Capitalising on the EM private credit opportunity set

Polina Kurdyavko, Head of BlueBay EM Debt, explains the key elements in implementing a successful private credit strategy and discusses how select exposure can offer investors an attractive risk-reward balance.

Macro uncertainty and volatility have been key features of the economic backdrop in recent years, and in emerging markets in particular, dislocations in pricing and capital availability have been felt acutely. Private credit investing – broadly speaking, non-bank lending to corporates – has come to the forefront, with stronger credit metrics in focus and investments in this space offering a haven from market volatility. The IMF estimates the size of the global private credit industry at just over USD2 trillion[1], and its rapid growth means that the industry looks set to play a role in financial markets for a long time to come.

This strong growth in private credit is also extending to emerging markets ("EM"). Fundamental changes in the banking sector following the financial crisis (with banks now subject to heightened regulatory and capital constraints), coupled with periodic bouts of market dislocation and a lack of alternative sources of capital, have resulted in us seeing a wealth of investment opportunities within EM private credit.

A strong track record in EM debt investing

Investing in both private credit and EM calls for a skilled team of experienced and specialist investors. BlueBay was established as one of Europe's first specialist alternative credit managers in 2001, and we have since become one of the region's largest specialist active managers of fixed income, entrusted to over USD125 billion in assets under management in global corporate and sovereign debt, rates and FX[2].

Our EM Debt team has been investing in EM debt strategies since 2002, with over USD11.9 billion managed in active long only, total return and alternative solutions across sovereign and corporate debt, in both hard and local currencies[3]. We have the ability to leverage our firm's wider resources, including in global macro and developed markets ("DM"), while our history and deep relationships give direct access to EM policymakers and corporate issuers. This is instrumental when analysing opportunities across emerging economies.

We believe that our longstanding history in the market is one of our key competitive advantages, and 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. We believe that covering the private credit space successfully requires long-standing relationships and market access, and this is significantly enhanced by being part of a larger EM investment platform.

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.

This due diligence includes testing the range of potential stress scenarios, with a focus on cashflow generation, debt sustainability, leverage trends, refinancing risks and FX risk. Technical and ESG factors are integrated within the decision-making process. As a team with strong resources, we have rigorous bottom-up fundamental analysis capabilities but can also move quickly to capitalise on opportunities. Being the first port of call when these opportunities arise, and having deep sector and country knowledge to permit quick decision making, are key.

EM private debt versus DM

We believe that investors looking at traditional DM opportunities could 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) and weaker documentation.

Strong documentation helps put EM corporates in a stronger 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.

EM private credit strategies are also less common than in DM, and the lack of managers and competition in the market mean that many underlying loan terms can often be dictated.

Summary

Uncertainty regarding the market outlook and the corresponding risk aversion could remain a theme for the foreseeable future. This is precisely 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 historical 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.

Going forward, we believe that opportunities will continue to exist with EM private credit, and that a focus on high quality performing EM companies, enhanced by a small allocation to select stressed names, is a compelling strategy for navigating current markets. This allows investors to capitalise on a diversified pool of investment opportunities that offer asymmetric return profiles and can generate outsized returns, often enhanced even further if acquired opportunistically at a discount during periods of market dislocation. This selective approach, within a closed-end structure, provides the optimal approach for accessing outsized excess returns, while protecting against market volatility and downside risk.

[1] Fast-growing $2 trillion private credit market warrants closer watch (imf.org).

[2,3] As at 31 July 2024.