Nick Ivanov, CFA

Principal, Head of Emerging Market Corporate Bond Research

Aayush Sonthalia, CFA

Principal, Emerging Markets Corporate Portfolio Manager

JUNE 2019

Uncovering Alpha Opportunities in Emerging Market Corporates

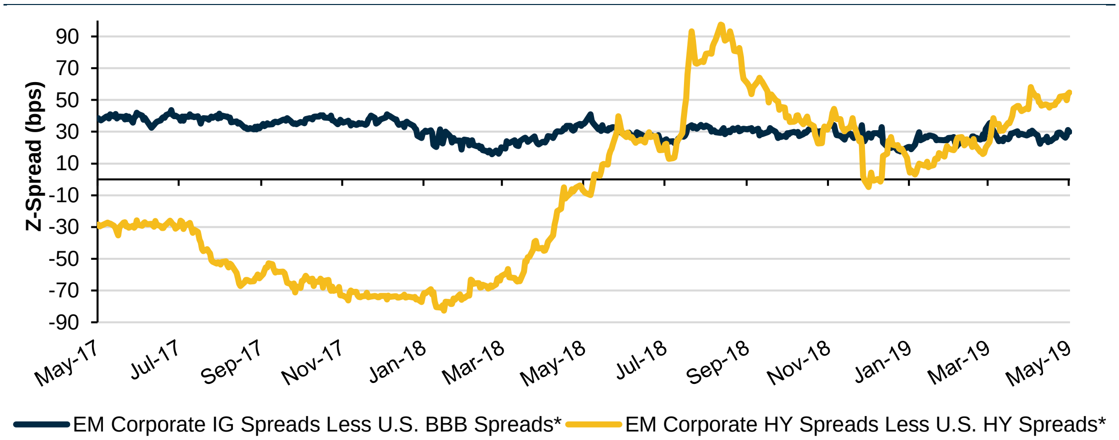
In a late-cycle environment where investors' ongoing search for yield has compressed credit spreads across a range of sectors, the nuances in emerging market corporate bonds have continued to present compelling opportunities. However, the characteristics of many EM companies—not necessarily pertaining to their credit quality—often make the fundamental analysis process different and more challenging than the evaluation of developed market corporates.

This paper touches upon the market opportunity across EM corporates and follows with examples of how global investors with in-depth knowledge of local business practices, politics, corporate culture, and solid fundamental analysis can take advantage of the idiosyncratic opportunities presented by EM corporate bonds.

The Draw

Investors' search for yield has become a hallmark of the maturing global expansion, such that periods of relatively wide spread differentials between assets with similar credit quality have tended to quickly compress. Yet, in situations where the credit analysis becomes more challenging, that spread differential may be more sustained, thus creating greater allocation opportunities for investors conducting thorough credit analysis. For example, in 2018, a less-constructive global backdrop and a major currency devaluation in Turkey contributed to a selloff in EM high yield corporates, which pushed spreads about 50 bps wide of those in the U.S. high yield sector. Similarly, EM investment grade corporates have traded about 15 bps to 45 bps wide of U.S. BBB corporates since mid-2017, and that differential was recently near the middle of the range at about 30 bps (see Figure 1).

Figure 1: EM IG Corporates Have Historically Offered More Spread than U.S. BBBs, Which Recently Became the Case for EM High Yield Corporates As Well

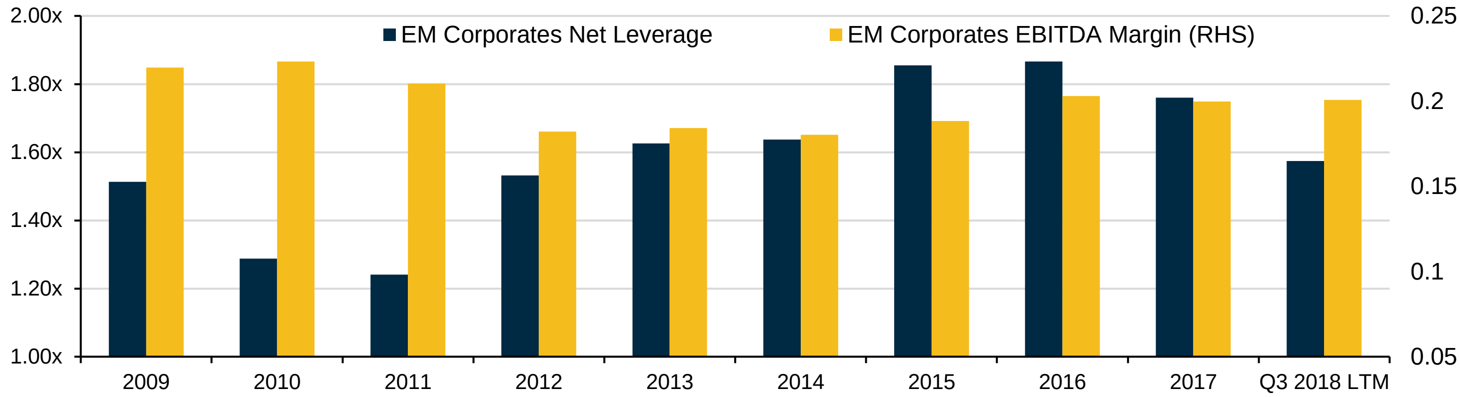


*Source: Bloomberg as of June 2019. * Spreads represented by J.P. Morgan indices: CEMBI Broad Diversified (EM Corps.), JULI (U.S. BBBs), and GABI (U.S. High Yield). For illustrative purposes only.*

WWW.PGIMFIXEDINCOME.COM

However, one should not assume that the spread differential among EM corporates is due to worse credit quality. Deleveraging across the sector in recent years brought net leverage down to about 1.6x from a recent peak of 1.9x in 2015, and EBITDA margins remain near their recent highs (see Figure 2). By contrast, the U.S. investment grade and high yield sectors posted net leverage ratios of 2.2x and 3.3x in the third quarter of 2018.[1] The deleveraging in the EM corporate sector has contributed to a relatively low default backdrop with expectations for a 2.2% default rate in 2019, compared with expectations for a U.S. high yield default rate of 1.5%, which would be below the long-term high-yield average of 3.0-3.5%.[2]

Figure 2: The Recent Decline in EM Corporate Net Leverage Amid Solid EBITDA Margins



Source: J.P. Morgan as of June 2019. For illustrative purposes only.

While the spread and deleveraging metrics support a relative-value case for emerging market corporates, the myriad idiosyncrasies across the asset class also create inefficiencies that managers with local knowledge and extensive experience analyzing EM corporates can exploit. The following points touch upon some of these idiosyncrasies and the subsequent examples demonstrate how an active manager may navigate these nuances in search of alpha-generating opportunities.

The Idiosyncrasies

Presence of the State: A significant difference between the developed market and emerging market corporate sectors is the outsized presence of state-owned companies in emerging markets. Indeed, more than 40% of the benchmark CEMBI Index is comprised of state-owned companies, and the concentration can be even higher in certain countries, such as China, where more than 60% of the index eligible debt originates from state-owned enterprises. In addition to cases of weak reporting, infrequent information flows—including lack of investor calls—evaluating companies with state ownership requires a careful analysis of politics and policies within the respective country. The following example of the Mexico City Airport Trust demonstrates how the state can affect an EM corporate bond investment.

Varying Inflation: Inflation in some EM countries is very high, which injects another layer of complexity when analyzing financial information. For example, the inflation rate in some countries, such as Argentina, is so high that hyperinflationary accounting measures are needed.

Organizational Complexity: EM corporate organizations tend to be complex and multi-layered, possibly consisting of tens or even hundreds of subsidiaries. The complex corporate structures are the result of corporate tax planning strategies or, in certain cases, attempts to obfuscate actual shareholders and/or corporate owners for specific reasons, such as safety concerns. The following example of a bond offering from Aabar Investments demonstrates a complex organizational structure.

Governance Questions: Corporate governance is another important consideration of investing in EM corporates. The independence of the Board of Directors varies and may depend on whether the company is state owned, privately owned, or publicly owned and listed on a stock exchange. Listed companies generally have better corporate standards due to the exchange's listing requirements. Another frequent governance issue is that EM corporates tend to transact with related entities more frequently than their DM counterparts.

[1] Sources: The U.S. investment grade net leverage ratio is J.P. Morgan, and the U.S. high yield net leverage ratio (ex-commodities) is BofA Merrill Lynch Global Research.
[2] Source of the default rates is J.P. Morgan.

Debut Issuers: The EM corporate sector continues to grow rapidly—more than doubling in size over the last several years from $860 billion in 2011 to $2.2 trillion by the end of 2018.[3] As such, issuance from debut issuers continues to grow, and for these newcomers, historical data, performance throughout a credit cycle, and general track record can be non-existent or difficult to find, thus adding a challenge to the credit analysis.

Accounting Standards: Although there has been progress in terms of improving accounting standards and transparency over the last decade, EM companies still present accounting challenges as some still follow local accounting regimes rather than International Financial Reporting Standards. For example, Mexican companies often do not report a statement of cash flow with their results, instead they may be required to do so only in their filings with the Mexican Stock Exchange, which are frequently only in Spanish. In addition, some Latin American countries, such as Chile, still use the direct method of accounting in the statement of cash flows, making it more difficult to identify changes in working capital and liquidity. Furthermore, the quality of footnotes and level of detail in many EM corporate financial statements varies by country and company. In certain countries, such as Russia, important corporate information is released primarily through the local media and not directly by the company. In addition to knowing the local language, the reliability and accuracy of such information must be carefully examined.

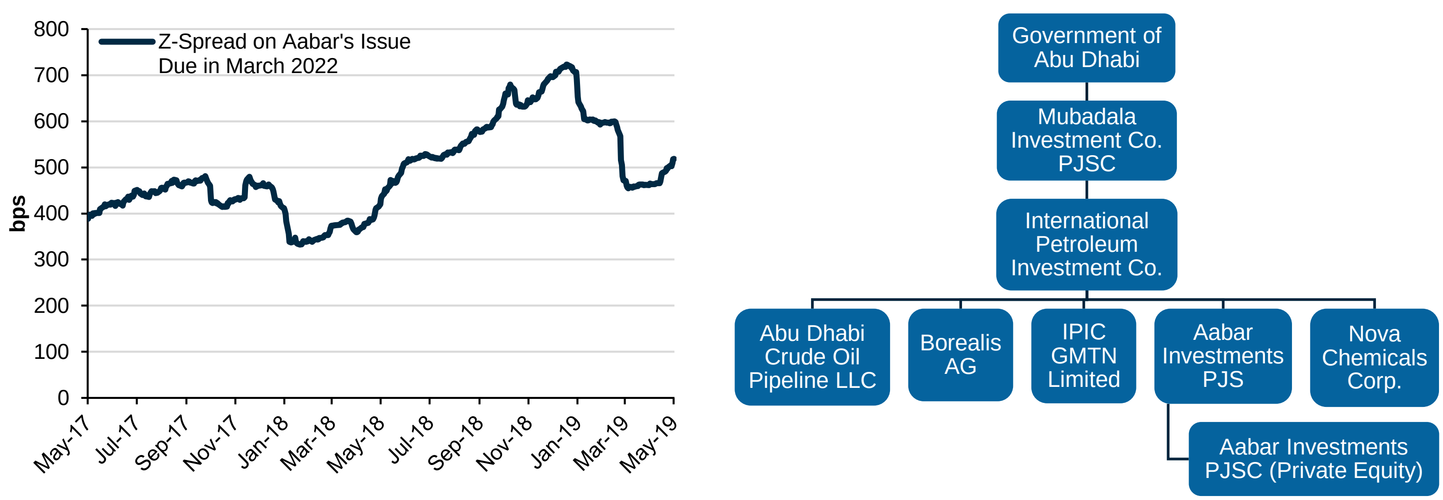
Challenging Comparisons: The historical information of EM corporates can be difficult to compare and establish a baseline. Indeed, some EM companies frequently change their functional currency, thus necessitating changes in their financial statements, and others don't always provide pro-forma statements to reflect M&A activity or large asset acquisitions or divestitures.

These features of EM corporates often add a degree of difficulty to the fundamental credit analysis. Yet, the market's potential inability to recognize and navigate these differences can lead to periods of overreaction and, therefore, opportunity. Thorough bottom-up research and local knowledge is vital to uncovering those opportunities as the following case studies demonstrate.

Case Studies

Aabar Investments is a firm with holdings in several industries and a relatively complex organizational structure. It was founded by Sheikh Mansour in 2005, and in 2010, it was acquired by International Petroleum Investment Co. (IPIC), which holds Abu Dhabi's long-term strategic investments and is owned by Mubadala Investment Co., the country's sovereign wealth fund. Aabar has two outstanding euro-denominated bonds that are convertible into the equity shares of the Italian bank UniCredit.[4] The spread levels on these bonds appeared attractive (see Figure 3) and relatively cheap to peers for several reasons: i) they were issued by a non-rated private company (Aabar) with no stand-alone financials and only indirectly linked to the government; ii) one of Aabar's private investments is Zurich-based Falcon Private Bank, which was tarnished by the money-laundering scandal associated with Malaysia's 1MDB investment fund; iii) the bonds are "orphans" as they are not in the benchmark convertible bond index; iv) and there is a scarcity of Aabar news and financial information from IPIC and Mubadala.

Figure 3: Aabar Spreads Appear Relatively Wide Amid a Layered Organizational Structure



Source: Bloomberg and PGIM Fixed Income as of June 2019. For illustrative purposes only.

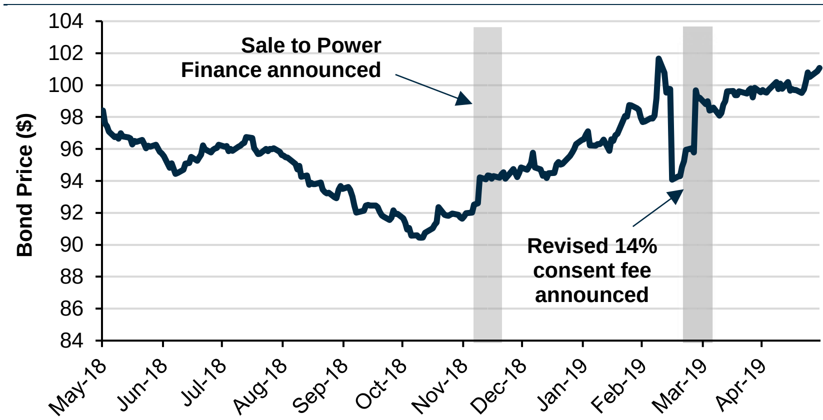
[3] Market size is based on J.P. Morgan's CEMBI benchmark.
[4] Aabar owns a 5% stake in UniCredit. The stake has an estimated market value of $1.3 billion.

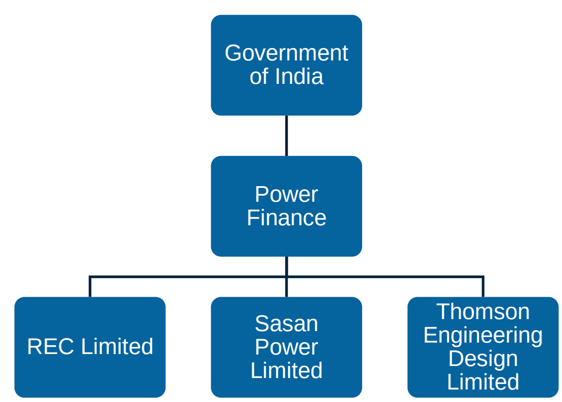
Given the complexities around Aabar, we used our experience in the region to form an investment opinion. Historically, going back to the regional real estate crisis of 2009, the government of Abu Dhabi has been very supportive to international bond holders. With that backdrop, we analyzed every IPIC financial report since 2010 to track the evolution of Aabar's assets, and we talked with local investors. We based our investment thesis on: i) Aabar's strong links to the sovereign; ii) Abu Dhabi's favorable track record of dealing with international investors; iii) the fact that IPIC continued to buy out Aabar's minority shareholders, thus indicating its support for the company; and iv) the relatively small size of the outstanding bonds as a percentage of Mubadala's balance sheet and the potential reputational damage to the sovereign fund if one of its firms were to default.

Power Finance and **REC Limited** are two majority government-owned entities that provide financing to India's power generating sector. The Indian government set divestment goals to help fund its fiscal deficit and announced that it would sell its stake in REC to Power Finance to raise around $2 billion. This triggered a change of control (CoC) clause in REC bonds as the government's effective stake dropped below 50%. A CoC clause is a standard bond covenant aimed at protecting investors from adverse changes in an issuer's ownership—e.g. in a leveraged, private-equity buyout—by granting bond holders the right to sell the bonds back to the new owners at par or a slight premium.

In an attempt to persuade bondholders to waive the CoC clause (stating that redeeming the bonds at par posed a cash drain), REC offered to pay investors 5% of the par amount of the outstanding bonds. The proposal amounted to the difference between where the bonds traded *after* the government's divestiture announcement (i.e. 95% of par) and the CoC put price (100%). However, the proposal failed to capture that these same bonds traded at about 80% of par *before* the sale announcement—a far cry from the 5% offered. Therefore, bondholders pushed back against the 5% proposal, demonstrating to the company that without the CoC clause the bonds would actually settle in the mid-80s after the transaction closed, hence warranting a larger consent fee. With the end of the Indian fiscal year rapidly approaching, the company agreed to pay a 14% of par consent fee, thus allowing bondholders, including PGIM Fixed Income, to benefit from the CoC protection originally structured into the bond.

Figure 4: Changes in REC Bond Prices Based on Change of Control Expectations with Its Sale to Power Finance



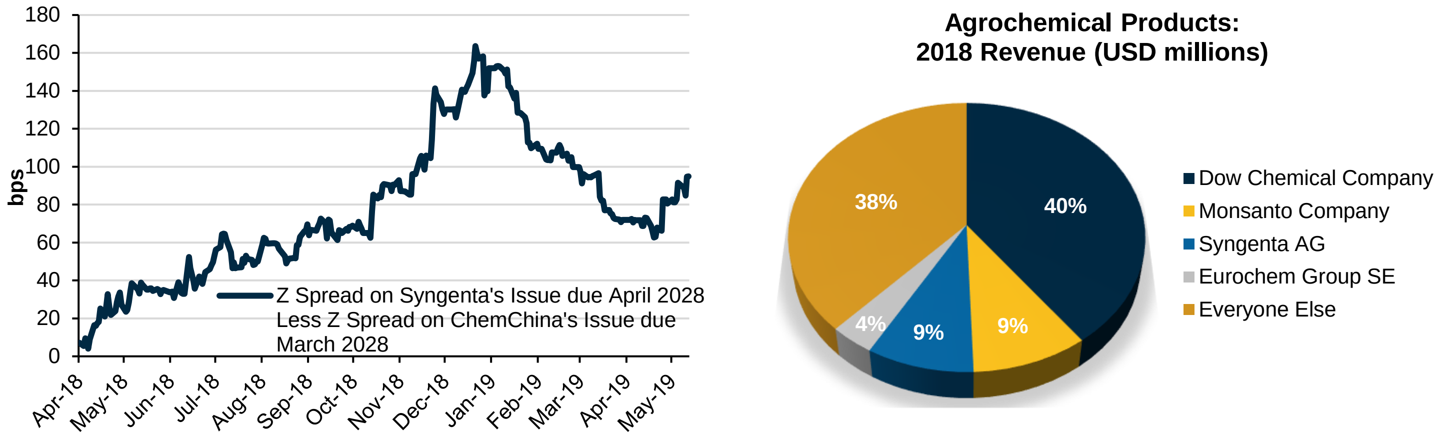


Source: Bloomberg and PGI Fixed Income as of June 2019. For illustrative purposes only.

Syngenta AG is a Swiss agrochemical company that was acquired by China National Chemicals Corp (ChemChina), a 100% sovereign-owned entity and the country's largest chemical company with interests spanning commodity, specialty, and agricultural chemicals. The $44 billion transaction was China's largest acquisition of a foreign company ever, thus taking on strategic importance given the size of the transaction and Syngenta's expected contributions to the firm's profit margins. Driven by an increase in leverage, Moody's downgraded Syngenta's credit rating to non-investment grade when the transaction closed. However, Moody's rating did not factor in any support from the Chinese government or, by proxy, from ChemChina. ChemChina subsequently provided tangible support for Syngenta by injecting funds from its own balance sheet to help Syngenta pay down $2 billion of a buyout loan.

We spoke to both companies to confirm ChemChina's level of support for Syngenta. Our research also provided comfort that Syngenta's liquidity profile gave it ample capacity before it would need further support. As the third-largest player in the global oligopolistic agricultural-chemical industry (see Figure 5), we felt that Syngenta's standalone credit strength had been overlooked by the market. Indeed, our thesis of solid support from ChemChina and strong standalone credit-strength played out as Syngenta's bond prices recovered nicely.

Figure 5: Syngenta Spreads Widened On its ChemChina Acquisition Despite Adequate Standalone Credit Quality as One of the World's Largest Chemical Companies

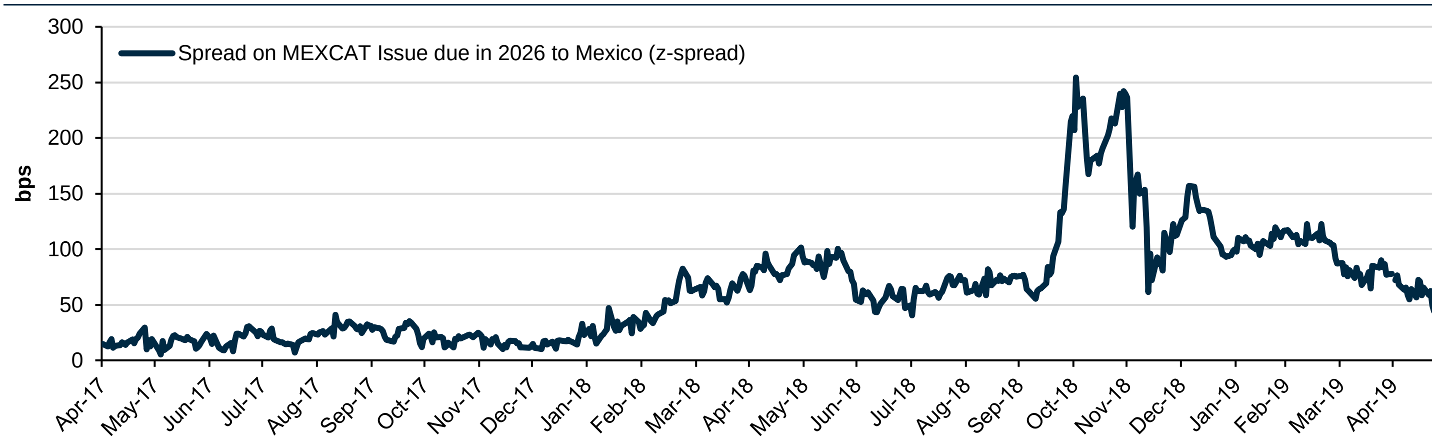


Source: Bloomberg and PGIM Fixed Income as of June 2019. For illustrative purposes only.

Mexico City Airport Trust (MEXCAT) is a 100% state-owned entity that was formed to raise capital for Mexico City's new international airport. In 2014, the Mexican government announced plans to construct the new airport as the existing facility was nearing capacity. The estimated cost of the new airport was $13 billion and would be funded by both public funds and via the capital markets. MEXCAT raised $6 billion of bonds secured by tariffs charged on passengers departing from the existing and planned airports. Mexico's newly elected president, Andrés Manuel López Obrador, opposed the new airport, and in October 2018, after a public referendum with the majority rejecting the construction, he cancelled the project after more than $3 billion had been spent.

Consequently, the new administration launched a tender offer for the MEXCAT bonds. Up to 30% of the bonds would be tendered at 90% to 100% of par value, and bondholders were asked to agree that the bond offering documents would remove references to the new airport for a minimal consent fee. Bondholders organized and wisely opposed the offer. A revised offer subsequently increased all tender prices to par. In addition, a "principal accumulation account" was established for the issuer to contribute $200 million annually for the repayment of the bonds either through tender offers, open market purchases, or at maturity. The MEXCAT investment case offers an example of poor economic decisions being made for political reasons. However, because the sovereign and its state-owned entities need ongoing access to the capital markets, MEXCAT bondholders were able to extract a favorable outcome, and MEXCAT spreads consequently recovered (see Figure 6).

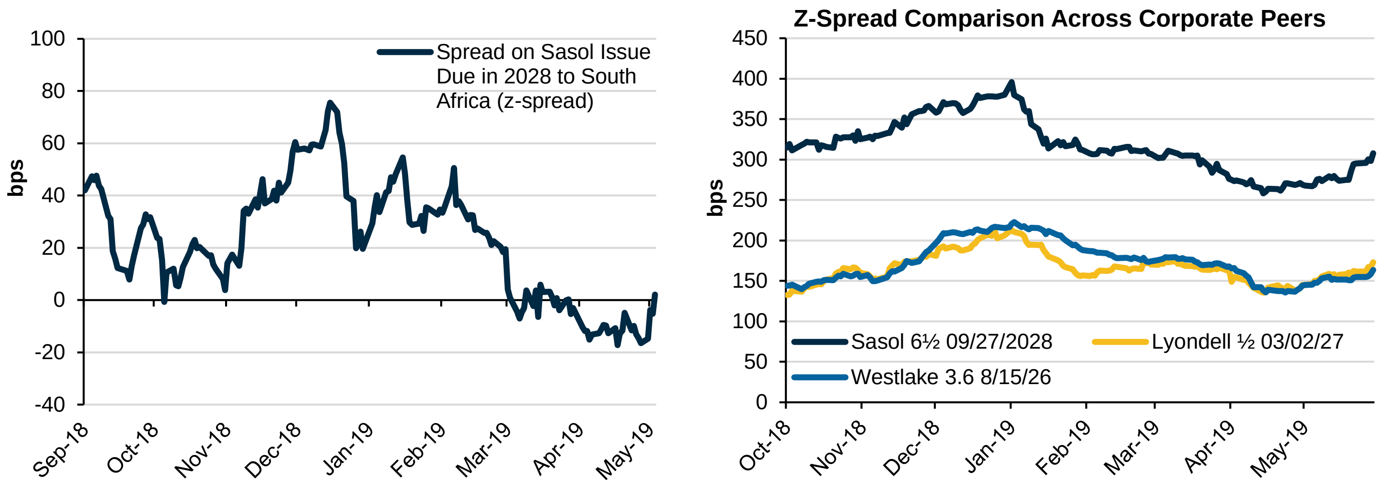
Figure 6: MEXCAT Spreads Recovered After Bondholders Organized and Elicited a Revised Tender Offer



Source: Bloomberg as of June 2019. For illustrative purposes only.

Sasol is a global leader in coal-to-liquids production. Over the years, the company expanded its South African operations to a global footprint to produce a wide range of fuels and petrochemicals. Currently, about 60% of Sasol's operating profit is generated in South Africa, and only 20%-30% is generated in developed markets, such as the U.S. and Europe. However, the company is in the final stages of investing over $12 billion to build a world-scale ethane cracker and derivatives plant in the U.S., which is set to begin operations in 2019. The company estimates that in three to four years, this complex will be generating roughly a quarter of its operating profit. At that point, the operating profit generated in the U.S. and Europe is expected to exceed the profit generated by its South African operations. South Africa has a volatile macroeconomic history, and the lower proportion of revenue generated in the country will lower Sasol's country risk. Despite its growing developed market presence, Sasol's bonds still trade with a South African-risk discount. As the U.S. chemical complex begins operating and generating profits, the trading discount should decline, and Sasol's bonds should appreciate in price and start trading in line with other large, international chemical producers (see Figure 7).

Figure 7: Although Sasol's Spreads Have Narrowed Relative to South Africa, Its Spreads Still Trade More Than 125 bps Wide of its DM Counterparts



Source: Bloomberg as of June 2019. For illustrative purposes only.

Conclusion

As investors' search for yield continues in an environment of historically low government rates and tight credit spreads throughout the developed markets, emerging market corporate bonds continue to provide opportunities for investors with extensive experience analyzing the nuances of the asset class, such as state ownership, organizational complexity, and varying accounting standards. The preceding case studies demonstrate how these nuances can affect the credit analysis process and how managers with the required research capabilities can capitalize on the idiosyncrasies in a rapidly expanding asset class.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 2019.

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; and (iii) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients as defined in Directive 2014/65/EU (MiFID II). In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012.

2019-2947