Outlook for EM Distressed Debt

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Despite the insipid recovery in the global economy, largely fueled by policies that promote additional debt and inflation, distressed debt investors have yet to benefit from the logical culmination of such an untenable accumulation of debt. Up to now, policymakers have successfully postponed the payback, but we believe that they are running out of options. Although the Fed has announced a continuation of its zero interest rate policy, there are no more QE-type silver bullets, and fiscal austerity measures are likely to be highly de-stimulative. With the political pressures on banks – particularly in Europe – to improve capital ratios, the deleveraging process has just started and is likely to affect the global economy, and particularly emerging markets, for several years. Further, pressures in the global capital markets will likely limit the appetite for new high-yield issuance, exacerbating the pressures. Similar to 2008, difficulties in the financial markets for EM instruments are likely to be caused by exogenous factors emanating from the developed world.

Gramercy estimates that there could be $156 billion in emerging markets debt defaults over the next several years. The estimated market value of such face value would be $54 billion assuming an average price of 35 cents on the dollar. We expect a large concentration of these defaults to occur in Eastern Europe, given their large exposure to European banks, higher share of high-yield issuers, and heavier amortization schedule. This estimate is based on our assumption that 20 percent of the high-yield debt outstanding and 5 percent of high-yield sovereign bonds will default by 2014. These rates are relatively in line with the historical trends and assume a minor peak default rate of 6 percent in 2012 and a major peak default rate of 14 percent in 2014. We also include a few defaults by fallen angels (investment grade downgrades) and high-yield sovereign issuers. If we include stressed performing credits, which we estimate peaking at $385.70 million, we believe that the EM distressed market could reach $541.37 billion over the next three years.

Basis of our Estimates

Our default projections are based on the estimated size of the EM external debt market, which reached $3.79 trillion as of December 2011, according to data by ING (see Figure 1). About 78 percent of the EM debt market is comprised of corporate debt, a segment that has grown rapidly during the past five years (see Figure 2). ING estimates that there were $289 billion in corporate high-yield bonds (or 33 percent of total corporate bonds), and $336 billion in high-yield sovereign debt as of December 2011. In addition, ING estimates that about 7.4 percent of all corporate loans, or $154 billion, belong to issuers below investment grade. In sum, Gramercy estimates that there is $779 billion in high-yield debt outstanding as of December 2011, or 20.5 percent of the total.

Figure 1: EM External Debt Outstanding

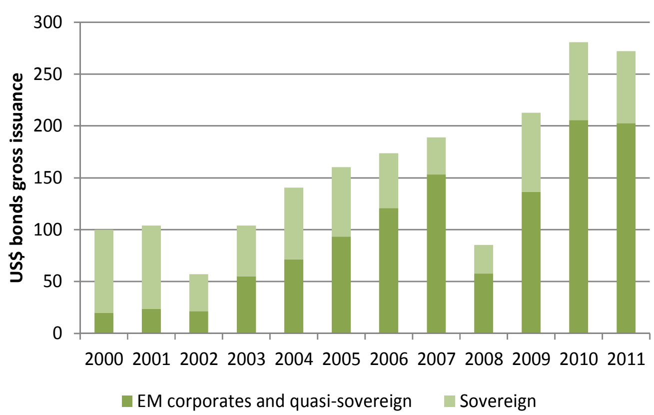
In US$ billion as of Dec 2011

Sovereign/Quasi-sovereigns	**834**
Investment Grade Bonds	414
High Yield Bonds	336
Loans	84
Corporates	**2,956**
Investment Grade Bonds	575
Investment Grade Loans	1,938
High Yield Bonds	289
High Yield Loans	154
Total EM debt	**3,790**

Source: ING, Gramercy

Notes: Not-rated issuers included in high-yield

Figure 2: EM External Bonds Gross Issuance



Source: JPMorgan

To estimate the amount of debt that is likely to default in the next three years, we use historical default trends. According to data compiled by ING since 1970, minor cycle peaks in default rates have occurred every 2.8 years and major peak cycles have occurred every 13.06 years, both using the median (see Figure 3). These high-yield default rates peaked at a median of 5.12 percent in minor cycles and 11.53 percent in major cycles. It is important to highlight that the major cycles continue to get shorter and the peak default rates continue to rise. An extrapolation of the historical trend suggests that the next minor peak in defaults should occur in 2012 and the next major peak in 2014.

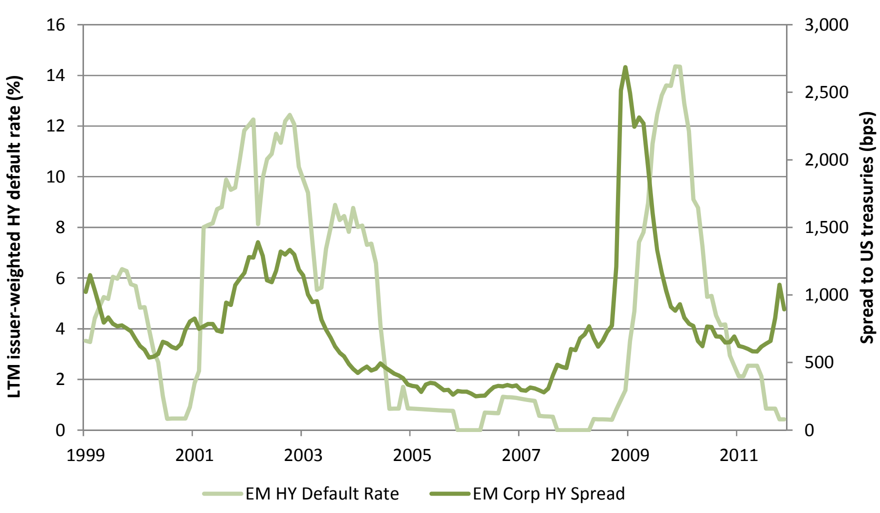
Figure 3: Timing Between Credit Booms and Busts (1970-Present)

Major cycles	HY default rate	period (years)
9/30/1970	10.90	
9/30/1991	12.15	21.00
6/28/2002	10.55	10.74
11/30/2009	14.50	7.43
Median	**11.53**	**10.74**
Trend	**14.27**	**4.20**
Mini cycles	**HY default rate**	**period (years)**
9/30/1970	10.90	
11/30/1972	2.63	2.17
12/29/1978	2.65	6.08
2/27/1981	1.60	2.17
10/31/1983	4.37	2.67
8/29/1986	6.19	2.83
6/30/1988	5.12	1.84
9/30/1991	12.15	3.25
5/31/1996	3.25	4.67
2/29/2000	5.67	3.75
6/28/2002	10.55	2.33
11/30/2009	14.50	7.43
Median	**5.12**	**2.83**
Trend	**10.01**	**4.28**

Source: ING

We expect to see a number of defaults throughout this year, and there have already been two major defaults in emerging markets in January 2012: BTA Bank of Kazakhstan and Berlian Lajou Tanker of Indonesia. Two of the most robust predictors of high-yield defaults – bond yields and rating downgrades – indicate that bond defaults will increase in the coming months. Sudden rises in bonds yields, such as the 400 bps increase during the 3Q11, have historically anticipated default rates by about 12 months, as shown in Figure 4. Secondly, net credit rating changes deteriorated sharply during the past two quarters, as shown in Figure 5. A sustained trend of negative net rating changes typically anticipates defaults by three to six months.

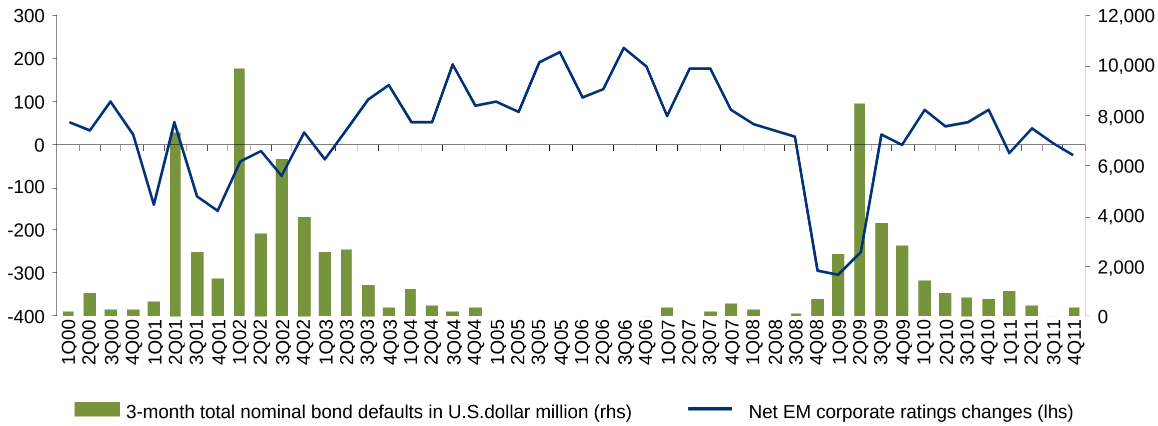
Figure 4: Distressed Debt as Predictor of Defaults



Source: Bank of America

Furthermore, negative rating outlooks on EM corporates outweigh positive ones by two percentage points and stand at 12 percent of total bonds as of December 14, 2011, according to Deutsche Bank. Likewise, sell-side research analysts expect high-yield default rates to increase in 2012. For example, JPMorgan expects the EM high-yield default rate to rise to 5.8 percent from 0.5 percent in 2011, with most defaults expected from Chinese issuers in shipping, industrial, and property sectors and in the CEEMEA region.

Figure 5: Net Credit Ratings Changes and Nominal Default Levels



Source: Emerging Markets Biweekly Report, November 2011, ING

While it is challenging to anticipate from where these defaults will occur via a top-down approach, analyzing the quality of the issuers and amount of debt maturities by region does provide some insights. The obvious candidate is Latin America, which has the largest amount of high-yield bonds outstanding, with $103 billion as of December 2011. A second candidate would be Eastern Europe, which has the highest share of high yield bonds with 41 percent of the total corporate bond market, or $73.51 billion. Despite having the largest corporate bond market, Asia does not figure as the leading candidate given its large proportion of investment grade issuers (See Figure 2). In the corporate loan market, Eastern Europe is also an obvious candidate given its relatively large size ($419 billion) and large proportion of high-yield issuers (17 percent).

Figure 6: External Corporate Bonds by Geography

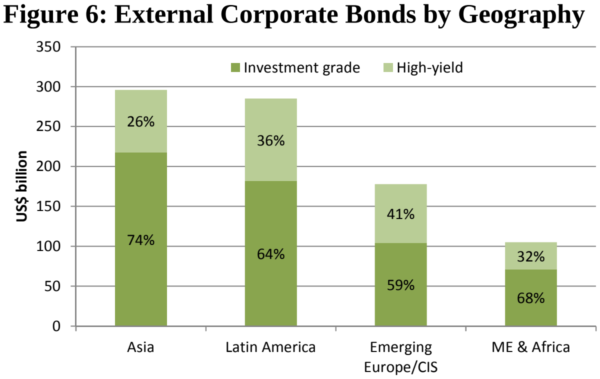
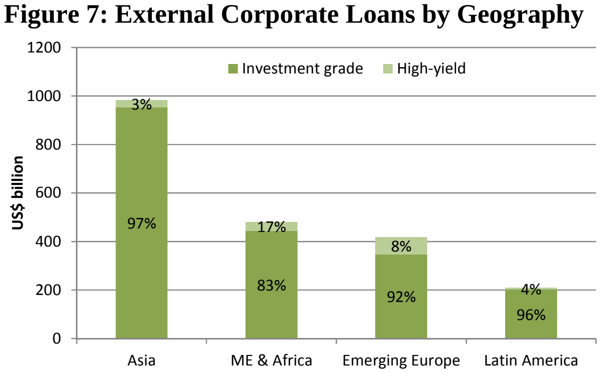


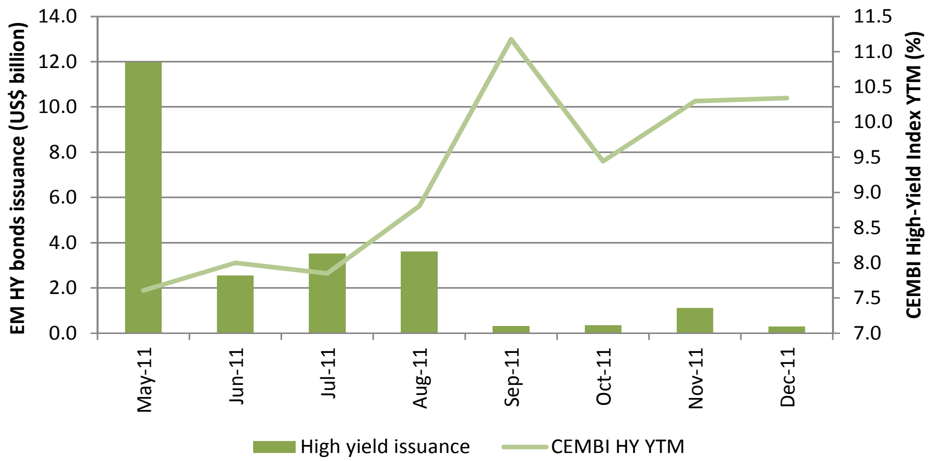
Figure 7: External Corporate Loans by Geography



Source: JPMorgan, ING

A second approach is to analyze the regional debt maturity schedules. Although debt maturities are not the main trigger of defaults, they do play an important role in periods where refinancing options are scarce, which is the underpinning of our thesis over the next several years. Figure 8 shows how the issuance of high-yield bonds halted during the 2H11 as yields rose, putting issuers with maturities at risk.

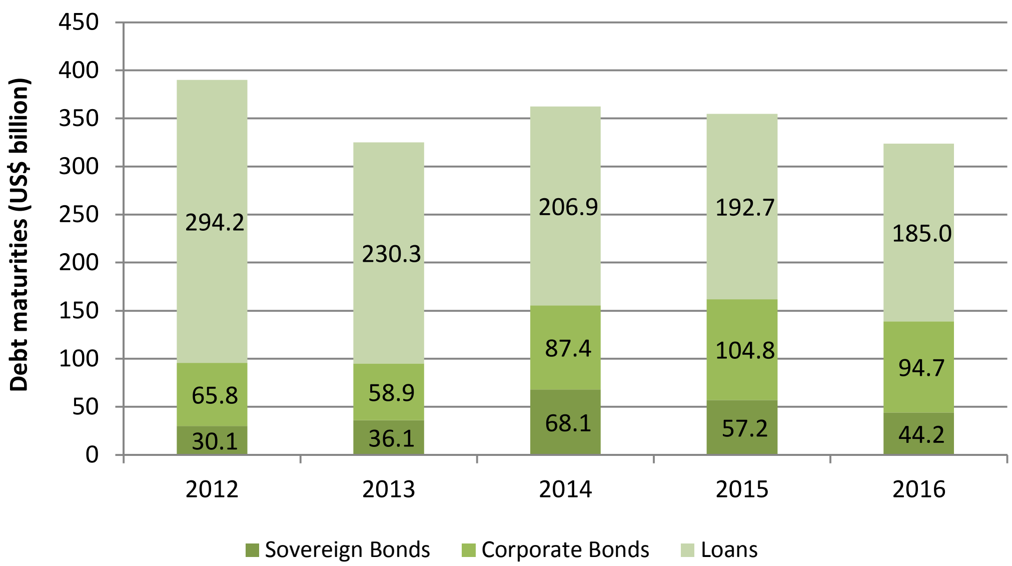
Figure 8: EM High-Yield Issuance Halted During 2H11



Source: JPMorgan

ING estimates that there are $1.75 trillion in EM external debt maturities in the coming five years, or 48 percent of the total debt stock. The EM aggregate debt maturity schedule does not have a particular heavy year, but corporate bond maturities do pick up significantly in 2014 and 2015, as shown in Figure 9. The region that faces the most challenging schedule is Eastern Europe, with $55.1 billion in corporate bonds and $28.9 billion in high-yield loans in 2012-2014. Latin America does not appear to have heavy refinancing needs in the next three years given that it has only $25.2 billion in corporate bonds and $2.6 billion in high-yield loans.

Figure 9: EM External Debt Maturities 2012-2016



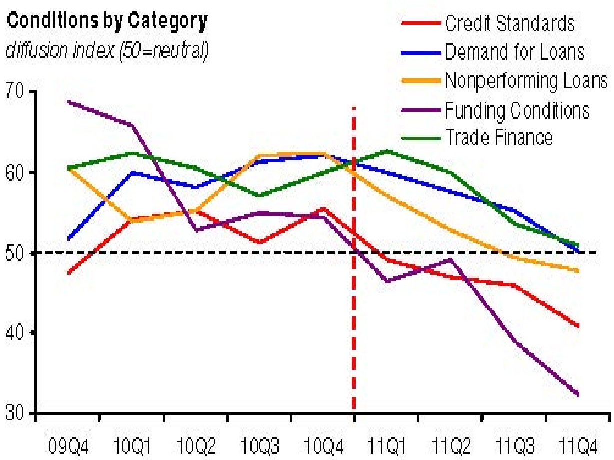
Source: ING

Given our thesis that a key trigger of debt defaults will arise from Western European banks shrinking their balance sheets, we also identify those regions most exposed to such contraction. Again, Eastern Europe is the obvious candidate given the large presence of European banks. Eastern Europe, Central Asia, and Africa represented 46.24 percent of the total EM assets held by European banks. This amount reached $1.4 trillion or 11.6 percent of their aggregate balance sheets as of September 2011, according to ING. European banks provided over 80 percent of the lending in most of Eastern Europe, particularly the Baltics and Balkans.

Latest bank flows and lending indicators suggest that the pull-back from European banks has already started. Last year, European banks cut their claims in Emerging Asia on an ultimate risk basis by 2 percent during the third quarter of 2011, the first drop since the fourth quarter of 2008, according to BIS data. While Emerging Asia is the region with the lowest direct exposure to European banks, it is the most vulnerable to sudden capital withdrawals through the banking system, given that 63 percent of all their international claims had a remaining maturity of less than one year. Latin America and Eastern Europe, the regions with the largest European bank penetration, reported a lower but not insignificant amount of short-term claims, ranging from 40 to 60 percent of total claims.

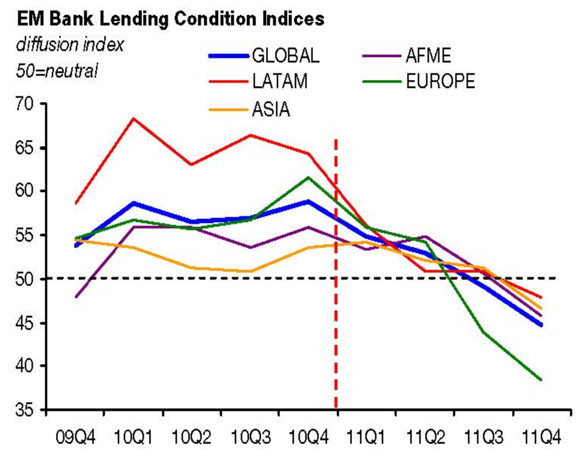
The latest IIF's EM Bank Lending Conditions survey also showed a gloomier outlook than all previous surveys with global banking conditions weakening substantially over the past three months in all major regions. The key factor driving this index lower continues to be tight funding conditions, reporting its weakest level to date (see Figure 10). The situation has deteriorated the most in Eastern Europe, largely due to the rapid deleveraging of European banks. IIF commented that all indices for Eastern Europe, especially the credit standards index, declined to worrisome levels (see Figure 11).

Figure 10: Global EM Lending Conditions



Source: IIF

Figure 11: Regional EM Lending Conditions

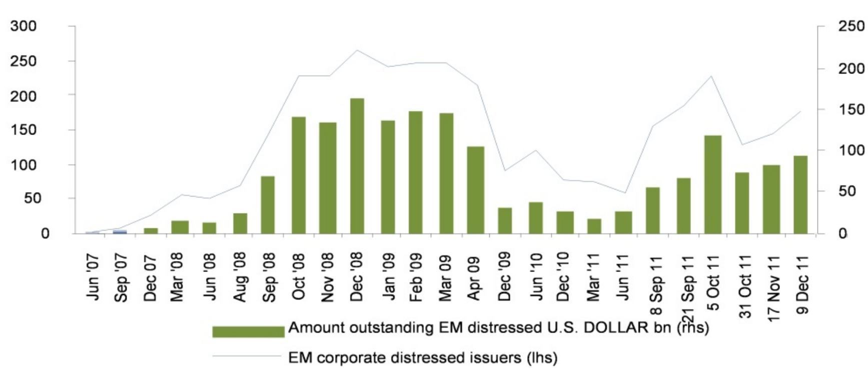


Source IIF

Calculation of Emerging Markets Distressed Debt Over the Next Three Years

Within this context, Gramercy expects that 20 percent of high yield corporate bonds and loans outstanding and five percent of high-yield sovereign bonds will default by 2014. Together with a small amount of investment grade corporate debt and high-yield sovereign debt defaulting, these rates result in $155.67 billion in debt defaults or $54.49 billion using an average price of 35 cents on the dollar. These magnitudes are in line with the historical trends and assume a minor peak default rate of six percent in 2012 and a major peak default rate of 14 percent in 2014, both in the corporate debt market.

Figure 12: Fluctuating Size of EM Distressed Debt Market



Source: Emerging Markets Biweekly Report, November 2011, ING

Furthermore, Gramercy expects 45 percent of all EM corporate high-yield bonds, 20 percent of EM corporate high-yield loans, 21 percent of all sovereign high-yield bonds, and a small percentage of investment grade corporate bonds to trade at stressed levels (1,000 bps over treasuries) accompanying these peak episodes of distress (see Figure 12). Using these rates, the amount of stressed debt would reach $385.70 billion with a market value of $289.28 billion using an average price of 75 cents on the dollar. These magnitudes are also in line with recent episodes of market distress, as shown in Figure 12. ING estimates that about 30 percent or $83 billion of high-yield bonds traded at stressed levels in December 2011, 83 percent or $150 billion of high-yield bonds in December 2008 and 43 percent or $120 billion in October 2011. As previously indicated, periods of market distress tend to occur more frequently and typically anticipate the waves of defaults.

Accordingly, we believe that the EM distressed market, including both defaulted and stressed performing issues, could reach $541.37 billion over the next three years (see Figure 13).

Figure 13: Projected EM Distressed Debt Market 2012-2014

In US$ billion (Amount outstanding as of Dec. 2011)		Default Rate	Amount	Peak Stressed Rate	Amount
Sovereign/Quasi-sovereigns	**834**				
Investment Grade Bonds	414	0.00%	-	0.00%	-
High Yield Bonds	336	5.00%	16.79	21.00%	70.51
Loans	84	0.00%	-	0.00%	-
Corporates	**2,956**				
Investment Grade Bonds	575	2.00%	11.50	10.00%	57.49
Investment Grade Loans	1,938	2.00%	38.77	5.00%	96.92
High Yield Bonds	289	20.00%	57.73	45.00%	129.89
High Yield Loans	154	20.00%	30.89	20.00%	30.89
Total EM debt	**3,790**		**155.67**		**385.70**

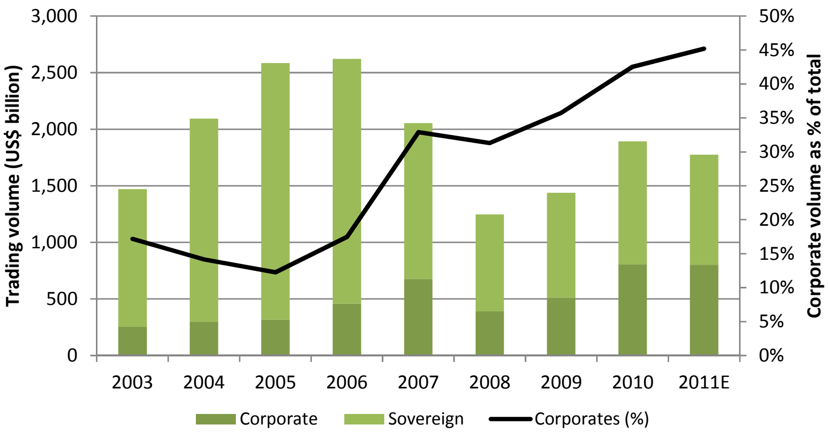
Source: ING, Gramercy

Notes: Excludes local currency debt, not-rated issuers included in high-yield

Trading Liquidity

We believe that the EM secondary market is robust enough to support an active trading strategy for distressed debt. According to the Emerging Markets Trade Association (EMTA), sovereign and corporate bond trading volumes reached $1.4 trillion during the first nine months of 2011 or an average daily volume of $7.21 billion. Trading volumes in emerging markets debt have not returned to the peak level attained in 2006, although they have sharply rebounded off the lows of 2008 (see Figure 14). However, it is important to recognize the structural changes in the EM debt market, where many of the U.S. dollar sovereign debt issues have been refinanced with local currency instruments. Looking deeper, the trading turnover for all corporate bonds has doubled since 2005-06, and surpassed the previous peak which occurred in 2007. We also note that these amounts do not consider private debt and loan instruments that are not tracked in the emerging markets debt statistics.

Figure 14: EM bonds trading volume



Source: EMTA

Note that our estimates of market size do not assume any investments in the debt of issuers from the periphery of the Eurozone. Debt from "submerging Europe" already shares many of the attributes traditionally ascribed to emerging markets, and the poor -- and worsening -- credit metrics suggest that the sovereign risk profile will put such debt firmly into the emerging markets category. Overall, we believe that our projections are based on historical levels and can materially vary depending on how the state of the global financial markets unfolds. The deepening of the European banking crisis, developed sovereign debt defaults, and a severe Chinese recession all have the potential to increase the distressed debt projections considerably.

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