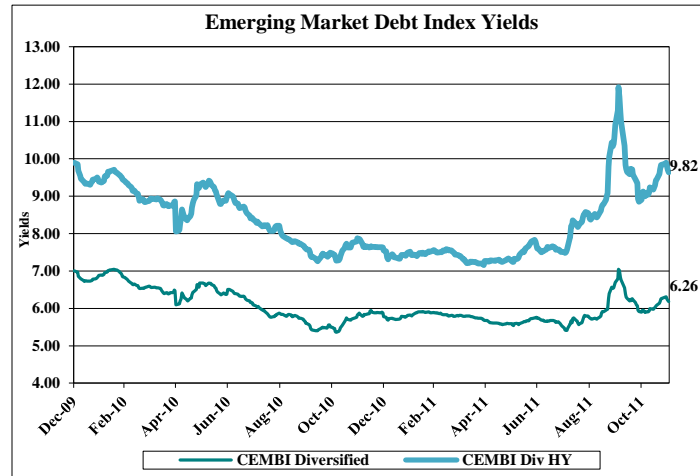


Returns have been very attractive, even despite the sharp sell-off in 2008. The three year EM high yield return is 27.1%. Despite the 40% drop from the peak in March 2008 to the trough in October 2008, the five and seven year returns have been very strong (see table). These figures compare very favorably with the returns in the U.S. high yield market. For example, five year returns were similar in magnitude (U.S. high yield five year return is 7.2%). However, despite the comparable returns, U.S. high yield volatility was much higher at 14.2% versus only

10.2% in EM high yield. As investors continue to recognize the benefits of EMD in their portfolios and the markets continue to expand towards corporates, EM high yield is sure to benefit.

<u>EM High Yield</u>	<u>3-Year</u>	<u>5-Year</u>	<u>7-Year</u>
Annualized Returns	27.1%	7.2%	8.5%

The final question is: What does this mean for today? Clearly, the continuing volatility in Europe is raising questions about the durability of markets post the Lehman crisis. We think this will create a tremendous buying opportunity. There will likely be accidents along the way, as some high yield corporates will ultimately be forced to restructure their debt burden in 2012 and 2013. However, we expect those numbers to continue in line with the default rate of the U.S. high yield market. JP Morgan officially forecasted the EM high yield corporate default rate to be 2.6% in 2012. We believe that number could be higher; however, it is unlikely to breach 10% in even the most pessimistic scenario. The strength of the underlying economics means that if yields widen, investors will be rewarded richly for following the experience of the U.S. high yield market back in the 1980s. Valuations today (see chart below) are closer to a buying opportunity than mid-summer levels. Yields are well below the 23% peak that we saw in the



heart of the crisis in 2008. However, if there is a second down trade as a result of the crisis in Europe, the rewards that investors will receive by opportunistically adding EM high yield exposure to their portfolios should prove to be similar to the experience investors felt post the Michael Milken era which ultimately ushered in the start of a new asset

class in fixed income. Mandates have continued to evolve from USD denominated sovereign debt in the 1990s and early 2000s, to local sovereign debt in the mid-2000s and now the expansion is slowly moving into EM corporate debt. As you can see in the final table, USD sovereigns have witnessed a dramatic expansion, local market sovereigns have been the second beneficiary, and EM corporates are now gaining investor recognition. EM high yield is at the third phase and positioned to eventually move to the forefront of investors radar screens. EM high yield presents a great opportunity for those that are early investor's in a developing asset class.

#### Assets Benchmarked Against Specific EM Debt Indices

EM Indices	9-Jan	10-Jan	10-Sep	11-Nov
<b>External Debt</b>	<b>198,621</b>	<b>231,333</b>	<b>305,407</b>	<b>229,123</b>
EMBI Global Diversified	118,391	149,409	214,490	162,094
EMBI Global	53,030	62,374	75,217	67,029
EMBI+	27,200	19,550	15,700	-
<b>Local Market Debt</b>	<b>35,865</b>	<b>62,319</b>	<b>79,176</b>	<b>142,532</b>
GBI-EM Global Div	18,783	42,310	56,873	123,098
GBI-EM Div	4,775	9,418	9,893	7,934
GBI-EM Broad Div	6,455	6,063	3,760	3,300
GBI-EM	4,382	4,118	6,920	7,200
GBI-EM Global	1,420	150	1,350	0
GBI-EM Broad	50	260	380	1,000
<b>Corporate External Debt</b>	<b>-</b>	<b>7,187</b>	<b>13,939</b>	<b>29,314</b>
CEMBI Broad Diversified	-	6,187	11,877	17,577
CEMBI Diversified	-	1,000	2,062	6,055
CEMBI Broad	-	-	-	4,452
CEMBI	-	-	-	1,250

To put a balanced perspective on this opportunity, we have to weigh the value proposition of EM high yield assets with higher yields and lower expected default rates versus their unique risk factors. Higher economic volatility of issuer home countries and markets, the continued development of corporate governance, and weak creditor rights in many jurisdictions remain defining characteristics of emerging markets. While we believe EM high yield is on the cusp of a broadening of both the investor base and issuer universe, we recognize that navigating these risks requires the experience and knowledge of a manager who specializes in EM in order to find the real value in the market place.

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