Emerging markets private credit: an attractive, alternative approach

With the private credit industry growing at pace, **Mihai Florian**, EM Debt Senior Portfolio Manager at RBC BlueBay, explains why EM corporates are in a stronger position than their DM peers and why a long, established track record in EM investing is key to understanding this nascent asset class.

A strong history in both alternatives investing and emerging markets

Our BlueBay investment platform has over two decades of experience managing hedge funds and alternative fixed income strategies, including private credit, with a long track record of strong performance. Sitting within RBC Global Asset Management, we manage over USD130 billion in fixed income[1] and offer enhanced flexibility and diversified solutions across developed and emerging markets to meet our clients' needs.

We have been investing in the emerging market debt (EMD) space since 2002, with over USD11.7 billion in dedicated AUM[2]. With 26 investment professionals, the team averages 19 years of investment experience and covers the full universe of EM sovereigns and corporates (in both hard and local currency). An extensive track record investing in EMD means team members have significant experience in harnessing the dispersion of the asset class, capturing upside potential across the universe.

Looking back to the aftermath of the financial crisis, many developed market 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, given our long history in both private credit and EM, we saw the potential for an attractive, alternative approach, and one that remains largely untapped: performing hard currency loans to large, healthy EM corporates.

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 compared to liquid EM markets.

A focused but flexible strategy

Our closed-ended strategy, BlueBay Emerging Market Illiquid Credit Fund I, invests across a range of EM countries, including Turkey, Poland, Brazil, and Mexico, and aims to take advantage of the illiquidity premium that can be extracted by investing in the loans of high-quality, blue chip EM corporates.

The longer-term investment horizon of a locked-up fund means these vehicles are not susceptible to the shorter-term risk dynamics of market volatility and flow fluctuations in the EM asset class. While spreads and yields in public markets widen and tighten depending on the phase of a market cycle, loans are not affected in the same way. In addition, the loan space has been growing in recent years and shows no signs of abating.

We also limit portfolio investments to hard currency assets only. Illiquid strategies in EM, particularly those involving corporate investments, do not tend to mix well with local currencies. The illiquidity, combined with local currency exposure, introduces significant FX risk. This can be a major concern in EM.

Being an EM private credit investor means being prepared to 'look through the cycle'. We have a variety of sleeves in our strategy, including secondaries, new money, and stressed. Each sleeve is designed to ensure that no matter where we are in a cycle, we have a sleeve suitable for the prevailing market environment.

We employ a 'dual track' approach, considering both primary and secondary loans, which allows us to tap into market opportunities at different points in the cycle. For example, when the market was experiencing volatility in 2023, we saw more opportunities in the secondary market, purchasing syndicated loans from banks looking to de-risk their balance sheets. On the other hand, when a considerable amount of liquidity came back to the loan market in 2024, there was a substantial pick-up on new money, primary loan opportunities, as public markets were still unavailable for most issuers.

The market opportunity

We have witnessed structural changes in the banking sector since the financial crisis, with banks subject to heightened regulatory and capital constraints. This has resulted in a diminished flow of funding to corporates and has created an opportunity for private credit managers.

It is worth pointing out that in EM countries, medium-to-large sized businesses are particularly reliant on this funding. From our research, we see over 90% of funding in these countries coming from banks, compared to 50-60% in Europe and 20-40% in the US. This has created a significant opportunity for managers with deep EM knowledge.

Furthermore, EM local capital markets lack depth, and alternative sources of capital, such as insurance company capital, are limited. An overreliance on the banking sector has contributed to a wealth of investment opportunities within EM private credit. This paves the way for strategies that focus on loans to high-quality corporates with low leverage and extended financing, under very robust documentation.

Why invest in EM, not DM, private credit?

We believe that investors looking at traditional DM opportunities can benefit from incorporating select EM private credit in their portfolios, to take advantage of higher yields for comparatively stronger credit exposure. Although it can seem counterintuitive, EM corporates are currently in a stronger position than their DM peers and, in many jurisdictions, can offer investors better protection on both financial and documentation fronts.

Our research shows that EM corporates can compare favourably to their DM counterparts, with lower default and higher recovery rates. As investors focusing on healthy and growing EM companies with substantially lower levels of leverage, we see that achieving similar returns in DM would require meaningfully greater risks (i.e. distressed debt) and weaker documentation.

Strong documentation helps put EM corporates in a more robust position than their DM peers, as typically, loans are executed under ‘old style’ documentation, with a full financial covenant package, restrictions on disposals, moving assets and dividend payments to shareholders, and enhanced protection from a creditor’s perspective.

In DM, over the last five-plus years, we have seen a rise in ‘covenant-lite’ structures. With around 90% of deals under these structures, there have been a number of situations where companies move assets away from the existing borrowing perimeter and raise new money, priming, in effect, the existing creditors, which substantially reduces recoveries for the ‘old’ creditors. This is not a situation that arises in EM countries.

There is also less competition for EM assets. It’s very rare to hear about an EM private credit strategy, whereas in Europe alone, there are over 200 managers. Since the financial crisis, there have been many new managers coming to market with direct lending strategies, mostly focusing on the European market. This has eroded both return potential and documentation protection. Within the EM space, we have witnessed much smaller amounts of capital raised (both in absolute and relative terms). This means we can dictate a lot of terms in the documentation and have substantial leverage when it comes to pricing discussions.

Over two decades experience investing in EMD

With investment experience in the asset class since inception in 2002, our team’s focus on EM private credit is a natural extension of our expertise in the space.

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. Being the first port of call when opportunities arise and having deep sector and country knowledge to permit quick decision-making gives us a key competitive advantage.

Covering the EM performing loans market successfully requires longstanding relationships and market access, and this is significantly enhanced by being part of a large, established EM investment platform. Our history means that when looking at private credit opportunities we often source from direct, long-term relationships across the EM spectrum. This allows a selection of the best risk-return opportunities, materially de-risks our investment process, and provides a constant flow of potential investments across geographies and sectors.

Investing in EM assets is often said to equate to higher risk, yet with deep layers of sector and macro specialism in our team, we are well placed to carry out the in-depth financial and commercial due diligence required for private credit investing. Our team has deep experience across sectors and through credit cycles, drawing on sovereign, sector, and structuring expertise throughout the investment process.

Furthermore, as a team of specialist investors in the asset class, we understand the potential pitfalls of EM private credit investing, as well as the opportunities. Misunderstanding credit risks is first and foremost on the list, but other factors can come into play within EM, such as execution and enforcement risk, given the global scope of the opportunity set.

A focus on high-quality opportunities in uncertain times

A selective approach is everything when investing in the EMD asset class. With over 80 countries and 13 industries, the opportunity set is vast. Yet not all EM countries can be painted with the same broad brushstroke. Poland, for example, is a very different investment proposition to Kazakhstan, yet both fall under the ‘EM’ umbrella.

We believe a targeted investment approach, largely focusing on high-quality performing EM credits, but enhanced by a small allocation to select stressed names, is a very compelling strategy for navigating current markets.

The macro backdrop continues to look uncertain in 2025, and the corresponding risk aversion could remain a theme for the foreseeable future. In our view, this is why investors should carefully assess the risk-reward profiles within their portfolios to ensure they have sufficient diversification in their exposure. With this in mind, and considering that credit spreads are at historic lows, investors in DM private and liquid markets could question whether they are being fully compensated for the credit and market risk they currently hold.

We believe high-quality EM corporate private debt investments, generating 500bps per turn of leverage, can make a significant contribution to investment returns while improving the overall credit characteristics and diversification of risk exposure. A selective approach within a closed-ended structure provides the optimal approach for accessing outsized excess returns, while protecting against market volatility and downside risk.

RBC BlueBay Asset Management

[1,2]As at 31 December 2024. As at the same date, RBC Global Asset Management’s AUM totalled USD485 billion.