BlueBay
Asset Management

EMERGING MARKETS

Using illiquid credit to address long-term investment goals

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Introduction

Despite having successfully navigated volatile markets and the uncertain economic outlook in 2020, long-term institutional investors continue to face significant challenges. Surveys show 66% of pension funds consider themselves to be cashflow negative and 53% of those that are cashflow positive today expect to be negative within five years. New risk-based capital regimes mean insurance companies face higher capital requirements which limit their investment latitude, just at a time when real yields are at historical lows and fears of stretched valuations are at the forefront of investors' minds.

Over the last decade, many institutional investors turned to illiquid and private credit strategies, initially in the US followed by Europe, as an attractive alternative to raise portfolio yields and lower volatility. However, even this avenue has shown its limitations – lower yields continue to put pressure on target returns, exacerbated by large amounts of dry powder competing for attractive investments and forcing many of these strategies to reach further down the credit curve.

The rapid growth of distressed funds over the last 12 months or so could potentially offer new opportunities for those with a higher risk appetite, but many investors face limited scope for such allocations.

In this paper we discuss why investors should consider selectively broadening their geographical remit beyond the traditional developed market (DM) regions. We believe a broader geographical approach would enable long-term investors to access a compelling and largely untapped opportunity set that can offer a meaningful boost to returns and lower weighted-average-life (WAL) without increasing underlying risk.

In our view, a select subset of high-quality emerging market (EM) illiquid credit investments can offer significant potential benefits as a standalone investment or as a structural allocation to complement an existing private credit portfolio. This strategy has the potential to deliver double-digit returns with superior leverage ratios and lower WAL than the DM equivalent.

Emerging markets illiquid credit overview

Focus on performing credits (secondary, new money & stressed)

Investment remit spans the vast global emerging markets universe

Target hard currency instruments with a preference for senior secured debt

Primary source of returns sought through current income (interest) & asset price appreciation

Capitalise on market dislocation & temporary mispricings

Strong growth of private credit strategies has changed investor portfolios

Many long-term investors' initial experience with private credit was through corporate mid-market direct lending strategies and increasingly through mezzanine and distressed strategies, focusing on DM.

Chart 1 shows the significant amount of capital that has been deployed in the global private credit space over the last 10 years with realised net internal rates of return (IRR) averaging 8-9%. Distressed funds have delivered slightly higher returns on average, with a handful generating 15%+ although the credit cycle has broadly not been prime for such strategies during this period. Anecdotally, we have seen a number of DM distressed funds deploying capital into EM opportunities to counteract this and boost returns.

Long-term investors with predictable cash outflow requirements face a number of unique challenges in their search for income against a backdrop of low yields and volatile investment conditions.

Within the DM world, sponsorship of private credit strategies among these investors has been flourishing following the successes of the past 10 years. The current levels of dry powder are estimated to be well over USD100 billion, based on Preqin data. However, the surge in interest has also led to a reduction in the DM 'illiquidity premium', with direct lending strategies targeting 5-9% IRR levels.

For long-term investors seeking double-digit returns, the options are more limited within DM credit. A notable exception to this is in the distressed universe, where a number of new strategies have emerged following the coronavirus-related market dislocation.

While the opportunities for capturing returns are shifting, the need for income and yield remains stronger than ever. For example, two-thirds of pension schemes consider themselves to be cash-flow negative, according to Mercer's 2020 European Asset Allocation insight. In a compressed return environment and with investment-grade low-risk options increasingly scarce and expensive, we believe these pension programmes are likely to find it increasingly challenging to meet their liabilities without meaningfully increasing their risk profiles in the current landscape.

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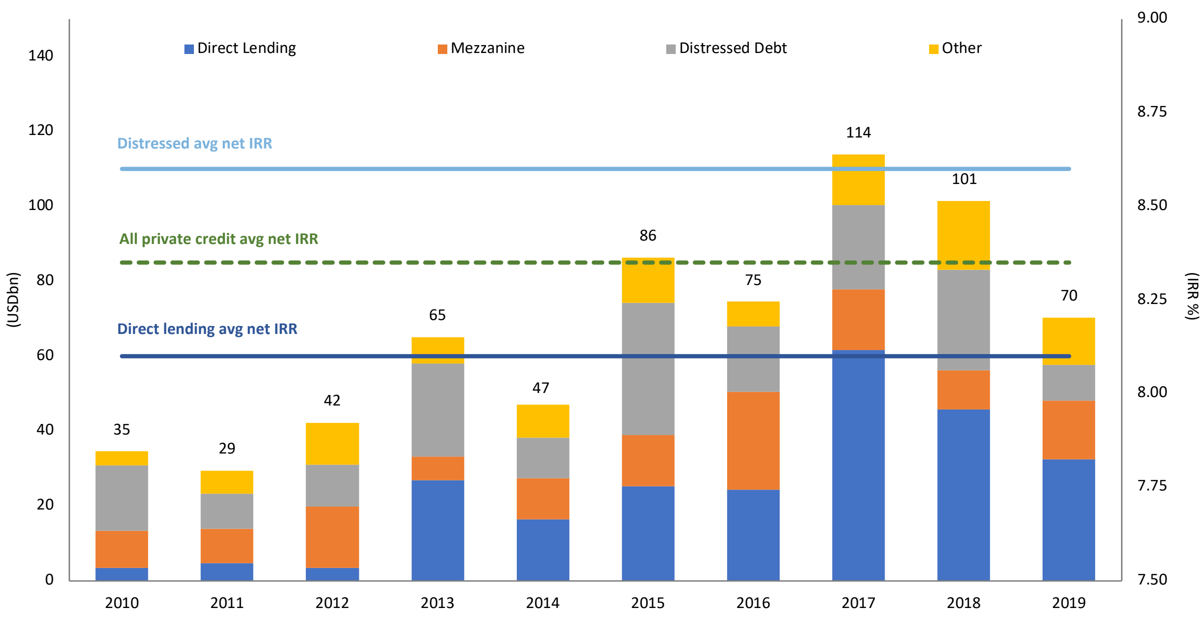
CHART 1: CAPITAL DEPLOYED AND NET REALISED IRRS



Source: Preqin, at at 31 December 2020

The investment proposition

A potential alternative to enhance returns while maintaining a conservative risk profile

We believe there are compelling alternative sources of income that can be accessed through high-quality corporates in the EM illiquid credit space without the need to go down the credit quality curve.

Just as there has already been an increased allocation to private markets at the expense of liquid strategies (both in equities and credit), we expect to see growing allocations to the EM space among DM-focused schemes.

To address the issue of returns in DM-focused private credit strategies coming under pressure, we believe long-term investors should consider an allocation to EM illiquid credit. In our view, by allocating even 5-10% of their private credit portfolios to EM illiquid credit, investors will have the potential to:

- **increase returns on their private credit portfolio by approximately 50bps**
- **maintain a conservative approach to credit risk by focusing on performing EM credits**
- **reduce overall WAL and interest-rate sensitivity**
- **introduce an uncorrelated asset class.**

Table 1 summarises how the key metrics of EM illiquid credit compare against other opportunities in private credit. The approach can provide potentially attractive returns that are comparable to distressed funds, while also offering lower leverage and WAL than other opportunities. On top of its merits as a stand-alone investment opportunity, we believe this subset of private credit can also play a valuable role within a broader private credit portfolio, providing a diversified source of returns and low correlation to other private credit strategies with similar liquidity characteristics.

What drives the attractive risk/reward balance?

1. **Credit risk**
   EM corporates have lower EBITDA leverage (on average this is 2-4x) when compared with the target corporates for DM private credit strategies (5+x).
2. **Documentation protection**
   The majority of loans in DM are now 'covenant-lite', while in EM, lenders benefit from financial covenants and borrower restrictions which, in the right jurisdictions, can translate into better recoveries should the underlying corporate enter a distressed period.
3. **Double-digit returns**
   We believe the asset class has the potential to generate double-digit returns.
4. **Integrating ESG**
   Within EM, perhaps even more so than in DM, integrating ESG factors in credit selection, due diligence and engagement, by following a pragmatic and tailored approach, is critical to investment outcomes and typically leads to a better risk/reward balance. Additionally, the lack of alternative sources of capital for many of these corporates paves the way for lenders to be more influential when engaging on ESG issues.
5. **Deep opportunity set**
   Tradable hard currency primary syndicated loans issuance between USD100-200 billion annually.
6. **Less competition for EM assets**
   Within the EM space we have seen substantially smaller amounts of capital raised (both in absolute and relative terms), which has preserved significant influence for existing managers over underlying returns.
7. **Comparable default & recovery rates**
   EM corporates have historically had comparable default and recovery rates versus their DM counterparts. In recent years, EM have delivered better rates than DM.

TABLE 1: RISK-ADJUSTED DM PRIVATE CREDIT STRATEGY RETURNS VS EM ILLIQUID CREDIT

	Private debt	Distressed	Infrastructure	EM illiquid credit
Risk – leverage	5+x	7+x	6+x	2–4x
Risk – documentation	Weak – moderate	NA	Strong	Strong
Target net return	5–8%	12+%	2+%	12+%
Investment WAL	5+ years	5+ years	7+ years	2–3 years

Source: Preqin, BlueBay Asset Management, as at March 2021

EM illiquid credit target portfolio characteristics

- Medium-to-large corporates across EM regions
- Meet key fundamental credit (e.g. 2-4x leverage) and ESG criteria
- 2-3x the public markets spreads for the same risk
- Mostly senior secured instruments
- Floating-rate loans addressing any expected core rates increase
- Typically amortising structures
- Shorter WAL than the public market equivalents
- Hard currency instruments
- English law documentation

Considering an EM illiquid credit allocation within a broader portfolio

In tables 2 & 3, we consider a case study of a long-term investor and the impact of adding a small allocation to EM Illiquid investments to an existing DM private credit position. The current portfolio contains the three most widely used strategies within the private credit universe: direct lending, distressed and infrastructure debt.

TABLE 2: LONG-TERM INVESTOR'S TYPICAL DM PRIVATE CREDIT ALLOCATION

	Allocation %	Target net return	Risk*	WAL (yrs)
Private debt	40%	6.0%	Moderate-high	5
Distressed	20%	12.0%	High	6
Infrastructure	40%	3.0%	Low	8
Total	100%	6.0%	Moderate-high	6.4

Source: BlueBay Asset Management as at March 2021. *Risk is defined as a combination of underlying borrower leverage and instrument documentation.

TABLE 3: LONG-TERM INVESTOR – PORTFOLIO PROFILE INCLUDING TACTICAL EM ILLIQUID CREDIT ALLOCATION

	Allocation %	Target net return	Risk*	WAL (yrs)
Private debt	35%	6.0%	Moderate-high	5
Distressed	17.5%	12.0%	High	6
Infrastructure	37.5%	3.0%	Low	8
EM illiquids	10%	12.0%	Low-moderate	3
Total	**100%**	**6.5%**	**Moderate**	**6**

Source: BlueBay Asset Management as at March 2021. *Risk is defined as a combination of underlying borrower leverage and instrument documentation.

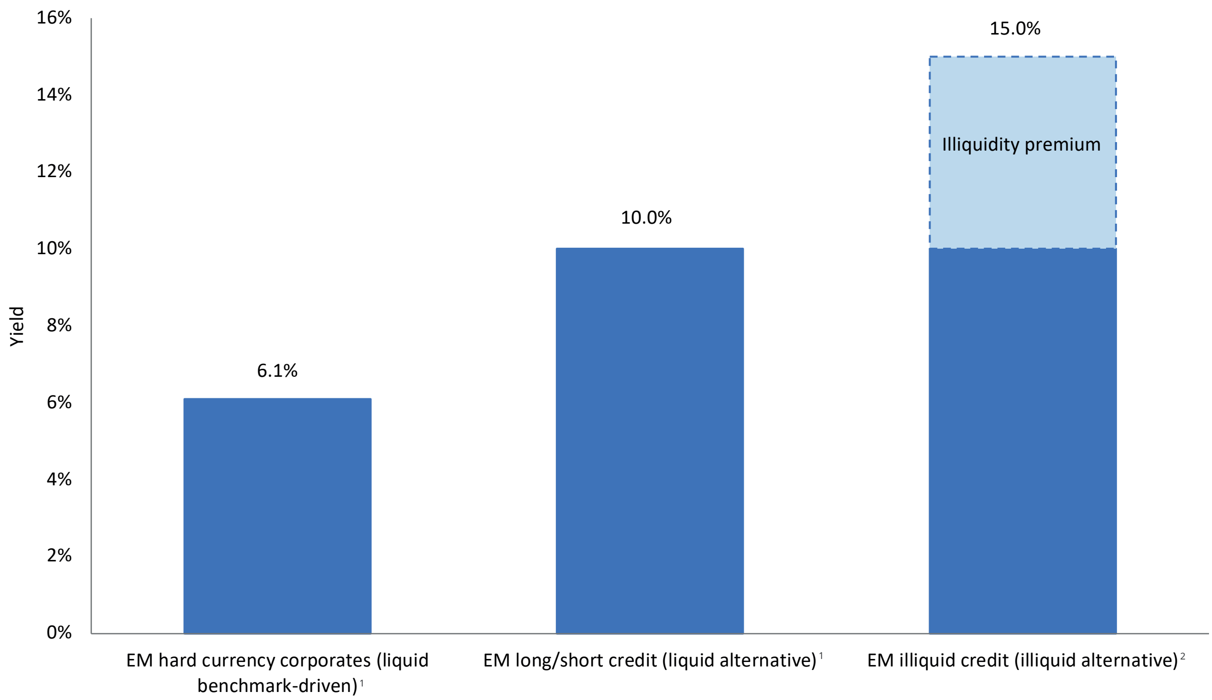
We believe that a structural allocation to EM illiquid credit provides the following benefits:

- **Pick-up in income/yield**
- **Similar-to-lower portfolio risk**
- **Uncorrelated to the rest of the portfolio**
- **Lowers the portfolio investments' WAL**

Rewarding the illiquidity premium within EM

Looking through a different lens, given the limited competition and capital scarcity, EM illiquid credit delivers a substantial illiquidity premium compared to EM liquid alternatives, even when limiting the scope of investments to higher-quality stories and lower leverage metrics, as shown in chart 2.

CHART 2: ILLIQUIDITY PREMIUM VS. LIQUID EM CORPORATE STRATEGIES



Source: BlueBay Asset Management as at March 2021. *Risk is defined as a combination of underlying borrower leverage and instrument documentation.
[1] 5-year average gross returns [2] Target gross IRR.

Investors in public markets are increasingly leveraging opportunities to interact with issuers. This dialogue is all the more robust in private credit, presenting a particularly robust avenue to engagement on ESG matters, including relevant policies and initiatives.

Chart 2 shows that even within a narrow scope of higher-quality names, illiquid EM assets generally offer a yield pick-up of 5% compared to liquid alternative EM strategies and 9% compared to liquid benchmark-driven EM strategies. The illiquid credit approach described above allows access to the largest part of the EM corporate credit universe (more than 90% of the funding needs for EM corporates are coming from the banking sector in loan format). Such a strategy would also permit flexibility in terms of focusing on both secondary and new money opportunities, allowing investors to deploy capital across the economic cycle.

Investors in public markets are increasingly leveraging opportunities to interact with issuers. In our experience, this dialogue is all the more robust in private credit, presenting an attractive avenue to engagement on ESG matters, including relevant policies and initiatives. This close engagement also creates opportunities for greater disclosures related to ESG issues and risk mitigation.

Combining liquidity levels

It is also important to consider the merits of an illiquid allocation in EM alongside liquid, public market strategies. Here, the illiquid 'sleeve' has the potential to dampen portfolio volatility. This is partially attributable to the buy-and-hold nature of the strategy but additionally, because the underlying loans tend to be more conservatively structured, involving bespoke terms and structural features with tighter covenant packages (including financial covenants).

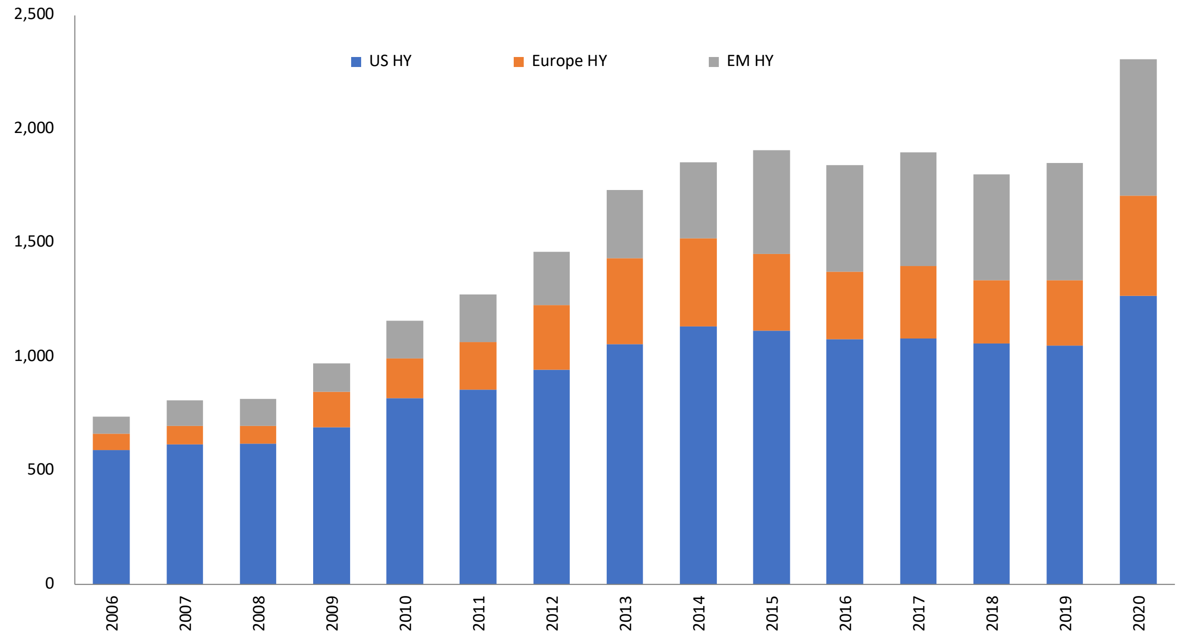
Large addressable market for EM illiquid credit

We believe the supply/demand dynamics in the EM loan space make it a particularly compelling opportunity to exploit in today's economic environment, where competition for investment opportunities in other markets can be fierce.

Charts 3 & 4 illustrate that the EM syndicated loan market continues to be active with a healthy annual supply rate of around USD200bn. While banks continue to lend to healthy EM corporates, their ability and willingness to hold these loans on their books for the full WAL is sometimes challenged. Regulatory restrictions, occasional ad-hoc risk reduction protocols and strategic allocation away from certain countries or particular relationships can require swift balance-sheet reduction, leading to a supply of secondary loans in the market.

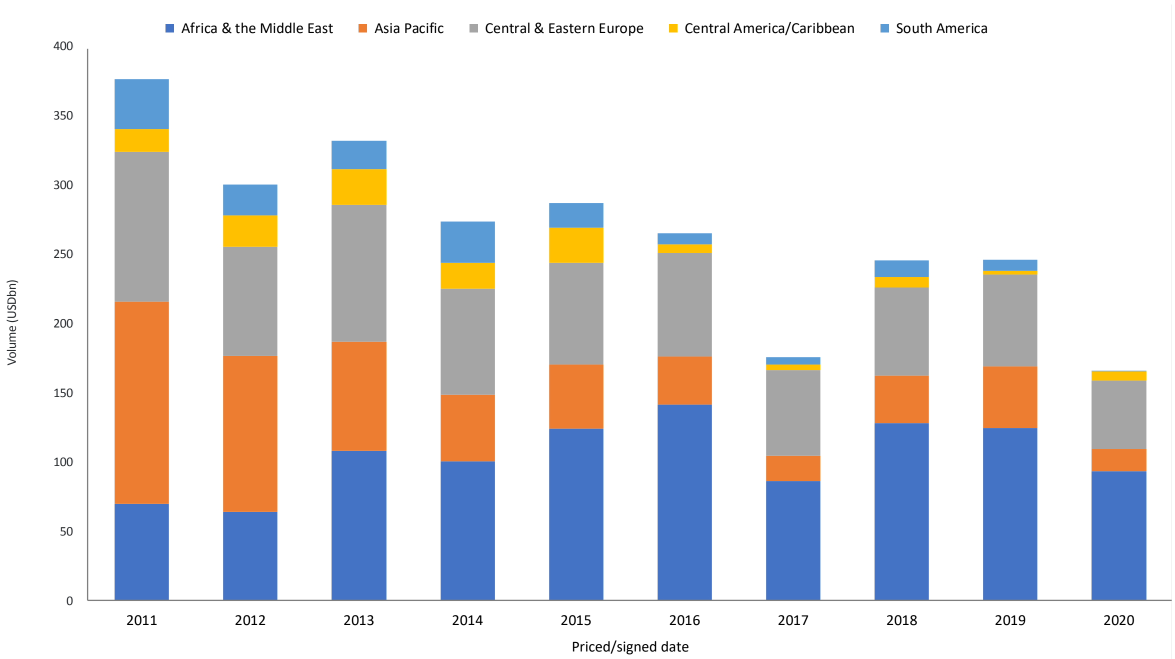
Unlike DM, where there is significant dedicated capital to absorb supply, the dry powder in EM is relatively insignificant compared to the potential supply. This creates interesting opportunities for investors to pick-up high-quality assets at a meaningful discount to the market.

CHART 3: SIGNIFICANT GROWTH IN EM HY OVER THE LAST DECADE (USDBN)



Source: High yield issuance: BofA Global Research, as at 12 March 2021

CHART 4: EM SYNDICATED LOANS VOLUME (USDBN)



Source: Loan Radar, as of 31 December 2020

Conclusion

A natural expansion of the private credit asset class

In an environment of low rates and economic uncertainty, long-term investors face a number of challenges in their search for reliable and consistent sources of income to meet their liabilities. We believe building a structural exposure to EM illiquid credit could help to boost returns and lower portfolio WAL without compromising credit quality while, at the same time, provide valuable diversification benefits.

EM illiquid credit can help to enhance traditional allocations within both private credit and liquid EM portfolios by offering a sizable potential pick-up in risk-adjusted return with typically lower correlation and volatility.

DM-focused private credit strategies are an established asset class with increasing investor appetite. The asset class, especially within the European context, has only recently matured with dedicated allocations from global investors. We believe a similar story of growth and convergence will occur with the EM universe within the next 5-10 years. We also believe at a time when there is still limited competition for the underlying assets, the current environment presents an attractive window of opportunity for investors to start considering a structural allocation to EM illiquid credit.

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Senior Portfolio Manager

Mihai is a Senior Portfolio Manager within the Emerging Markets Team. He joined BlueBay in January 2020 and his primary portfolio management responsibilities include the illiquid strategy covering loans, illiquid instruments, special situations and distressed. Prior to joining BlueBay, Mihai was a Founding Partner for the credit strategies at Helios Investment Partners. Mihai has 20 years' experience including on the sell-side where his last role was heading the emerging markets structuring team at Bank of America Merrill Lynch across fixed income, currencies and commodities. Mihai holds a Master's Degree (MSc) in Economics and Finance from Warwick University.

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