

The Next Emerging Markets Distressed Cycle?

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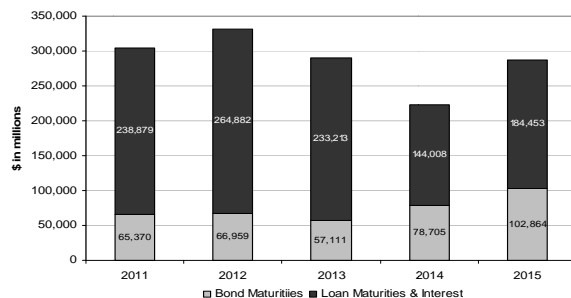
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The outlook for distressed investing in emerging markets appears poised for a new resurgence. Our view is based on the significant amount of corporate debt maturities in emerging markets coupled with the tightening of monetary and fiscal policies in emerging markets over the last six months. We believe this environment will make refinancing high yield debt difficult. Moreover, as we look at the sovereign debt crisis in the periphery of Europe, we see opportunities in the new “sub-merging markets” for significant sovereign debt restructurings requiring emerging markets style experience and expertise. There are few dedicated players in the emerging markets distressed space and this lack of competition will allow a manager with extensive distressed investing expertise to capitalize on the wealth of opportunities and achieve outsized returns.

Emerging Markets Corporate Maturities

There is a significant amount of emerging markets corporate debt maturing over the next five years. ING estimates that there are \$1.38 trillion of corporate bonds and loans maturing by 2015, which represent about 57% of the total emerging markets debt outstanding as of December 2010 (See Exhibit 1). Specifically, there are nearly \$650 billion in emerging markets corporate debt repayments scheduled for 2011 and 2012. JPMorgan estimates that the region with the largest maturity amount is Asia, led by South Korea and Hong Kong, with 23% of total debt in Asia maturing from 2011 to 2015. This is very different from the situation in the developed markets where the high liquidity allowed over-levered high yield issuers to “kick the can down the road” and push the maturity profile in aggregate past 2015.

Exhibit 1: Emerging Markets Corporate Bond and Loan Maturities by Year



Source: ING, Dec. 2010

“Sub-Merging Europe” – The Next Sovereign Debt Crisis

Emerging markets have historically been classified in terms of geographic areas. However, we believe that emerging markets need to be redefined, particularly in light of the European sovereign debt crisis. Traditionally, emerging markets have been categorized as nations that have low-to-moderate income with social or business activity that is in the process of rapid growth and industrialization. In our opinion, today emerging markets should be considered those countries in the world *except* members of the G 7, Australia, New Zealand and the countries that have been considered high income countries by the World Bank for the past five consecutive years. Emerging markets also encompass developed countries that have issued sovereign debt that is rated below investment grade or developed countries that have issued sovereign debt that may still be rated investment grade but, in our opinion, is highly likely to be downgraded below investment grade within the investment horizon. By these standards, countries in the periphery of Europe, what we call the “sub-merging markets,” either are today or may in the near future be suffering from a similar debt service crisis as the traditional emerging markets (then called LDCs) of the 1980s.

As we discussed last month in our report, European sovereign debt woes came to light in October of 2009 when it was revealed that Greece had understated its debt figures in connection with its financial reporting to Eurostat. Despite an EU and IMF rescue package, Greece is facing a problem well known to participants in emerging markets and high yield debt in which distress costs have set in and financing might only be available at prices that will bankrupt the issuer. The woes in Greece have begun to shift to the rest of “sub-merging Europe” as economic pressures in Ireland, Portugal, Belgium, Spain, Italy and other highly indebted countries could lead to a widespread crisis. As European sovereign woes continue, volatility is increasing and liquidity is drying up.

Concern about rising government deficits and debt levels across the globe coupled with a wave of downgrading European government debt has created fear in financial markets. We feel that sovereign distressed debt out of the periphery of Europe may present a tremendous opportunity for distressed investors with the right skill set and mind set. Looking

at the remainder of 2011 and beyond, we expect the environment to be one where it will be increasingly difficult to refinance stressed sovereign debts.

Exhibit 2: Credit Ratings of “Sub-Merging Europe” and Global Comps

(in trillions of €)

Rescued Countries	Credit Rating Moody's/S&P	10 Year Bond Yield	10-Year CDS Implied Probab. of Default	2010 GDP	% of GDP			
					Public Debt	Public Debt	Public + Private Debt	Fiscal Deficit
Greece	B1/BB-	14.9%	83%	€ 0.23	(0.33	142%	330%	-9.6%
Ireland	Ba3/BBB+	10.3%	59%	€ 0.15	(0.15	96%	293%	-32.2%
Portugal	Ba1/BBB-	9.5%	61%	€ 0.17	(0.14	92%	379%	-8.6%
Contagion Concerns								
Spain	/a2/AA	5.5%	34%	€ 1.06	(0.64	60%	389%	-9.2%
Italy	/a2/A+	4.8%	24%	€ 1.55	(1.84	119%	268%	-4.6%
Belgium	A1/AAA	4.3%	23%	€ 0.35	(0.34	97%	385%	-4.6%
Reference Countries								
Germany	Aa1/AAA	3.3%	11%	€ 2.50	(2.00	80%	287%	-3.3%
France	Aa1/AAA	3.6%	16%	€ 1.95	(1.64	84%	324%	-7.7%
U.K.	Aa1/AAA	3.5%	12%	€ 1.69	(1.31	77%	453%	-10.4%
U.S.	Aa1/AAA	3.4%	16%	€ 11.06	(10.13	92%	355%	-10.6%
Australia	Aa1/AAA	5.5%	10%	€ 0.93	(0.21	22%	237%	-4.6%
Japan	Aa2/AA-	1.2%	15%	€ 4.12	(9.08	220%	477%	-9.5%
China	Aa3/AA-	3.9%	15%	€ 4.43	(0.78	18%	163%	-2.6%
Brazil	Ba3/BBB-	12.8%	19%	€ 1.57	(1.04	66%	142%	-2.9%

Source: IMF and Bloomberg

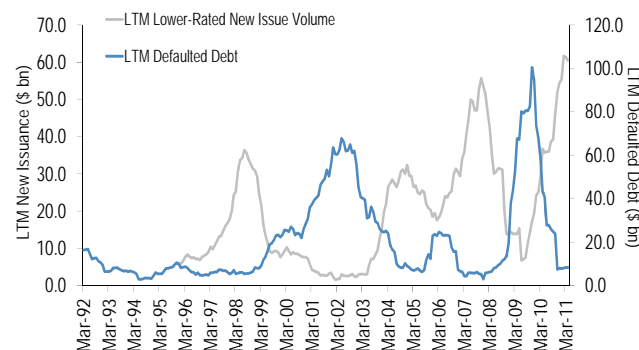
The Credit Cycle – Maturity Bulge

Tighter monetary policies globally will weigh on credit quality and on high yield credit availability. The unprecedented monetary and fiscal stimulus from the past two years will end soon and the reversal will have a negative impact on corporate earnings and access/costs to capital. In such an environment, many companies will be unable to refinance. While developed economies will likely stay with easy monetary policies for the foreseeable future, the situation in emerging markets is quite different. Consumer prices in emerging markets have started rising rapidly and as a result, policymakers have already started monetary tightening. This pattern of tightening is likely to continue for the remainder of 2011 and beyond.

Exhibit 3 shows that easy credit has been a predecessor of distress and default in developed markets over the last two decades. The spikes in defaulted debt in 2002 and 2008 were both preceded by sharp increases in new low-rated bond issue volumes that peaked at \$31.0 billion in 1998 and \$53.6 billion in 2007. Both of these periods were characterized by a sharp expansion of the monetary base and/or reduction in interest rates. As explained above, the prior period of low interest rates and abundant liquidity supplied by central banks is planting the seeds for the next period of distress. While it is useful to take an opportunistic approach and monitor the credit cycle to overweight

investment allocations into distress, the time lags between the stages as well as the policy-makers decisions are very difficult to predict. A result of the cyclical nature of credit supply is concentrated debt maturity schedules. While the situation in developed markets looks ominous, we expect the potential for far greater volatility in emerging markets inflows and outflows to result in an even more pronounced turnaround in risk appetite.

Exhibit 3: New Issue Volume vs. Defaulted Debt



Conclusion

The attractiveness of distressed investing in emerging markets was highlighted in a recent study from ING on recovery rates for the distressed period of 2007 to 2010. ING estimated that the weighted average recovery value for the \$27.7 billion in emerging markets corporate defaults in the latest cycle was 45.5% at workout date and 58.5% at current prices, both on a median basis. While it is likely that average recovery values for emerging markets corporate bonds will be reduced by the defaults yet to be restructured, these preliminary results are encouraging for emerging markets distressed investors. We feel that distressed investors who are patient and have the dry powder will be richly rewarded with opportunities in this next leg of the distressed cycle. In the meantime, the opportunities in the high yield emerging markets corporate bond markets remain interesting as long as one can be selective and identify the companies with the fundamentals and technicals to sustain them through this next part of the cycle.

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