RBC BlueBay Asset Management

Unlocking the illiquidity premium in EMD

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We discuss how – at a time of global uncertainty – investors in emerging markets private credit can benefit from enhanced yield and a compelling risk-reward balance.

Key takeaways

- The illiquidity premium is the potential to harvest additional returns from investing in an illiquid vehicle. The longer-term investment horizon of a locked-up fund allows investors to access this premium.
- In emerging markets, the drivers for capturing the illiquidity premium are an overreliance on the banking sector by borrowers, shallow local debt capital markets relative to developed markets, and a lack of alternative pools of capital.
- Recent geopolitical events have enhanced the opportunity to capture the illiquidity premium. Investor risk appetite has diminished, further restricting EM borrowers' access to traditional funding channels and creating an impetus to search for new funding alternatives, such as private credit.
- Due to a lack of competition for EM illiquid assets, our strategy offers a meaningful premium over more liquid instruments with a much shorter duration, given the underlying amortising nature of the loans we invest in.

An evolving asset class against an uncertain backdrop

Macro uncertainty and volatility have been key features of the economic backdrop for some time, and in emerging markets (EM) in particular, dislocations in pricing and capital availability have been felt acutely. Private credit investing has come to the forefront in EM, with stronger credit metrics in focus and investments in this space offering a haven from market volatility.

Following the GFC in 2008, many developed market (DM) investors turned to alternative investment strategies, such as private credit, to enhance the yield in their portfolios, while others broadened their geographic reach to include EM assets, focusing primarily on liquid, public market strategies. However, we saw the potential for an attractive, alternative approach, and one that remains largely untapped: **high-quality performing loans targeting healthy, low-leveraged corporates, under fully-covenanted documentation**.

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These loans can offer potential advantages to investors looking to enhance portfolio yield without compromising on robust legal documentation or having to venture into higher leveraged, distressed opportunities. Through income-distributing, drawdown structures, investors can capture a substantial illiquidity premium – a yield spread above public corporate bonds to compensate for the illiquid (or non-tradeable) nature of an investment – compared to liquid EM markets.

Coming into 2025, we saw substantial volatility, mainly driven by geopolitical events. Despite this, credit spreads have weathered the storm quite well thus far. However, we have seen this uncertainty, coupled with the recently-announced tariffs, starting to affect not only investor risk appetite but, more importantly, confidence amongst corporates. While tariffs were expected across the board, what was surprising was the large differentiation between countries and the expected response. At first, China was more affected while LatAm tariffs were more modest. That said, countries such as Mexico have a large share of their exports sold to the US compared to other countries.

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A diversified pool of investments is key

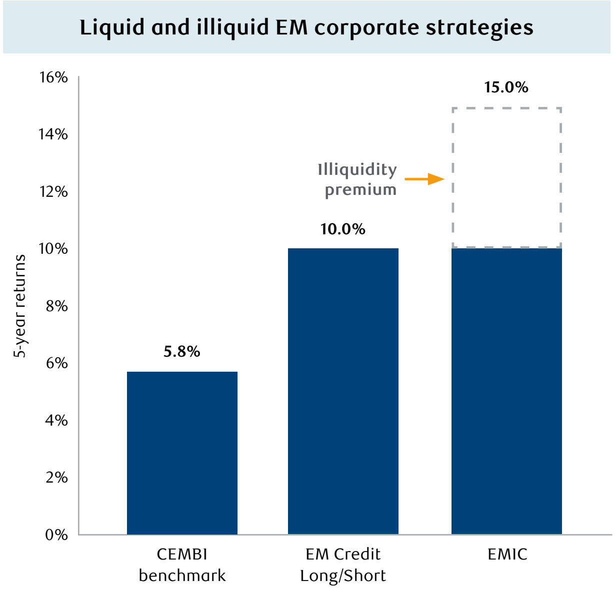
Our strategy does not just focus on one market, as we believe that the optimal approach is to have investments and a pipeline split evenly between regions, such as LatAm and CEEMEA. We expect a further global re-alignment, with LatAm on a relative basis being the 'winner' thus far. Within CEEMEA, we expect corporates to be driven more by fiscal stimulus, and we would expect this to mitigate negative effects from the global tariff war.

For our pipeline, this means more new money opportunities, a trend that we have been seeing for the last six-plus months and one that we expect to increase going forward.

Rewarding the illiquidity premium in EM

Given the limited competition and capital scarcity, EM private credit can deliver a substantial illiquidity premium compared to EM liquid alternatives. Even within a narrow scope of higher-quality names and lower leverage metrics, 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 (Chart 1).

Chart 1: Investors are offered a meaningful premium over liquid instruments



Source: RBC GAM, as at May 2025.

We see four key drivers for capturing the illiquidity premium:

- **Lack of competition for EM illiquid assets:** there are fewer asset managers and substantially lower amounts of dry powder available.
- **Lack of alternatives:** the EM borrowers over-rely on the banking sector, the local debt capital markets are shallow (relative to DM), and there are a lack of other alternatives pools of capital existing in DM.
- **Deep sourcing channels:** covering illiquids requires long-standing relationships and market access, which relies on being part of a larger organisation. The BlueBay fixed income platform has blue-chip status within the sell side community and extensive corporate relationships.
- **Ability to act fast:** being the first port of call when opportunities arise (particularly in instances of forced selling) and having deep sector and country knowledge to permit quick decision making is key. The size of our 26-strong investment team ensures we are well equipped to perform in-depth, bottom-up analysis of issuers and sectors, but also means we can move quickly to capitalise on opportunities.

A targeted approach can achieve an attractive risk-reward balance

We employ a targeted investment approach, largely focusing on high-quality performing EM credits, but enhanced by a small allocation to select stressed names. Our investment philosophy focuses on medium to large EM corporate borrowers where we are able to achieve 300-500 bps of an illiquidity premium. We focus on healthy corporates where the underlying leverage is 2-4x.

The underlying loan documentation is old style documentation and includes a full set of financial covenants, with restrictions on asset disposals and payment to the shareholders.

This approach allows us access to the largest part of the EM corporate credit universe (more than 90% of the funding needs for EM corporates come from the banking sector in loan format, compared to 50-60% in Europe and 20-40% in the US). This gives us flexibility in terms of focusing on both secondary and new money opportunities, allowing investors to deploy capital across cycles.

Boosting returns without compromising on credit quality

In the current environment of economic uncertainty, long-term investors face challenges in their search for reliable and consistent sources of income. We believe building a structural exposure to EM private credit could help to boost returns without compromising on credit quality, while providing valuable diversification benefits.

The asset class can help enhance traditional allocations within both private credit and liquid EM portfolios by offering a sizeable potential pick-up in risk-adjusted returns, with typically lower correlation and volatility. DM-focused private credit is an established asset class, while the EM asset class 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 that 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 private credit.

> **"Having the ability to lock capital for 5+ years allows these investors to gain the illiquidity premium."**

Given the lack of competition for EM private credit assets, investors can drive pricing discussions, documentation protection, and security packages, and ultimately pick the best risk-reward investments. For example, as mentioned above, the target underlying corporates typically have a net leverage position of 2-4x and underlying loans are executed under English (or New York) law documentation, with a full set of financial covenants, restrictions on assets disposals, and restrictions on distributions to the shareholders.

Private credit investments have historically had low volatility and have provided steady current income cashflows. These types of assets are well suited to longer-term investors who require steady cash inflows. Having the ability to lock capital for 5+ years allows these investors to gain the illiquidity premium.

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