

ARGENTINA 2020: THE PATH TO A SUCCESSFUL SOVEREIGN DEBT RESOLUTION

Having spent the better part of the past 30 years focused on sovereign debt resolutions, we have identified five Principles that have historically provided a successful framework and could do the same for Argentina in 2020.

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Gramercy (and its seasoned team) has a long history of participating in and catalyzing successful sovereign debt resolutions in emerging markets, including in Argentina, over the past 30-plus years. As such, we have been asked by many investors to provide our perspective on the challenges Argentina faces today vis-à-vis resolution of its current debt obligations.

The three major questions related to sovereign debt restructurings are centered on: 1) the objectives 2) the process and 3) the pitfalls.

We address these issues by focusing on principles to guide participant behavior, the parties involved and the optimal processes for success. Also, given the tendency among some market participants to refer back to Argentina's last (and painful) restructuring experience, we focus on the key distinctions between the current set of facts and circumstances and those related to its 2001 debt stock. In short, we believe that only by focusing on and solving the material challenges through a consensual process that fairly shares the burden between all interested parties can those involved catalyze an ideal solution that benefits all, starting with the Argentine people: a virtuous shock.

A virtuous shock does more than provide a pathway to a favorable and sustainable outcome for all. It also enables a recovery window which catalyzes economic growth, improves trust, and establishes credible hope for the longer-term. The opportunity and objective should be a secular change that not only addresses the current challenges but also underpins obtainable, sustainable, and inclusive economic growth for stakeholders, and in particular for the 45 million Argentines who have seen this movie before (and way too many times for much of the population).

Principles for successful debt solutions:

Having spent the better part of the past 30 years focused on sovereign debt resolutions, including nearly 20 years intimately engaged in Argentina, we have seen successful and unsuccessful attempts at identifying and solving sovereign debt challenges. From this experience we summarize five Principles that have historically provided a successful framework (followed by a positive outcome) and could do the same for Argentina in 2020. These include:

1. Determine the material challenge/problem
2. Solve for that problem
3. Do not try to solve problems that do not exist or that provide limited benefits when solved
4. Do not create new problems
5. Implement a solution (considering steps 1-4 above) in a timely and transparent fashion, while catalyzing a virtuous shock.

In order to instrument an effective debt restructuring, these Principles should be used as a strategic filter to guide the decision making process and the behavior of all parties involved.

Determine the material challenge/problem:

In order to solve a problem, one must determine the key issues to address. Much as when one treats an illness or injury, prior to medication, proper diagnosis and triage is warranted. We see this in Argentina, where we have already witnessed a myriad of potential “solutions” without seeing a concise reference to (and therefore not addressing) the material problem at hand.

Relying analytically on a proper Debt Sustainability Analysis (“DSA”), Argentina clearly has an urgent liquidity crisis. A cash flow analysis of the next 4 to 5 years clearly demonstrates that debt amortizations are coming due which simply cannot be refinanced in the capital markets as they mature. Once these liquidity issues are properly addressed, it becomes less clear that additional indebtedness related problems exist and therefore need to be addressed. A solvency issue does not dominate.

Solve for that problem:

Since liquidity is a current problem for Argentina, the best place to focus our collective efforts is on extending maturities and temporarily reducing or exploring alternative funding programs for cash flows that come due over the next 4 to 5 years. In essence, a need exists for a “recovery window” and the best way to do so is through a “menu approach” that recognizes the particular circumstances of different creditors:

- For commercial creditors, this would take the form of extending maturities that come due in the that window as well as assessing the need of cash flow relief mechanisms and/or new capital commitments to address coupon payments.
- For the IMF, this would mean waiving, modifying and extending the current IMF “Stand-By Arrangement,” thereby moving toward a longer-term program that builds a path back to the capital markets.
- Paris Club creditors would assist in the process by simply extending or refinancing their maturities that come due in the recovery window.

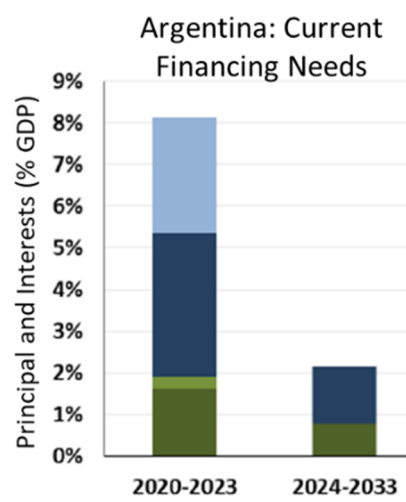
Consensual debt re-profiling has proven crucial in generating positive credit cycles, international reserve accumulation, the orderly restoration of corporate and provincial access to capital markets at increasingly-attractive rates to fund investments and public works programs. All of this should combine to provide sustainable and inclusive growth.

Do not try to solve problems that do not exist or create a limited benefit upon resolution:

Based upon historical precedent, one of the greatest risks/potential pitfalls facing the upcoming negotiations is the notion of trying to solve problems that either do not exist or whose resolution creates limited benefit from a risk/reward perspective. Examples of such mistakes can be found more broadly in EM restructurings as well as in Argentina’s past experience with debt restructurings.

One potential pitfall would be if the parties involved demanded concessions that were not well founded in a proper DSA, but instead driven by external factors. Another potential pitfall is in zero-sum, intra-creditor behavior. This could be between the IMF and bondholders, or amongst different classes or jurisdictions of bondholders.

The reality is that very little is gained in the Argentina DSA exercise through zero-sum behavior as opposed to cooperation and collaboration on the material challenges facing the country. Of course, a menu of options may be necessary to satisfy the various constituents, but any menu will need to be “full course” for participants, and based upon fairness and rational burden sharing amongst all the interested parties.

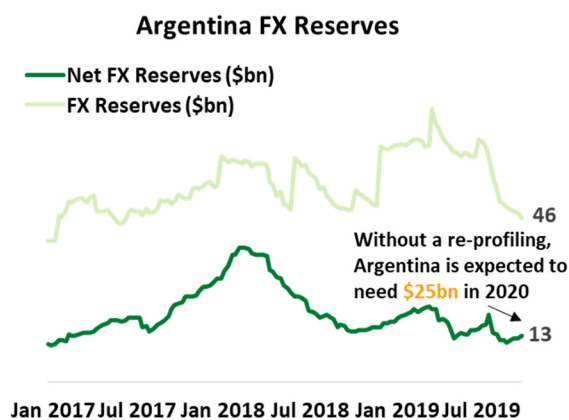


Source: MacroSynergy Partners, Gramercy. As of October 2019

Gramercy and other creditors we have spoken to are willing to take a patient capital approach to Argentina that gives the economy time for an inclusive recovery and proper growth to take hold. At the same time, trying to achieve certain debt sustainability by assessing debt dynamics today is like trying to time Usain Bolt with two broken legs. It's preferable for all to allow time to heal, and doing so catalyzes inclusive growth that is beneficial to all.

Do not create new problems:

The risk of focusing efforts on problems that do not necessarily exist, or solutions that provide limited benefit, is that of creating new problems.



Source: Bloomberg, Haver Analytics, Gramercy.
As of October 2019.

Through the lens of a proper DSA, pushing for unwarranted haircuts or solutions that treat local USD bond debt or “local law” different than “foreign law” provides limited/questionable benefits, and most certainly dramatically increases the implementation risk. Arbitrary positions/proposals that do not solve the known material challenges will most certainly present new challenges. The risk/reward of attempting to implement questionable solutions is simply not worth the risk.

It is clear that we need to avoid past actions, including premature initiation of unilateral offers, premature litigation by bondholders, and coercive mechanisms such as the Lock Law in 2005, which prohibited the government from paying “holdout creditors.” None of those actions solved any material challenges, and all unintentionally contributed to making matters worse. Unilateral approaches can disrupt markets, generate volatility and cripple economic growth; and they are avoidable.

It is our view that without Argentina quickly reaching a consensual deal with all creditors, there will be no access to capital markets, no credible IMF exit and limited Foreign Direct Investment.

Implement a solution (using 1-4 above) in a timely fashion and catalyze a virtuous shock:

Prior to the primary elections (PASO) in August, members of the Alberto Fernández inner circle were claiming that resolution of the debt challenges was a top priority and that time was of the essence in doing so. In fact, they stated that if Macri were to win the markets would provide a window of 6 months to credibly address the debt-related issues, but if Alberto Fernández were to win markets would only give him “one day” to credibly address the challenges. Given the violent market reaction to the PASO (that led to the almost certainty of an Alberto Fernández first round victory) that “one day” turned out to be a negative four months.

The bad news is that time is of the essence given maturities that are coming due. The good news is that since all the parties increasingly recognize this and are mostly aligned, as they should be in the case of Argentina 2020, resolutions can come rather quickly. We witnessed the speed and power of cooperation/collaboration in Mexico in 1995 and again in Korea in 1997.

By anchoring a resolution in the aforementioned Principles, Argentina, the IMF and its commercial creditors can ignite a virtuous shock that is a win-win-win, as opposed to a zero-sum game.

It's different this time.

Although there appear to be similarities between the facts and circumstances today and those of 2001, we are struck by the distinct differences and the opportunities embedded in those differences.

The first material difference is the size of the current obligations to the IMF vs those in 2001. Argentina owes the IMF five times more in 2020 than it did in 2001. As a result, unlike 2003, the agreement between Argentina and the IMF will have to rely upon future access to the capital markets.



The obligations to the IMF cannot credibly be paid down without the ability to refinance those obligations in the capital markets. At the same time, Argentina aspires to anchor the economy on a stable currency, growth and FDI (Vaca Muerta) in particular. Access to the capital markets cannot be achieved by a sequential Senior / Junior creditor approach that thereafter

As of December 17, 2019. Sovereign yields as reflected in the JPMorgan EMBIG Argentina Sub-Index. Source: Bloomberg, JPMorgan.

unilaterally imposes conditions on commercial creditors. Unlike 2003, this time it takes three to tango from day one: Argentina, its multilateral and commercial creditors working simultaneously to create a mutually beneficial outcome as opposed to the IMF striking a deal with Argentina that leaves the country and its other creditors worse off.

Another big difference this time is the lack of incentive (thus far) and new mechanisms to avoid a material holdout issue. If Argentina runs a consensual process with its creditors, then Collective Action Clauses (“CACs”) in the bond indentures should incentivize the behavior and outcome they were designed to achieve. Equally important, the most material holdout challenges were catalyzed by two bond contracts that had unintended floating rate coupons that made the incentive for holding out just too compelling for some. Most of the holdout battle was centered on two floating rate bonds, Argentina SPANS and FRANS. The bonds’ floating rate coupon was the published yield to maturity of other bonds on the curve. The holdout incentive was created when the yield to maturity was still incorrectly published despite defaults/low prices (What is the YTM for a bond in default?) on the reference securities. As such, while most bonds had stated coupons of 7% or 8%, these bonds incorrectly started accruing at 40% plus per annum. Fortunately, those conditions do not exist today. By remaining current on debt until an exchange is offered, CACs, lack of loopholes and consensual behavior should all combine to discourage Argentine Holdouts in 2020.

Past performance is not necessarily indicative of future results.

Source: Gramercy, JPMorgan, Bloomberg, MacroSynergy Partners and Haver Analytics.

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“A problem well stated is a problem half solved.”¹

In the case of Argentina 2020, through the lens of proper DSA, it is clear that Argentina has immediate liquidity challenges that make refinancing debt over the next 4 to 5 years nearly impossible; but it’s solvency can and should be secured while accelerating the path to sustainably high and inclusive growth. A consensual re-profiling of maturities would solve these short-term liquidity challenges. On the other hand, imposing haircuts, zero sum behavior and unilateral actions will not resolve the material challenges of Argentina’s debt stock, but most certainly would cause execution risk and other undesirable externalities. Avoiding such pitfalls will allow Argentina and its creditors to execute a successful liability management exercise and ignite a virtuous cycle.

The stakes are high: 45 million Argentines are counting on us all to work together, get it right this time and, in the process, create obtainable, sustainable and inclusive growth for them and for future generations. Let us not repeat the mistakes of the past and let them down, rather, we should learn from those mistakes and embark together on a principled, cooperative and mutually reinforcing approach.

1. Charles Kettering.

January 8, 2020

About Gramercy

Gramercy is a dedicated emerging markets investment manager based in Greenwich, CT with offices in London and Buenos Aires. The firm, founded in 1998, seeks to provide investors with superior risk-adjusted returns through a comprehensive approach to emerging markets supported by a transparent and robust institutional platform. Gramercy offers both alternative and long-only strategies across emerging markets asset classes including capital solutions, private credit, distressed debt, USD and local currency debt, high yield/corporate debt, and special situations. Gramercy is a Registered Investment Adviser with the SEC and a Signatory of the Principles for Responsible Investment (UNPRI).

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