



## Market Comment | Emerging Market Corporate Bonds

March 2014

### Strategic themes in this issue

- **EM Investment Grade** – still in the sweet spot
- **China** – slower growth good for credits. Targeting beneficiaries of a 5-year political agenda
- **EM Exporters** – hard currency revenue is a natural hedge against weaker forex
- **Mexico** – benefiting from spillover US recovery
- **2014 carry** – from small and off-benchmark issuers – could generate returns of 6-8%

### Dear investor

#### A turbulent start to 2014

Emerging market investors were beset by constant 'shock, horror, de-risk and run' headlines throughout January. But luckily, faced by the same macro events, asset classes still behave differently.

From our perspective, as bottom-up investors in hard currency corporate bonds, this higher macro-economic volatility has served to drive up spreads but it doesn't really explain credit risk at an individual company level. Seen from this level, EM credits are way too cheap for the default risk that you take with them. Thus we remain very positive about the long-term prospects for EM corporate debt and believe that it continues to offer investors considerable diversification benefits within an EM portfolio.

If anything, developments in 2014 to date have crystallised our thinking about a number of strategic themes that we had already adopted in our portfolios back in the Autumn. What's more, an increasing number of credit market analysts are echoing our opinions. This encourages our belief that our strategy will benefit – in the longer term – from some of the volatility-inducing headline risk factors (lower growth, weaker currencies) that appear so negative at first glance.

#### Investment Grade – still in the sweet spot

Recent market volatility has only served to increase the relative value dislocation in the market whereby the risk-reward profile for Emerging Markets Investment Grade bonds looks very appealing relative to US High Yield. This is especially the case if you adjust for the "hot money" effect in the US market which has resulted in a high proportion of 'cov-lite bond issuance. Cov-lite bonds are characterised by the lack of restrictions/covenants imposed by the bondholders against the management and company.

It has therefore continued to be an important part of our strategy to increase IG exposure where possible.

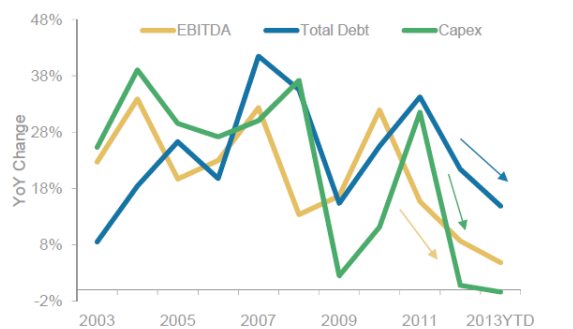
What is also noteworthy is that EM High Yield relative to DM High Yield has also become very interesting, especially when you consider that EM corporates currently hold cash equivalent to roughly 31% of their total debt while US corporates only hold cash equal to 18% of their total debt.

#### China – The motor economy slows

In China we continue to see that credit is piling up, and 'crossover' leverage has also piled up in the corporate sector. So we need to ask: 'Where is the corporate risk? What is

driving it up? And now that the Chinese Government has ordered the banks to rein in on credit, will we now see a tendency for companies to deleverage? The figure below seems to suggest that Chinese companies have already started the process.

Corporate EBITDA, capex and total debt growth (YoY)



Note: Analysis carried out on MSCI China non-financial corporates.  
Source: Bloomberg, Morgan Stanley Research.

We believe that State Owned Enterprises could be at a turning point. Until now their focus has been on building up capacity, which was intended to increase growth. Now, with the shift towards the consumer-driven economy, the emphasis is more on efficiency versus capacity. This means that SOEs may no longer be the perfect credit story because they are now politically driven and therefore less predictable.

When predictability reduces, credit uncertainty increases. For this reason, we have become less weighted to that part of the Chinese credit market and have very little exposure to state-owned companies. For us the China/HK exposure is very much driven by the themes outlined in the Government's 5-year plan so that we target companies whose businesses will benefit from the declared political agenda.

#### China's 5-yr Plan 2011–15 key targets:

- Sustainable and inclusive growth
- Industrial upgrading
- Protection of the environment (with clear pollution reduction targets)
- Greater energy efficiency
- Promotion of domestic consumption

Our portfolio includes a number of companies set to benefit from the Plan – particularly the emphasis on pollution reduction. We own a clean water systems manufacturer, a producer of water pipelines for inland conurbations (important for political stability) and a manufacturer of control systems for the prioritized Chinese underground public transport system which will encourage people not to use cars.

Our investment is also aligned with the government's desire to promote more domestic consumption in the economy. Our portfolio exposure to 'Retail China' is achieved through Investment Grade bonds in major department stores and supermarkets.

Even if China only registers GDP growth of 5-6%, the nation's 3-400 million-strong aspirational middle class still represents huge spending power and it's a consumption machine that will just keep rolling on. So we are opting for large IG retailers with low credit and duration risk.

#### Weaker domestic currencies good for exporters

In the High Yield sector the foreign exchange effect has made life more interesting. A weakened currency doesn't necessarily result in a higher credit risk. If a company has dollar-denominated debts and the local currency is depreciating, this may result in an immediate increase in leverage because debt is re-priced quicker than cash generation. If, however, the company is an exporter, the question becomes one of how much of its revenue is generated in \$/hard currency. In many cases, dollar-denominated revenue streams more than cover the debt. We look for companies that either hedge their dollar debt or else have high export revenues that act as a natural hedge.

One example of this is our Brazilian Agribusiness, Marfig (discussed in our last letter) which is well-positioned to ride out any volatility in the Brazilian Real. The negative impact of BRL depreciation on Marfig's USD-denominated debt is offset by the fact that approximately 50% of Marfig's revenues are derived from exports. These export revenues cover interest payments on the debt many times over. Plus, Marfig's revenue base is set to increase as the weakening BRL to USD which leads to higher demand. At the end of the day, the overall effect will be to strengthen profitability and lower credit risk.

We have allocated our weightings in HY towards exporters in sectors that will be robust even in the event of another downturn.

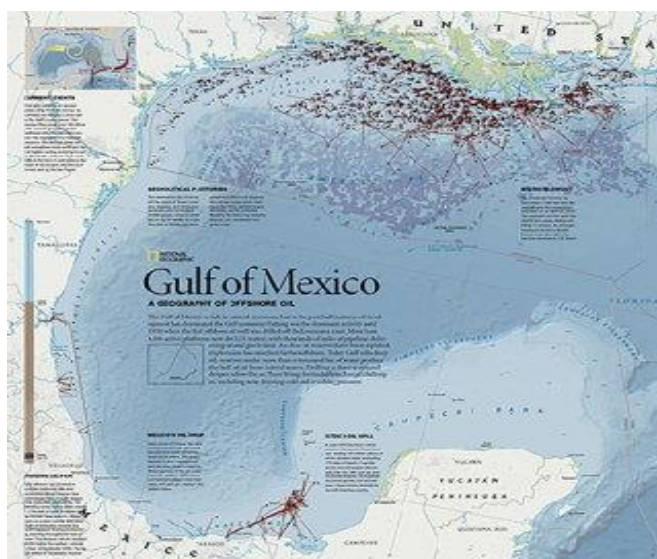
Our China High Yield exposure is in companies that are deleveraging and taking good care of their balance sheets. We see perfect credit conditions of positive growth (but not too much). There are fewer signs of manufacturing bottlenecks but there is still a strong demand for Chinese goods. Recent figures indicate that China's export growth picked up from 4.3% year-on-year in December to 10.6% year-on-year in January, which exceeded expectations. Our expectation for mid-term growth is between 7 and 7.5%. China remains the factory of the world and that won't change overnight. With the government trying to decrease banks' loan books this is a good period for finding strong new issues.

In Brazil it's the same story. The weak FX factor becomes attractive if you invest in exporters whose products are virtually essential - such as commodities or agricultural. We are avoiding companies generating their profits from domestic consumption because we fear some economic fragility.

## Mexico – economic reforms and ripple effect from US recovery

We are very bullish on Mexico for reasons of peso weakness, spill-over effects from US growth and the political willingness to undertake economic reforms that will be very positive for the long term.

For example in the second half of 2013, the Mexican government announced an energy reform that will allow other companies to look for oil in the Mexican Gulf. This will result in significant capital inflow to the economy.



The map shows the current network of pipelines laid by exploration companies in the Mexican gulf. It clearly shows the under-exploitation of potentially oil-rich Mexican territory, relative to US territory.

Another example is that the Mexican transport minister has announced a huge budget for infrastructure projects. This is likely to prove beneficial to companies such as our portfolio holding Cemex. This cement manufacturer suffered pain after the financial crisis. It had bought companies in the US and suddenly its revenue dropped significantly. It remained loss-making until Q4 2013 when it had its first positive cash flow.

We were attracted to Cemex because it has been deleveraging its balance sheet to adjust for new demand coming in as a result of the infrastructure announcement.

## 2014 is about collecting the carry

In 2013, the carry in the portfolio was very important and responsible for the fact that the fund generated a positive return against the index's negative return. Our small cap, off benchmark exposure limited the risk, as did the coupon payments that we had locked in.

We believe that there may be some further headline induced volatility in the market but that 2014 will be a year driven by carry and, in our opinion, this should result in the fund delivering returns of between 6 and 8%.

From our bottom-up perspective credit risk is still very cheap relative to default risk. We expect stable-to-lower default risk in 2014 because:

- Developed nations will achieve stable-to-positive growth and this spills over to the Emerging Markets which have 40-50% of world GDP.
- Fewer short-term corporate bonds will be reaching maturity in the next couple of years – in fact an historic low relative to total issuance. It is usually at the point of refinancing that companies default. Therefore if fewer companies have to refinance, the default risk is likely to be less.

Because the authorities are keeping a close eye on leverage in the banking sector, liquidity is low. This means that more and more companies will issue bonds. The value of EM corporate bond market is now around \$1.1trillion, making it at the size of the US High Yield market.

This growth has not been driven by larger companies issuing more debt but by more companies becoming active in the

market. This creates a more diverse investable universe and creates the opportunity for us to make the difference with our investment strategy which is tilted towards the smaller companies and smaller issues where we can take a premium for our investors.

Yours faithfully



**Toke Hjortshøj**

Senior Portfolio Manager

*On behalf of Sparinvest's Value Bonds Team*

## Key portfolio statistics as at 31 Jan 2014

Sparinvest SICAV - Emerging Markets Corporate Value Bonds:

Holding Statistics	Fund	Benchmark
Duration	3,57	4,90
Average Price	98,5	102,72
Yield to Maturity	8,21	5,36
Spread	811	415
Rating	BB-	BBB
NDE	70,19	129,81
Price/book	1,43	1,85

The mentioned sub-fund is part of Sparinvest SICAV, a Luxembourg-based, open-ended investment company. For further information we refer to the prospectus, the key investor information document and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee for future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for investments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription fees. For investors in Switzerland the funds' representative and paying agent is RBC Investor Services Bank S.A., Zurich Branch, Badenerstrasse 567, P.O. Box 101, CH-8066 Zurich. Published by Sparinvest, 28, Boulevard Royal, L-2449 Luxembourg.