EMERGING MARKETS DEBT

Active Engagement: Good for Both Investors and Issuers in Distressed EM Debt

By: Federico Sequeda, CFA | December 21, 2022

Boston - Emerging markets (EM) debt has faced a challenging year in 2022, along with almost all other fixed income sectors. EM countries with significant problems typically garner the most headlines, especially if their debt falls into "distressed" status — usually defined as trading at a spread of 1,000 basis points or more.

Headwinds for EM debt issuers this year combined in a "perfect storm," including:

- Higher borrowing costs/interest rates to pay back creditors in this elevated rate environment
- Stressed fiscal policies
- The general risk-off environment

This has resulted in an unusually high number of distressed debt EM countries, rising from under five a decade ago to about 20 currently.

The MSIM Emerging Markets Debt team builds portfolios by focusing on country-level macroeconomic and political research and stand-alone analysis of specific risk factors such as currency, credit spreads and interest rates. Over our two decades of investing in EM debt, this process has guided us in navigating distressed debt environments.

Our close analysis reveals there is a repeatable distressed debt investment process — part art and part science — that can be applied over time. But this requires a high level of active engagement by managers with expertise in EM countries, along with a good deal of persistence and patience. As discussed below, active engagement has led to greater recoveries — an outcome that benefits both EM issuers and investors.

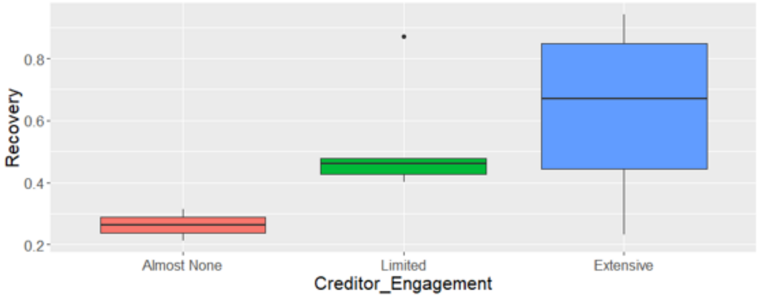
Patterns in Distressed Debt

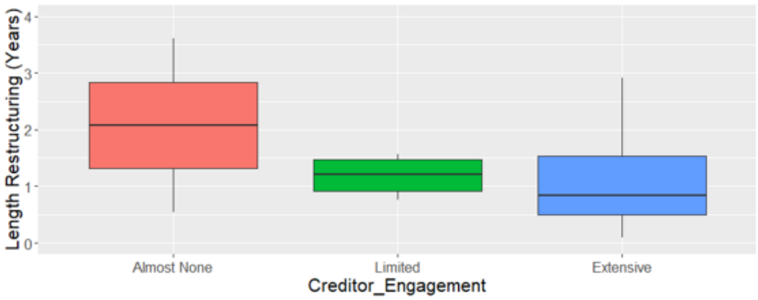
We reviewed 12 restructurings between 2008 and 2018 and found that bond prices have tended to fall strongly in the three weeks leading up to a restructuring announcement, and then usually bottom out over the subsequent two months. Over the next three months, the defaulted bond prices increased by an average of 20%.

We believe there are several reasons for the rebound. By the time of the restructuring, the only remaining investors are those prepared to see the issuer through its problems. Also, some countries are spurred to enact long-overdue reforms, perhaps with IMF assistance.

The chart below shows that active engagement by EM investment managers has been crucial for successful restructurings. Creditor committees that have engaged with debtors had a median recovery of 60 cents on the dollar, over less than one year, versus 30 cents over more than two years, with no engagement, based on a review of 24 restructurings over the past several years.

Active Engagement Has Recovered More Value, More Quickly





Source data set: 24 bond restructurings from Park & Samples (2021), Asonuma & Trebesch (2016), Cruces & Trebesch (2013) and Eaton Vance's data set, December 2022.

These results underscore the extra mile active managers must go for successful restructurings. In our experience, the manager needs to travel to the country and meet with key policymakers like the minister of finance, central bank governor and the IMF. It isn't enough just to review restructuring proposals — the manager needs to have a seat at the table to help devise it.

Bottom line: Our research shows that when managers engage intensively in restructurings, both issuers and investors can benefit.

Risk Considerations: *The value of investments may increase or decrease in response to economic and financial events (whether real or perceived) in the U.S. and global markets. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. In emerging or frontier countries, these risks may be more significant. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Exposure to derivatives involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other investments. As interest rates rise, the value of certain income investments is likely to decline. The value of commodities investments will generally be affected by overall market movements and factors specific to a particular industry or commodity, including weather, embargoes, tariffs, or health, political, international and regulatory developments.*

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