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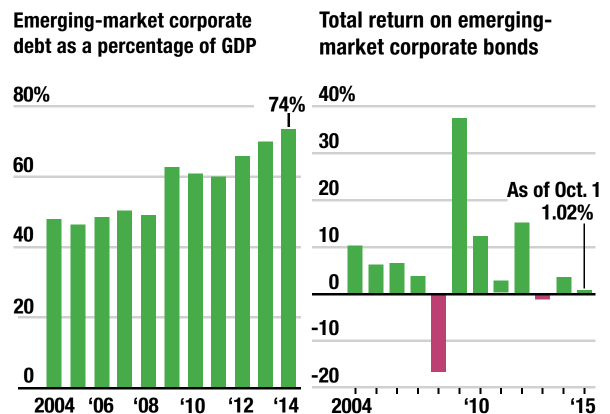
COMMENTARY

Emerging Market Debt: Another Test for the Financial Markets?

With oil hitting a 12-year low below $30 per barrel and with the volatility and decline of worldwide equities markets during the first weeks in January 2016, some are warning of a return to the bleak days at the beginning of the Great Recession.[1] In our April 2014 *Commentary* "High Yield Debt: Credit Bubble and Litigation Risks," we warned—perhaps presciently—that a credit bubble may be forming in the high yield debt ("HYD") market, including in the emerging markets ("EMs").[2] In particular, soaring debt levels in emerging markets such as China, Indonesia, Malaysia, Thailand, Turkey, and Brazil raised concerns about the risks associated with debt issued from emerging markets.[3] Over the past 18 months, this trend has continued,[4] and concerns about a potential bubble have intensified. The events of the last two weeks only add further credence to existing fears that the increasingly volatile HYD market will trigger another global financial crisis.[5]

In October 2015, the International Monetary Fund ("IMF") released a detailed report warning that as "advanced economies normalize monetary policy, emerging markets should prepare for an increase in corporate failures."[6] In the months following the IMF's warning, Standard & Poor's disclosed that global corporate default rates have reached their highest levels since 2009, with emerging market issuers representing approximately 20 percent of defaults in 2015.[7] At the same time, analysts report that over the course of the last four years, EM default rates have risen from .7 percent to 3.8 percent, while U.S. default rates have risen from 2.1 percent to 2.5 percent over the same period.[8] Some market participants anticipate that defaults will continue to rise in 2016.[9]

Emerging Fears



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This *Commentary* highlights the legal and economic challenges that financial institutions—particularly in their roles as underwriters and/or placement agents for EM debt offerings—may face in connection with emerging market debt as significant changes in the global economy continue to develop. This *Commentary* also suggests some steps a prudent institution may now undertake to prepare and protect itself against potential litigation that experience has shown often follows in the wake of the market downturns.

The Macroeconomic Environment Suggests a Bumpy Road Ahead

Over the past six to eight years, issuers in several emerging markets have taken advantage of the global search for yield to issue high yield bonds, often denominated in U.S. dollars or euros. Historically low global interest rates, a strong Chinese economy, and a strong commodity cycle all aided the rush to HYD issuers in the emerging markets. But now, a trifecta of macroeconomic developments portends a significant risk of corporate defaults and perhaps broader market disruptions as the U.S. raises interest rates, the Chinese economy falters, and the commodity cycle turns.

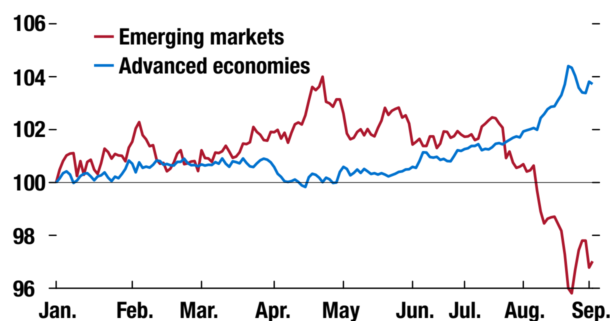
Rising Interest Rates. Rising interest rates will present substantial challenges in the high yield space as borrowing/refinancing becomes more expensive for speculative grade companies throughout the emerging markets. The U.S. Federal Reserve raised rates in December 2015, and further increases are anticipated. Normally, expectations of increased rates lead to higher bond yields, but yields on U.S. Treasury bonds have declined in recent months.[10]

A sustained increase in interest rates by the U.S. Federal Reserve would put downward pressure on high yield bond prices and undercut interest in this asset class.[11] A possible scenario might see investors pulling money out of emerging markets and driving up borrowing costs for local companies.[12] Higher interest rates in the U.S. may also prompt investors to shift their investments, in a so-called "flight to quality," that could hobble EM issuers looking to refinance.[13] Here, any sharp uptick in capital outflows could disrupt markets as a result of limited liquidity as investors are unable to find buyers for the bonds that they wish to sell.[14]

In Southeast Asia, the effects of an increase in interest rates could be especially acute. Foreign investors have engaged in much of the local currency lending, but those same investors are likely to pull their investments when interest rates rise.[15] Thailand, for example, already has high rates of indebtedness, and further rate movements by the Federal Reserve could lead to a higher speed of outflows.[16] The effects of this potential sell-off could be compounded by the large wave of maturities in the coming years from emerging market issuers that took advantage of cheap borrowing.[17] Recent high-profile defaults in the HYD market, including defaults by a high-profile Chinese real estate developer that was unable to make interest payments on its U.S. debt in April 2015, may contribute to growing investor concern about this market.[18]

The Strengthening U.S. Dollar. One immediate impact of these developments has been the relative strengthening of the U.S. dollar, resulting in higher debt service costs for a number of emerging market issuers. For example, high-profile speculative grade issuers in emerging markets such as South Africa, Turkey, India, China, the Philippines, and Indonesia have all sold dollar-denominated bonds in recent months.[19] Over the same period, the dollar has gained approximately 7 percent when compared with emerging market currencies over the last 12 months, and it has gained even more against the currencies of Brazil and Turkey.[20]

The Weakening of EM Currencies



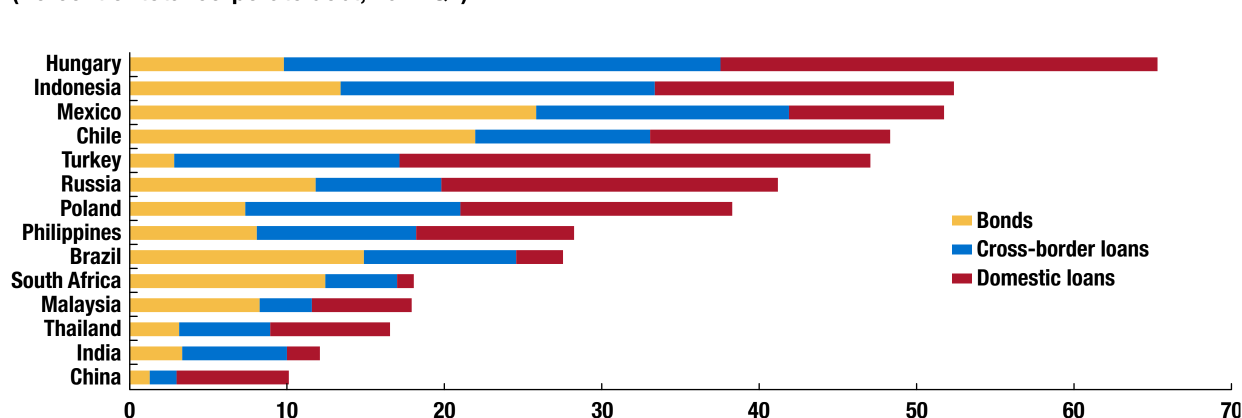
Source: IMF Global Stablity Report, October 2015, pg. 7 Figure 1.5

In Asia, issuers have tripled their foreign-currency debt from US$700 billion to US$2.1 trillion during the years between 2008 and 2014.[21] Risks from currency fluctuations are especially noteworthy in China, where a small group of property developers have, since 2011, accounted for US$41 billion of total outstanding HYD or 30 percent of all HYD in Asia.[22] In fact, these homebuilders have become the single biggest source of dollar-denominated HYD in Asia. With maturities and defaults looming, investors are justified in expressing concern. But these risks are further exacerbated in countries like Turkey and South Africa, where high external debt persists amid a dearth of U.S. dollar-denominated cash flow.[23]

Issuers that sell their services and products locally and whose revenues are in local currencies will be most exposed to exchange rate risks as a stronger dollar leads to more expensive interest payments on their dollar-denominated debt.[24] A significant change in currency values could lead to bankruptcies and defaults for companies that cannot manage this increased debt burden.[25]

Emerging Market Companies: Exposure to Dollar Strength and Commodity Prices

Foreign Currency Nonfinancial Corporate Debt
(Percent of total corporate debt, 2014:Q4)



Source: IMF Global Stability Report, Cotober 2015, pg. 7 Figure 1.5

Protective Measures: Managing Litigation Risks

The 2008 financial crisis has taught us that once the underlying collateral suffers distress and investors suffer losses, financial institutions will soon be facing lawsuits engineered by plaintiffs' attorneys to recover their clients' lost investments through litigation: asserting claims of fraud, negligence, incomplete/inaccurate disclosure, breach of fiduciary duties, and breach of contract.

As noted in our April 2014 *Commentary*, issuers, underwriters, dealers, and other participants in the HYD and emerging markets should review current practices and procedures, enhance those practices and procedures, and potentially adopt new practices and policies to protect against the consequences of a bursting of the HYD bubble. Now more than ever, institutions should ensure that proper safeguards and procedures are in place to protect against the litigation risks posed by any potential downturns in the market.

While participants in the emerging markets cannot fully insulate themselves from all the detrimental effects of a market failure, institutions that move early to install appropriate safeguards to identify, analyze, and address legal risks can minimize litigation exposure and maximize their ability to move forward toward full recovery and continued growth.

Four Steps You Should Consider Taking Now

1. **Assess Potential Exposure.** Underwriters and placement agents should begin now to investigate and assess potential exposure to claims asserted by investors in debt issued by emerging market companies. In light of the relevant statutes of limitations, the inquiry should target offerings over the course of the past six years. This assessment should focus not only on onshore transactions but also on offshore transactions that may result in litigation being filed in the U.S.
2. **Perform Due Diligence.** Comprehensive due diligence by both issuers and underwriters can minimize the likelihood that the negative consequences of changes in the macro environment will be a surprise. Understanding the details of an issuer's business model or the complexities of a structured product and how they will be affected by the many risks that are on the horizon is a crucial step in minimizing potential litigation.
3. **Prepare for Potential Litigation.** Institutions with clients around the world have to marshal an understanding of both U.S. law and the laws of multiple jurisdictions to prepare effectively for any potential litigation, particularly in the context of bankruptcy and insolvency proceedings in a wide variety of emerging market jurisdictions. In an accompanying *Commentary*, we discuss some of the issues presented. The risks highlighted above will affect global markets in different ways, requiring flexible responses and an understanding of multiple legal regimes.
4. **Engage Counsel Early.** Institutions should involve counsel during the earliest stages of any downturn in the market to analyze exposure, evaluate potential claims, and advise on sensitive internal and external communications. The speed with which modern markets move necessitates the creation of a dynamic strategy to deal with legal challenges long before they arise.

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