

Corporates fight off default mode

Emerging market investors who gorged on an increasing array of corporate debt products face uncertain times as companies' balance sheets come under pressure. Default and recovery rates will vary greatly by country, writes Sudip Roy

THIS YEAR MEXICAN glassmaker Vitro reaches its centenary. Sadly for the Monterrey company it will not be celebrating in style. Instead it is fighting for its future after announcing in late January that it had failed to make a payment of \$293 million in derivatives contracts. The company also served notice that it did not intend to make scheduled interest payments on three bonds, leaving it potentially open to claims of \$1.2 billion by investors.

Although Vitro's biggest shareholder, the Sada family, is trying to restructure its debt in a transparent way, that is not enough for one counterparty. On February 5, Vitro announced that Credit Suisse had filed a lawsuit in New York against one of the company's subsidiaries demanding payment of \$85 million after the company's default on its derivatives contracts. In a rather cryptic response Vitro said on its website that it was "analysing alternatives".

Those alternatives are unclear, as is the outcome for bondholders of Vitro's debt restructuring. Fitch Ratings reckons the recovery rate could be anything between 31 cents on the dollar to 50 cents. Vitro's debt is trading at about 20 cents.

Conservative forecasts

Vitro is just one of a growing number of emerging market corporates struggling to meet debt repayments. With no signs of the global financial and economic crisis abating, defaults are inevitable.

JPMorgan's Corporate Emerging Markets Bond Index implies a default rate of 8% for this year and the Merrill Lynch High Yield Emerging Market Corporate Bond Index implies a default rate of 25%. In contrast, S&P predicts a 9.6% default rate for global speculative-grade corporate bonds.

If the forecasts prove to be accurate the situation will be uglier for corporates than during the last crisis to hit the emerging markets. Then, following Argentina's default in 2002 and concerns about Brazil's political future, the peak default rate for high-yield emerging markets credits was only 11%.

As for recovery rates, it's impossible to make precise predictions but the market assumption for the Cembi is 20 cents on the dollar, while for corporate high-yield emerging market debt it is 10 cents. In comparison, in 2002 the recovery rate for the latter was 40 cents.

Underlying the implied default rates are refinancing risks for emerging market corporates. This year, refinancing needs in the public markets amount to about \$211 billion, according to JPMorgan. Bond amortizations account for \$55 billion of that total, with the biggest redemptions in Russia, Korea, Mexico and UAE.

With the international capital markets closed to all but top-rated sovereigns, such as Mexico, and government-related entities, such as Pemex, there is bound to be a big funding gap – about \$20 billion, estimate analysts at RBC Capital Markets. Some companies will be able to tap their banks (depending on the strength of the banks' balance sheets), borrow in domestic capital markets, issue equity, or gain state support to cover the gap. None of these options, however, is foolproof, so many corporates will have little alternative than to seek a debt restructuring, especially given deteriorating cashflows. Corporates that are in countries where the sovereign is also facing financial constraints, such as Ukraine, will be under additional pressure.

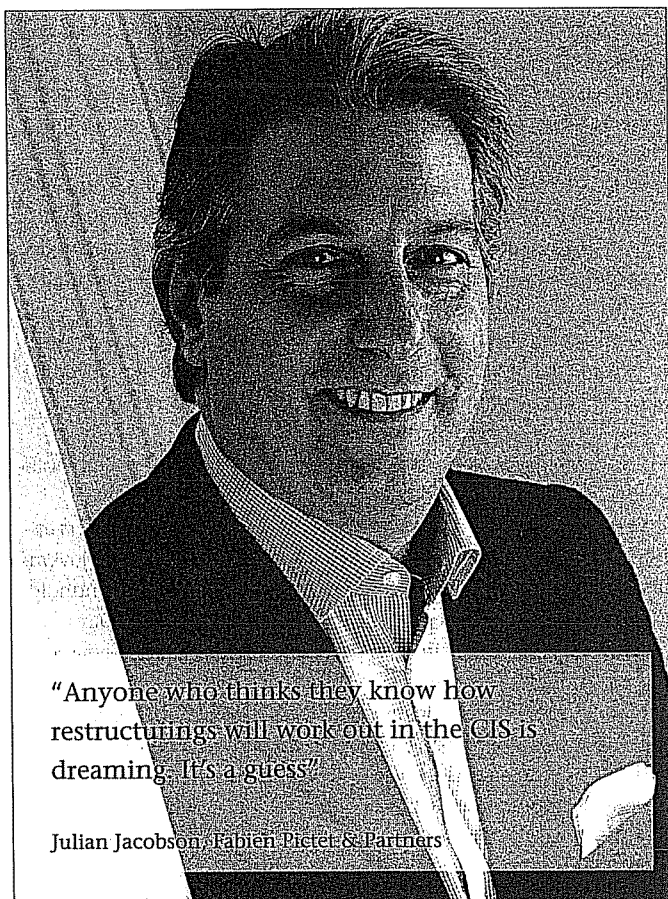
Still, some investors believe the implied default rates are too pessimistic. "To assume that one-quarter of all emerging market high-yield corporates will default with a 10 cents recovery rate is very conservative," says Polina Kurdyavko, an emerging markets fund manager at BlueBay Asset Management. "I just don't see this happening. This year we will see defaults but only from companies that have no options for refinancing, such as levered high-yield companies."

Julian Jacobson, an emerging markets fixed-income portfolio manager at Fabien Pictet & Partners, agrees that the implied default rate is too high. "To understand why," he says, "one has to realize that credit spreads are the result of two main components: default probability and liquidity risk."

"When the credit crunch finally hit, both risks started feeding off each other, with the results we are all too familiar with: spreads exploded, while a massive liquidity premium helped push yields on US Treasury bills and bonds to historical lows."

One of the reasons why spreads widened initially in the emerging markets was that investors were selling some of their holdings in order to generate liquidity to support other parts of their portfolio. "That's why some of the implied default rates may not be a great indicator," says Ahmet Bekce, head of CEEMEA debt capital markets at Citi. "However, as the global economic environment continues to deteriorate and commodity prices remain depressed, there will be real differentiation in financial performance of various credits. This would result in more convergence of secondary credit spreads and implied recovery values and default rates."

The severity of the downturn is leading some people to adopt a pessimistic outlook. "There is an argument that emerging markets will suffer the most and that it could get quite ugly for emerging markets corporates over the next 12 to 18 months," says Stephen Phillips, a financial restructuring lawyer and partner at White & Case. "Given



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Julian Jacobson, Rabien Pictet & Partners

the extreme bad news of 2008, it is surprising how low the default rate was in the US and Europe. Corporate defaults began to take off in late 2008/early 2009 in the US and western Europe – the same trend is now being seen in emerging markets. The refinancing risk will be the key driver of defaults – particularly for regions where borrowing on short-term maturities was highly prevalent, such as eastern Europe."

He adds: "There is a time lag between deterioration in the US and western Europe that perhaps explains why many commentators came up with the decoupling theory. My concern is that things could get really bad, especially if the debt capital markets remain closed."

Shared traits

So far actual default rates are low. Last year, the default rate as a percentage of the total emerging markets corporate bond stock was 0.3% (\$1.56 billion of debt) according to JPMorgan.

Defaults, though, are beginning to step up. This is most apparent in Latin America, where, apart from Vitro, Mexican paper maker Durango and retailer Comerc, and Brazilian beef company Arantes have all defaulted in recent months. Elsewhere, eyes are especially trained on Russia, Kazakhstan, Ukraine, China and Indonesia, where a number of high-yield credits could find themselves in trouble this year.

The highest default ratios this year, according to JPMorgan, will be in Asia at 4.9% of the Asia high-yield corporate bond debt stock, and 1.1% of the Asia total. In Latin America, the US bank estimates a default rate of 1.5% of the region's high-yield corporate bond market – 0.6% of the total Latin America corporate bond market. In central and eastern Europe, Middle East and Africa, its prediction is for 2.9%

of the region's high-yield debt stock to default and 1.1% of the total.

In Russia, so far the majority of defaults are in the local rouble market, where 76 issuers are either in outright default, technical default, have not executed a put option, or are in arrears on a put option, according to Cbonds, an information service for the CIS markets.

There are anecdotal indications too of corporates failing to fulfil obligations on synthetic securities such as credit-linked notes – essentially private Eurobonds – issued by second- and third-tier credits.

"In the CLN market the lower down the credit ratings you go, the less likely you are to see orderly repayments," says Igor Hordiyevych, managing director, CEEMEA debt capital markets at UBS. "Some issues will either have to be restructured or they will go into default."

Some analysts believe it is also only a matter of time before there are defaults on publicly traded Eurobonds issued by Russian corporates. "In 1998 [when Russia defaulted on its local T-bill debt] defaults in the rouble market preceded defaults in the Eurobond market," says Philip Poole, global head of emerging markets research at HSBC. "I think we'll see something similar again."

Emerging market corporates most vulnerable to default will share traits, says Bekce. "They are highly levered; have relied extensively on external funding sources; have large maturing debts this year and next; and are in very cyclical industries and so have lost the ability to generate cash – the crisis will have hit them hard at an operational level."

Into the unknown

Although emerging markets have suffered numerous crises in the past, the nature of this one presents different challenges for borrowers, investors and governments.

One difference between now and even 10 years ago is that debt issuance out of the emerging markets is much more widespread. Regular international bond issuance by Russian, Kazakh and Ukrainian corporates has only become apparent in this decade.

Another difference is the range of securities that have become available to corporate treasurers. Although, as a general rule, leverage levels in the emerging markets were much lower than in the US and Europe and there was much less use of structured credit, capital structures have become more complex. "When you think back to the TMT bubble in 1999 many corporates had only a senior debt tranche with a layer of subordinated debt underneath," says Marisa Drew, EMEA co-head of the global markets solutions group at Credit Suisse. "Now corporates have first-lien financing, second-lien, high-yield bonds, PIK notes – even in many emerging market structures."

Then there is the issue that the investor base has broadened to include high-yield money managers, emerging market specialists, hedge funds, retail accounts and even equity funds. So previously straightforward procedures such as the formation of credit committees and gaining the consent of the majority of bondholders to agree to a particular course of action are now a bigger challenge, as is dealing with the diverse range of creditors for the corporates and their advisers.

All of these issues mean there will be plenty of uncertainty as to how a debt restructuring process might evolve. The guiding hand of history provides only a limited understanding, especially in central and eastern Europe where JPMorgan reckons up to \$2.5 billion of debt will be defaulted upon this year – in absolute terms the most in any emerging region. "Anyone who thinks they know how restructurings will work out in the CIS is dreaming," says Jacobson. "It's a guess."

HSBC's Poole says: "All restructuring phases are different. When I was at Barclays, I worked on the Brady debt issues in the early 1990s. That was a straightforward process in that the holders of the debt were all banks. Then the game changed as the investor base became more diverse. So when I was at ING and we were advising Ukraine in 2000 that was the first restructuring of sovereign bonds to include retail investors. Now it's different again."

Political will

One of the great unknowns of this crisis is how governments will react. "Sometimes restructurings will not necessarily be rational purely from an economic recovery point of view because of political sensitivities," says Drew. "A lot of governments want to be part of the restructuring of companies critical to their economies and are prepared to fund the bailouts. Therefore they will work with the adviser to reach a solution that they are happy with. That creates its own complications."

As in the US and Europe, governments throughout the emerging markets are drawing up support packages to prop up their most important companies. Take Russia, which accounts for 40% of total central and eastern Europe, Middle East and Africa corporate issuance. "Companies' ability to withstand a deep domestic downturn and avoid default will largely depend on where the government chooses to allocate state assistance," says a JPMorgan report from December.

At the end of last year the Russian government announced a list of 295 companies that it says are vital to the functioning of the economy – because they are a big employer or are based in a strategic industry or have close ties to the banking system or political elite. Companies on the list include Gazprom, Lukoil and Rosneft.

This list is supposed to bring clarity to the market but investors should beware the story of AirUnion. The airline, which is one of the supposedly too-important-to-fail 295 companies, defaulted in November after failing to make a coupon payment on a Rb1.5 billion (\$41 million) four-year bond issued in 2005 and eventually filed for bankruptcy. In response, the government decided to create a new carrier from the relics of the failed airline, with the state guaranteeing AirUnion's trade payables but not its bonds. "The company's operations were prioritized over paying bondholders," says Eduardo Suarez, a senior emerging markets analyst at RBC Capital Markets.

REFINANCING RISKS IN EMERGING MARKETS
ESTIMATED EM CORPORATE BOND AND SYNDICATED LOAN MATURITY TOTALS FOR 2009 BY COUNTRY (\$ MILLION)

Country	Loans	Bonds	2009 total
Russia	27,513	12,361	39,874
UAE	15,263	2,823	18,086
Mexico	12,199	3,249	15,448
Turkey	14,382	175	14,557
Korea	4,336	9,380	13,716
India	5,770	2,335	8,125
Brazil	6,480	1,465	7,945
Hong Kong	4,487	2,700	7,187
China	5,181	980	6,161
Kazakhstan	2,722	2,549	5,271
Total	155,620	55,383	211,003

Source: JPMorgan

Even government guarantees can produce uncertainty and twists, especially if the sovereign itself is under stress. In 2007, Ukraine's state road authority, Ukravtodor, took a \$930 million, 10-year loan from Morgan Stanley. One of the conditions of the loan was that if the sovereign suffered two downgrades in a year that could trigger a prepayment clause. That's exactly what happened. As the financial crisis took hold in the CIS last year, S&P downgraded Ukraine from BB- to B+ in June and then to B in October. The problem for the government, though, was that the prepayment clause could potentially imply cross-defaults on the sovereign itself.

The issue has been settled with Credit Suisse signing an agreement to become the lender of record for \$465 million of the loan. Credit Suisse declines to comment. The other half of the loan has been repaid early to Morgan Stanley.

Another consideration in a restructuring is the majority shareholder's motivation and willingness to sit down with investors.

One of the positive aspects of Vitro's default is that the owners appear to be handling proceedings in a responsible manner. In November the company hired Blackstone as an adviser, who told bondholders to prepare for debt negotiation talks on January 27, five days before Vitro's scheduled interest payment of \$44.8 million, which it subsequently defaulted on.

Throughout the past few months Vitro's statements have stressed that the company is seeking a solution that is in the mutual interest of itself and its creditors. How the debt restructuring proceeds remains to be seen, although some bondholders might demand equity to give them control. That will not be easy. The Sada family directly owns 24.9% of the company, although its influence is more pervasive through voting rights. "There is a concern that the equity holders will fight to keep control of the company at the expense of fair treatment for bondholders," says RBC's Suarez.

Legal framework

Arguably the biggest test for recovery assumptions is the rule of law and transparency of the judicial system. A weak legal environment "is likely to keep pressure on bond prices", according to JPMorgan, "and deter more traditional distressed debt investors participating even at current severely discounted levels; on average, 32% of the emerging markets corporate universe is trading at a cash price below 70% and 11% below 50%."

As Phillips at White & Case says: "Why would a fund want to buy distressed assets in the Ukrainian secondary market, where the environment is unpredictable, when performing European or US senior secured debt is trading in the 70s?"

Taking the legal route is often the last resort for bondholders. "The destruction of value is so great through a litigation and liquidation process that most participants will try to avoid it," says Drew.

During the Asia financial crisis in 1997, as Kurdyavko points out, for investors that owned senior unsecured debt and participated in voluntary restructurings the recovery rate was significantly above 25 cents on the dollar. If voluntary debt restructuring was not agreed – for those that chose to follow the legal route – in some cases the recovery on secured paper was less than 25 cents.

One of the problems of this crisis is that many emerging markets' legal systems are weak or untested. For example, although in Mexico the law that regulates insolvency proceedings for corporates, Ley de



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Marisa Drew, Credit Suisse

Concurso Mercantile, dates back to May 2000 no one can be sure the courts will understand and process complicated workouts with fairness and predictability. Creditors have concerns too as to how the *concurso mercantile* procedure will view the issue of controlling families' and shareholders' influence over a company and its assets.

The jurisdiction that analysts have the most concerns about is Russia, again largely because so much is untested. Michael Pugh, a capital markets partner at Lovells in Moscow, says that international bondholders can either seek to try to get Russian courts to enforce foreign arbitral awards against Russian debtors in default or take proceedings through the Russian courts directly.

The latter, he adds, merits serious consideration, partly because it is less time-consuming and expensive. "Creditors can get a decision much more quickly – say four to six months as opposed to eight months to a year," says Pugh.

Then there's the issue that the enforcement of foreign arbitral awards in Russia against Russian debtors is not always straightforward. "The Russian courts are entitled not to enforce awards that conflict with Russian public policy," adds Pugh. "The term 'Russian public policy' is a potentially wide bracket and it is unclear how Russian

courts will use it in the context of the financial crisis."

The use of more qualified and knowledgeable enforcement agents and trustees is one step bondholders can take to protect themselves better in future, although their usefulness can be limited. "Trustees can only do so much," says Jacobson. "They normally need to be spurred into action by bondholders and before they move they will require indemnity and a cast-iron legal opinion. I wouldn't put too much weight on trustees unless they are holders of some collateral."

Another step could be to insist on financial covenant packages for Eurobonds that are more common in loan documentation. That could give bondholders the same rights as bank creditors.

Whether or not that happens, tighter covenants for bond issues are inevitable, which should provide a degree of comfort to investors. "I really do believe that covenants are an early warning signal and allow investors to at least prepare themselves," says Credit Suisse's Drew.

Jacobson is again sceptical as to how useful tighter covenants are. "Unless you have collateral that you can access quickly, covenants do not protect you that much in emerging markets," he says.

In any case, he adds, often borrowers will ask for waivers from foreign investors that they will have little option but to consent to as triggering a covenant can lead to a much worse outcome.

In the CIS, for example, Russian mining group Polyus Gold's takeover of Kazakhgold is on track only after bondholders of the Kazakh company's \$200 million 9.375% notes due 2013 agreed to a control-clause waiver. After a vote was taken in early February, bondholders agreed to Polyus Group's offer of a five-point sweetener in exchange for the waiver. The clause required the bond to be redeemed at 101.

An earlier report in the *Financial Times* said that if Polyus Gold failed in its bid to buy its rival, there was a risk that Kazakhgold could default on a May coupon payment on its \$200 million bond and that even its status as a going concern could be put in doubt. "It's a no-win situation for bondholders," says Jacobson.


The Kazakhgold covenants were triggered by a potential change in ownership. For the most part breaches of covenant packages in the CIS bond market will not become evident for a while, says UBS's Hordiyevych. "The earliest breaches in the bond market won't be seen until the year-end numbers are produced in March and April."

What else can bondholders do? An Emerging Markets Traders' Association newsletter suggests investors can buy bonds with amortizing repayment structures instead of bullet ones and seek additional security, be that greater recourse to collateral or guarantees.

Another idea could be to own the same type of debt as the most powerful creditor, who is sometimes a leading shareholder too.

More than anything, though, investors need to undertake better due diligence. "Know your borrower, know your security, know your prospectus," says Kurdyavko.

"Bondholders need to look at the security package very carefully and really get to know the borrower's business better, especially how it would perform when it's under stress," says Pugh.

"So much financing was made on the assumption that there would be plenty of liquidity in the market to allow borrowers to refinance," he adds. "This crisis has knocked over that assumption." 



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