



How are emerging market corporates impacted by weaker domestic currencies?

October 2015

The diverse nature of the emerging market corporate universe means that an environment of weaker emerging market currencies is not necessarily a negative for all emerging market companies.

Much has been made of the impact of weaker emerging market (EM) currencies on the EM corporate debt universe in recent years. Many media articles and academic papers have been written on the topic, the majority of which come to the same conclusion – namely that weaker domestic currencies are negative for companies that operate in emerging markets.

The often-cited arguments are:

- Companies that have borrowed extensively in US dollars, yet have the majority of their revenues in local currency, face a currency mismatch when their domestic currency weakens versus the US dollar with the impact of an increase in leverage (net debt/EBITDA)
- Companies that also have a high proportion of their cost base in US dollars face margin compression (revenue – costs)

However, based on our extensive bottom-up research into all sectors in the EM corporate debt universe, we believe that in such an environment there are likely to be winners and losers. There will be companies that suffer from deteriorating credit metrics and ultimately default or restructure, but equally there are many companies that actually benefit from having a weaker domestic currency, e.g. commodity exporters.

As such, we believe that that risks associated with EM currency weakness are idiosyncratic in nature and not systemic.

Fig. 1 summarises the extent to which each sector in the JP Morgan CEMBI Diversified is affected by weak domestic currencies. At the sector level there is significant differentiation between sectors that are negatively affected, e.g. TMT and real estate, and sectors that are positively affected, e.g. oil & gas and metals & mining.

We believe that risks associated with EM currency weakness are idiosyncratic in nature and not systemic



Fig. 1 JP Morgan CEMBI Diversified sector breakdown

Sector	Index weight	Impact of local currency depreciation
Financial	30.9%	=
TMT	15.7%	-
Oil & Gas	14.0%	+
Utilities	8.6%	+
Consumer	7.5%	+ / =
Metals & Mining	7.0%	+
Industrial	6.1%	=
Real Estate	4.9%	-
Diversified	2.7%	=
Infrastructure	1.6%	= / -
Pulp & Paper	1.0%	+
Transport	0.2%	= / -

KEY:

- + credit fundamentals improve
- credit fundamentals deteriorate
- = credit fundamentals neutral

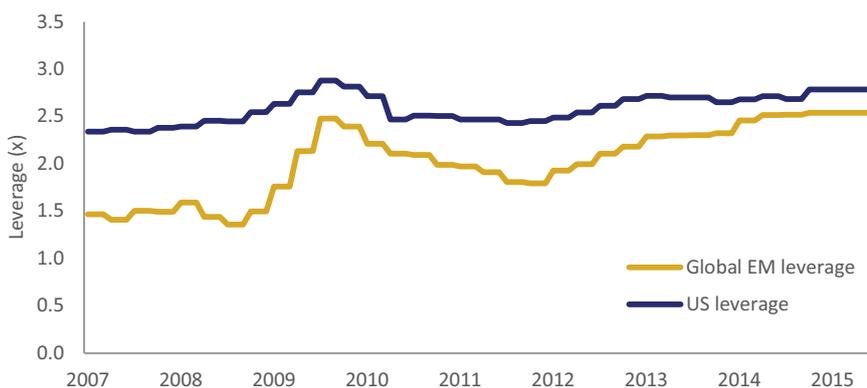
Source: JP Morgan, Bloomberg, BlueBay estimates, as at 28 September 2015. Conclusion reached based on a qualitative assessment by each analyst responsible for covering each of the respective sectors

Moreover, even within sectors significant differentiation at the individual company level exists. There are varying degrees of sensitivity to FX risk across companies in the same sector depending on the starting point of leverage, the proportion of US dollar debt outstanding, the hedging methodologies, refinancing needs etc.

Furthermore, we would also argue that although EM currencies have sold off across the board since 2012 — even by as much as 55% in the case of the Brazilian real — the impact on EM corporate fundamentals has been manageable. Leverage has increased slightly (~0.5x), albeit from a low base, and EM corporates are still less levered than their developed market counterparts (Fig. 2).

Although EM currencies have sold off across the board since 2012, the impact on EM corporate fundamentals has been manageable

Fig. 2 Leverage



Source: BAML, as at 31 August 2015

Although we are not oblivious to the obvious risks that weak EM currencies could present, we feel that it is not universally negative across the EM corporate debt universe. We believe that, if anything, it results in credit differentiation, which in our view underscores the need for thorough, fundamental, bottom-up credit analysis when investing in these markets.

The following highlights our views on the dynamics within each sector of the EM corporate universe (as represented by the JP Morgan CEMBI Diversified).

Financials

As a whole, the financial sector is one of the most heavily regulated and the impact of currency weakness varies on a country-by-country basis. While regulation limits direct open FX exposures at each bank, secondary asset quality effects can be felt through the corporate and retail loan book performance and loan book and funding mismatches. For example, the reporting of Turkish banks is transparent and the sector is well regulated, but the system has seen significant growth in FX loans to corporates and SMEs which are likely not hedged, leading to potential asset quality issues. This is compensated by adequate capitalisation of the banks. Similarly in Peru, while a high degree of dollarisation is present, the regulator has proactively encouraged de-dollarisation in the system and both the banks and the government have buffers in terms of capital and reserves to smooth the process of the depreciation of the Nuevo sol.

Technology, media and telecoms

The telecom sector is generally negatively affected by local currency devaluation. Revenues are almost entirely generated in local currency (other than roaming charges and some enterprise business), while a small element of costs will be US dollar-linked (e.g. roaming, but also some maintenance-related cost), so margins typically compress. Therefore, in terms of leverage, the risk depends on the extent of US dollar debt, which varies significantly by credit. There are other mitigating factors, like the stability of the respective currency, hedging policies, the starting level of leverage (which tends to be low), underlying growth in the business and ability to pass on the higher costs to the consumer.

All these points can vary between companies; for example, for Turkish telecoms a 50% devaluation could add 1.3 turns of leverage, but the starting point is only 1.3x. On the other hand, a Chilean telecom has fully swapped its debt into local currency so is only marginally impacted.

Oil & gas

Overall, most names in the sector have a positive exposure to devaluing FX as most revenues are in dollars whilst cash costs can be up to 60% in local currency, creating margin expansion in a stable commodity environment (or helping the companies deal with declining commodity prices, as is currently the case). Given the high dollar revenue base, capital structures are also weighted to dollars but, given the revenue mix described above, this remains more than manageable.

For this sector we believe the risk is much more from the declining cash-flows as a result of declining commodity prices, rather than the impact of local currency depreciation.

Utilities

Utility companies are typically well positioned in a declining domestic currency environment due to a number of factors. Revenues are often in dollars, in particular in Latin America, less so in Asia (typically 50% for the universe as a whole, closer to 75% for credits where we have exposure). FX is either explicitly passed on via tariffs or implicitly passed on as part of operation expenditure (typically fuel and cost of debt are denominated in hard currency). Consequently, as a result most of the utility space is well positioned.

Consumer

The impact on consumer companies varies greatly. Most of the food producers have US dollar export revenues that act as a natural hedge, while some of them have actively employed partial or full hedging strategies. A Brazilian beef exporter, for example, has over 80% of revenues in US dollars and has also actively hedged US dollar debt in Brazil, which is a significant cash windfall at the time of weakness in the real and decreasing leverage. On the other hand, supermarkets, white goods manufacturers and beverage companies have primarily local currency revenues, usually have unhedged US dollar debt and face some US dollar input costs that would mean margin compression. Anecdotally, year to date most companies have managed to mitigate the majority of this impact through price increases.

Retail in Peru for example, being quite vulnerable to a weaker local currency where a 25% move in the currency would increase their leverage by 0.6x, actually took action in the last 3–6 months to hedge over a third of their US dollar debt exposure.

Most names in the oil & gas sector have a positive exposure to devaluing FX as most revenues are in dollars whilst cash costs can be up to 60% in local currency

Metals & mining

This sector exhibits similar dynamics to oil & gas with the majority of companies reporting mostly dollar-based revenues with largely dollar-based capital structures and cash costs weighted to local currency. For steel companies there are three important factors to consider when analysing FX exposure. The first one is whether the company is vertically integrated to source its iron ore/scrap/coking coal domestically. If so, FX depreciation would be neutral/beneficial if exported. The second consideration is whether the company mostly supplies its domestic market or export market; if geared towards exports, it will be a beneficiary of FX devaluation. Thirdly, the debt stock in hard currency versus local currency, as the debt stock in US dollar terms would increase in case of FX depreciation. In 2H14 and 1H15, Russian steel producers saw the notable benefit of FX depreciation given that they are mostly integrated and geared towards exports.

Industrials

The industrial sector is a wide mix of companies, domestic businesses and exporters. For an exporter like an aluminium component producer, a 50% devaluation could reduce leverage by 0.7x. For domestic businesses like cement the impact is negative. In cement specifically, this is mitigated by the fact that typically all competitors are in the same position and hence price increases follow, raising EBITDA and limiting the impact on leverage.

Real estate

FX is problematic for most real estate companies because cash flows tend to be overwhelmingly in local currency. In China, despite being unhedged, we tend to see the highest concentration of US dollar debt at issuers with the highest ratings, and therefore credit profiles are robust for up to 30% declines in the renminbi, which is far more than most people expect. In addition, Chinese companies are currently actively refinancing in the local market, with proceeds being used to delever or reduce the cost of debt. In Indonesia, most developers are hedged, but hedges are very close to being exhausted, therefore we believe further losses from here would hurt credit metrics. Nevertheless, liquidity is strong and cash flows over the next 12–18 months are expected to be robust.

Infrastructure

For the construction companies in this sector we believe the impact would be negative, but companies typically have a natural hedge, i.e. local business is financed by local debt, while foreign business is priced in US dollars and financed in US dollars. For the ports, in most cases reporting is in US dollars and FX devaluation helps the margins, since tariffs are mostly US dollar-based or linked to US dollars versus local currency costs.

Pulp & paper

Generally we view companies in the pulp & paper sector as positively impacted by FX weakness through improved cost competitiveness, and exports comprise a large share of revenues. The pulp price in US dollar terms has also risen, driven by demand from China, and companies have seen improved margins on the back of this. These US dollar revenues balance the unhedged US dollar debt position.

Transport

This sector comprises government-owned railway companies in the Central Eastern Europe Middle East & Africa (CEEMEA) region, airlines in Latin America and structured bonds linked to airlines (enhanced equipment trust certificates, receivables backed financing). In our view the railway group is a loser in a deteriorating FX environment because typically >85% of revenues are in local currency versus 40–70% of debt is in hard currency. Therefore, although the income statement would be a small beneficiary given the local currency cost versus some foreign currency revenues, the impact on the balance sheet would be negative. That said, most of the government-related entities in the sector fully hedge their FX exposure.

For airlines in Latin America, the overall impact will depend on a share of US dollar revenues. Depending on this, the income statement could be neutral to an FX move. In terms of the balance sheet, most of the debt is in US dollars and therefore the impact will likely be negative. The structured bonds typically do not have FX exposure because the receivables/payments are denominated in US dollars.

FX is problematic for most real estate companies because cash flows tend to be overwhelmingly in local currency

The impact of EMFX is not universally negative across the entire EM corporate universe

This document is issued in the United Kingdom (UK) by BlueBay Asset Management LLP (BlueBay), which is authorised and regulated by the UK Financial Conduct Authority (FCA) and is registered as an investment adviser with the US Securities and Exchange Commission (SEC), and as a commodity pool operator and commodity trading advisor with the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). To the extent this document is accessible outside of the UK, it is issued by the following respective Bluebay entities or affiliates. In the United States, by BlueBay Asset Management USA LLC, which is registered as an investment adviser with the SEC and as an introducing broker with the NFA. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Hong Kong, by BlueBay Hong Kong Limited which is registered by the Securities and Futures Commission. In Australia, BlueBay is exempt from the requirement to hold an Australian financial services licence under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, BlueBay is not registered under securities laws and is relying on the international dealer exemption under applicable provincial securities legislation, which permit BlueBay to carry out certain specified dealer activities for those Canadian residents that qualify as "a Canadian permitted client", as such term is defined under applicable securities legislation. The document is provided for informational purposes only. It is not intended, nor should it be interpreted as investment, tax or legal advice. This document does not constitute an offer to sell nor is it a solicitation of an offer to purchase any security or investment product in any jurisdiction. This document is not available for distribution in any jurisdiction where such distribution would be prohibited and is not aimed at such persons in those jurisdictions. **Past performance is not indicative of future results.** BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. BlueBay is under no obligation to update the information in this document to reflect changes after the publication date. The information contained in this document is believed to be reliable, but BlueBay cannot and does not guarantee its accuracy, timeliness or completeness. No part of this document may be reproduced in any manner without the prior written permission of BlueBay Asset Management LLP. In the United States, this document may be provided by RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US"), a federally registered investment adviser founded in 1983. RBC Global Asset Management (RBC GAM) is the asset management division of Royal Bank of Canada (RBC) which includes BlueBay Asset Management LLP, RBC Global Asset Management (U.S.) Inc., RBC Alternative Asset Management Inc., and RBC Global Asset Management Inc., which are separate, but affiliated corporate entities. Copyright 2015 © BlueBay, is a wholly-owned subsidiary of Royal Bank of Canada and BlueBay may be considered to be related and/or connected to Royal Bank of Canada and its other affiliates. © Registered trademark of Royal Bank of Canada. RBC Global Asset Management is a trademark of Royal Bank of Canada. BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, partnership registered in England and Wales number OC370085. All rights reserved.

This article is only intended for distribution to institutional investors and financial professionals based in the US. This article is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any investment strategy and should not be construed as tax or legal advice.

Past performance is not indicative of future results. There can be no guarantee that any investment strategy discussed in this article will achieve its investment objectives. As with all investment strategies, there is a risk of loss of all or a portion of the amount invested. With respect to goals, targets, objectives, expectations and processes discussed in the presentation, there is no guarantee that such goals, targets, objectives or expectations will be achieved or that the processes will succeed. Any risk management processes discussed refer to efforts to monitor and manage risk but should not be confused with and does not imply no or low risk. The use of diversification within an investment portfolio does not assure a profit or guarantee against loss in a declining market. No chart, graph, or formula can by itself determine which securities an investor should buy or sell or which strategies should be pursued.

This article contains the opinion of the individual as of the date of the interview. Such views are subject to change without notice. Any securities mentioned may not be held in portfolio.

RBC Global Asset Management is the name used in the United States for certain investment advisory subsidiaries of the Royal Bank of Canada. RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US") is a federally registered investment adviser founded in 1983. BlueBay Asset Management LLP is authorized and regulated by the UK Financial Conduct Authority (FCA) and is registered with the Securities and Exchange Commission (SEC), the US Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). BlueBay Asset Management USA LLC is registered with the CFTC, SEC and the NFA. RBC Global Asset Management ("RBC GAM") is the asset management division of Royal Bank of Canada ("RBC") which includes RBC GAM-US, RBC Global Asset Management Inc., RBC Global Asset Management (UK) Limited, RBC Alternative Asset Management Inc., BlueBay Asset Management LLP and BlueBay Asset Management USA LLC, which are separate, but affiliated corporate entities. ®/™ Trademark(s) of Royal Bank of Canada. Used under license. © 2014 RBC Global Asset Management (U.S.) Inc.

Reprinted with permission.



**RBC Global
Asset Management**

