Emerging markets corporate bonds represent a growing and opportunistic segment of the overall emerging markets debt universe. A number of issuers are large, global, well-known companies in fast-growing countries, yet they are underrepresented in many international investors’ portfolios because they are not typically included in recognized benchmarks.

In recent years, emerging markets corporates have offered more attractive yields and higher returns than other fixed income sectors with similar credit ratings, while default rates have been on par or better than those of US high yield bonds. We look for this trend to continue for three key reasons:

- Supply Side: Growing Share of Emerging Markets Universe
- Demand Side: Expanding Investor Base
- Fundamentals: Improving Sovereign and Corporate Credit Quality

In this paper, we take a look at the evolution and characteristics of emerging markets corporate bonds and how they can add value either as a dedicated allocation or tactically in emerging markets debt, core plus, and other portfolios with credit exposure.

Evolution of the Emerging Markets Corporate Bond Market

Until the early 1990s, the emerging markets fixed income universe consisted primarily of government bonds of emerging markets countries issued in US dollars. Since then, this investment universe has developed and matured rapidly, lifted by fundamental improvements that made many emerging market economies the major drivers of global economic growth. Over the last decade, emerging markets governments successfully implemented disciplined fiscal and monetary policies that not only improved their credit quality, but also provided the necessary benign macroeconomic environment for the rapid growth of emerging market companies, as well.

The emerging markets corporate sector is comprised of corporate bonds denominated in hard currency, primarily US dollars, and in local currencies. The sector also includes quasi-sovereign bonds. Quasi-sovereign bonds are typically issued by companies in which the government owns a majority of the issuer’s voting shares. They are often considered strategically important to the sovereign entity but do not legally carry sovereign status for purposes of debt repayment.

Many emerging markets companies have large market capitalizations, increasingly transparent reporting, audited financial statements, and have their shares listed on global stock exchanges.
Supply Side: Corporates Are Growing Share of Emerging Markets Universe

The improving credit fundamentals of emerging markets countries over the past decade have decreased the need for many emerging markets governments to borrow in the external markets, thus shrinking the overall supply of sovereign bonds in the market. A parallel development has been the increase in emerging markets corporate bond issuance as companies increasingly tapped the public credit markets to finance growth and to expand activities.

Today, corporate bonds have become a major part of the broader emerging markets investment universe. Emerging markets corporate debt denominated in US dollars stood at $709 billion at year-end 2010, more than half the size of the total emerging markets sovereign debt universe, at $1.3 trillion, according to JP Morgan. As illustrated below in Figure 1, corporate issuance has steadily surpassed emerging markets sovereign issuance each year since 2003, reaching a record $211 billion in 2010.

![Figure 1](image)

**Figure 1**
Emerging Markets Debt – New Issuance
Sovereign and Corporate Debt (in $USD)
2000-2010


The emerging markets corporate sector has been increasingly populated by leading international companies across a wide variety of industries. The immense global demand for natural resources, and the rich endowment of many developing countries with valuable commodities, have made many emerging markets companies global powerhouses.

For example, Codelco, in Chile, is the largest copper producer in the world. JBS, in Brazil, is among the world’s largest meat producers. Fibria, also in Brazil, is the world’s largest pulp producer. In Peru, Copeinca is a global leader in the production of fishmeal and fish oil, while Petrobras is a global leader in offshore oil exploration. Gazprom, in Russia, is among the largest natural gas producers worldwide.

Emerging markets countries are home to five of the top 20 car manufacturers, three of the top 10 beverage producers, and five of the top 20 technology companies. China is home to the world’s largest bank, as measured by market capitalization.

**Emerging Markets Corporate Debt Top 10 Issuers**
*(JP Morgan CEMBI Broad Index)*

<table>
<thead>
<tr>
<th>Name</th>
<th>Country</th>
<th>% of Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hutchison Whampoa</td>
<td>Hong Kong</td>
<td>4.5</td>
</tr>
<tr>
<td>Gazprom</td>
<td>Russia</td>
<td>3.9</td>
</tr>
<tr>
<td>Petrobras</td>
<td>Brazil</td>
<td>3.5</td>
</tr>
<tr>
<td>Vale</td>
<td>Brazil</td>
<td>2.9</td>
</tr>
<tr>
<td>America Movil</td>
<td>Mexico</td>
<td>2.5</td>
</tr>
<tr>
<td>Abu Dhabi Nat Energy</td>
<td>Abu Dhabi</td>
<td>2.1</td>
</tr>
<tr>
<td>VTB Bank</td>
<td>Russia</td>
<td>1.9</td>
</tr>
<tr>
<td>Ras Laffan</td>
<td>Qatar</td>
<td>1.8</td>
</tr>
<tr>
<td>TNK BP</td>
<td>Russia</td>
<td>1.6</td>
</tr>
<tr>
<td>DBS Bank</td>
<td>Singapore</td>
<td>1.5</td>
</tr>
</tbody>
</table>


*Provided for discussion purposes only. Does not constitute a recommendation regarding the merits of investing in the debt of any of the issuers referenced. This does not constitute investment advice and should not be used as the basis for any investment decision. Does not constitute a representation that Prudential Fixed Income has purchased or would purchase any debt of the issuers referenced or that an investment in any debt of such issues would be profitable.*
Corporate Issuance Outpaces Sovereign Debt in Several Large Emerging Economies

The supply of corporate debt outstanding has already surpassed sovereign debt outstanding in several larger, more established emerging economies such as Russia, Brazil, and Chile. In Kazakhstan, corporate and quasi-sovereign issues are the only securities available for investors who want exposure to this country, as there are no sovereign bonds outstanding. Given the increasing amount of corporate versus sovereign new issuance, we expect emerging markets corporate debt to surpass sovereign debt levels in several other developing countries, such as China and South Korea, in the next several years. This will further expand the depth and liquidity of the sector.

![Figure 2](image)

Emerging Markets Debt – Outstanding Debt

**Sovereign and Corporate Debt by Country (in $USD)**

*As of November 30, 2010*

![Chart showing the comparison of sovereign and corporate debt by country.](chart)

*Source: JP Morgan. *Kazakhstan has no sovereign debt outstanding.*

Emerging markets corporate debt is well diversified globally across regions. Not surprisingly, total debt issuance declined sharply during the financial crisis in 2008, but has since rebounded to near pre-crisis levels. In 2010, corporate issuance was dominated by companies in Latin America and Asia. The relatively new markets of the EMEA region, which had expanded rapidly from 2000 to 2008, declined sharply in 2009 but are expected to trend higher again as the global economic recovery gains momentum.

![Figure 3](image)

Emerging Markets Corporate Debt Issuance by Region

**2000-2010**

![Chart showing emerging markets corporate debt issuance by region from 2000 to 2010.](chart)

Demand Side: Broadening Investor Base Fuels Demand for Corporate Bonds

Non-traditional emerging markets investors, such as hedge funds and “crossover” investors (those investors who do not have emerging markets corporate bonds in their benchmarks) have become significant buyers in recent years, drawn to the attractive yields and better risk-return characteristics of the sector. Historically, demand from these investors was opportunistic, largely dependent on market conditions and investors’ appetite for riskier assets. Now, they have become an ever-present source of demand. In 2010, we estimate that crossover investors accounted for about 20% of total new issue demand and, for certain investment grade issues, close to 50%. As illustrated below, emerging markets corporate bonds comprised 27% of crossover portfolios and 30% of assets in other non-traditional portfolios.

Table 1
Estimated Allocation of Emerging Markets Corporate Bonds in Institutional Portfolios
March 31, 2006 to September 30, 2010

<table>
<thead>
<tr>
<th></th>
<th>Mar-06</th>
<th>Nov-07</th>
<th>Sep-08</th>
<th>Sep-09</th>
<th>Sep-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dedicated EMD Investors</td>
<td>7%</td>
<td>12%</td>
<td>16%</td>
<td>15%</td>
<td>19%</td>
</tr>
<tr>
<td>Crossover Investors</td>
<td>10%</td>
<td>25%</td>
<td>19%</td>
<td>10%</td>
<td>27%</td>
</tr>
<tr>
<td>Other (hedge funds, sovereign wealth funds, etc.)</td>
<td>12%</td>
<td>18%</td>
<td>19%</td>
<td>14%</td>
<td>30%</td>
</tr>
<tr>
<td>Total</td>
<td>8%</td>
<td>8%</td>
<td>17%</td>
<td>15%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Source: JPMorgan. ¹$USD portfolios.

Recently, we have also seen growing demand from retail investors, particularly in Asia and Latin America. We expect this trend to continue for the foreseeable future given the healthier balance sheets and growth prospects for emerging markets countries relative to those of more developed countries.

The Establishment of Market Benchmarks Supports Growth of Dedicated Portfolios

In response to the tremendous growth in the emerging markets corporate sector, several banks have developed, or are in the process of developing, emerging markets corporate bond indices to measure the performance of liquid corporate bonds by country, credit quality, and maturity. Among the most widely known indices are the JP Morgan Corporate Emerging Markets Bond Index (CEMBI) and the Credit Suisse Emerging Market Corporate Index (CS-EMCI). Both indices were introduced in late 2007.

Table 2
Portfolio Assets Under Management Benchmarked Against Emerging Markets Debt Indices
2009-2010

<table>
<thead>
<tr>
<th>Emerging Markets Debt Indices</th>
<th>Jan-09</th>
<th>Jan-10</th>
<th>Dec-10</th>
<th>Index Market Capitalizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard Currency Sovereign Debt</td>
<td>$198,621</td>
<td>$231,333</td>
<td>$356,858</td>
<td>$403,477</td>
</tr>
<tr>
<td>EMBI Global and Global Diversified</td>
<td>171,421</td>
<td>211,783</td>
<td>342,058</td>
<td></td>
</tr>
<tr>
<td>EMBI+</td>
<td>27,200</td>
<td>19,550</td>
<td>14,800</td>
<td></td>
</tr>
<tr>
<td>Local Sovereign Debt</td>
<td>35,865</td>
<td>62,319</td>
<td>79,176</td>
<td>1,469,000</td>
</tr>
<tr>
<td>GBI-EM Global Diversified and Diversified</td>
<td>23,558</td>
<td>51,728</td>
<td>66,766</td>
<td></td>
</tr>
<tr>
<td>Other GBI-EM Indices¹</td>
<td>12,307</td>
<td>10,591</td>
<td>12,410</td>
<td></td>
</tr>
<tr>
<td>Hard Currency Corporate Debt</td>
<td>-</td>
<td>7,187</td>
<td>17,206</td>
<td>346,739</td>
</tr>
<tr>
<td>CEMBI Broad Diversified</td>
<td>-</td>
<td>6,187</td>
<td>12,092</td>
<td></td>
</tr>
<tr>
<td>CEMBI Diversified</td>
<td>-</td>
<td>1,000</td>
<td>4,530</td>
<td></td>
</tr>
<tr>
<td>CEMBI Broad</td>
<td>-</td>
<td>-</td>
<td>584</td>
<td></td>
</tr>
<tr>
<td>Local Currency Money Markets</td>
<td>-</td>
<td>10,800</td>
<td>13,593</td>
<td>20,060</td>
</tr>
<tr>
<td>Total</td>
<td>245,286</td>
<td>314,432</td>
<td>473,300</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: JPMorgan. As of December 31, 2010. ¹Other includes JPMorgan GBI-EM, GBI-EM Global, and GBI-EM Broad Index.
As the table above illustrates, assets under management benchmarked against the JP Morgan corporate indices more than doubled in 2010, to $17 billion. This amount is still quite small compared to the $357 billion of institutional portfolio assets benchmarked against the JP Morgan hard currency sovereign family of indices. Even so, the establishment of market indices dedicated to emerging markets corporate debt, the recent growth in assets of portfolios managed against these indices, and the sheer market value of these corporate indices ($347 billion as of December 31, 2010) suggests there is ample room for the continued growth of dedicated portfolios in this sector.

In summary, we believe the growing investor base for emerging markets corporate debt from non-traditional investors and dedicated portfolios should contribute to a further decline in the emerging markets corporate spread risk premium.

**Characteristics of the Emerging Markets Corporate Bond Sector**

The size of the emerging markets corporate bond market denominated in US dollars, including quasi-sovereign bonds, was $709 billion at year-end 2010, more than half the size of the US high yield bond market and five times larger than the European high yield market.

<table>
<thead>
<tr>
<th>Type of Corporate Debt</th>
<th>$ Face Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets Corporate</td>
<td>$709 billion</td>
</tr>
<tr>
<td>US High Yield Corporate</td>
<td>1.2 trillion</td>
</tr>
<tr>
<td>US Investment Grade Corporate</td>
<td>3.8 trillion</td>
</tr>
<tr>
<td>Euro High Yield Bonds*</td>
<td>140 billion</td>
</tr>
</tbody>
</table>

*Data for Euro high yield bonds is as of December 31, 2009.

**Structure is Similar to Developed Market Corporate Bonds**

Most emerging markets corporate bonds denominated in US dollars are similar in structure to developed market corporate bonds. They are typically plain vanilla, fixed rate bullet debentures with standard bond covenants comparable to investment grade or high yield US corporate bonds. For tax purposes, the typical structure in some jurisdictions, such as Russia, is a loan participation note which is different only in form from a plain vanilla debenture but in essence has the same risk characteristics. Recently, some Brazilian companies increased the issuance of perpetual notes to take advantage of the low interest rate environment and greater demand for attractive yielding securities. These bonds, however, tend to appeal more to retail investors than to institutional ones.

Emerging markets corporate bonds denominated in US dollars are typically issued under New York or English law and are accepted for clearance either through Euroclear or, in the case of 144A bonds, through the Depository Trust Clearing Corporation (DTCC), just like US corporate bonds. Some of the larger or quasi-sovereign emerging market companies are also included in various Barclays indices, including America Movil, Vale, Southern Copper, Endesa Chile, Pemex, and Petrobras.

**Diversified Across Countries, Industries, and Quality Ranges**

The hard currency emerging markets corporate bond market has evolved from a market dominated by Latin American companies, primarily Brazilian companies, to a global market spanning Emerging Europe, Middle East, Africa (EMEA) and Asia. It is geographically diverse, across both industries and quality ranges. This diversification expands the opportunity set for investors to select outperforming companies through careful bottom up analysis. It also offers opportunities to lower the volatility of portfolio returns.
Currently, the majority of emerging markets corporate bonds, nearly 70%, are rated investment grade (BBB or higher) by the major credit rating agencies, while 30% are high yield, non-investment grade companies. Not surprisingly, Asia, which has historically had a high percentage of investment grade sovereign issuers, also has the highest percentage of investment grade corporate issuers.

A Note About Local Currency Corporate Bonds

The local currency corporate market has also grown rapidly in recent years. Institutional investors in emerging markets countries — pension funds, investment funds, and leveraged buyers — searching for higher yielding alternatives to government bonds have supported the rapid evolution of a large local corporate market. Today, the local corporate market is estimated at $1.2 trillion in debt outstanding.¹ Unlike $USD emerging corporate bonds, however, the local corporate market is currently dominated by domestic investors and there are no standard market indices that formally measure the performance and characteristics of this sector.

¹Source: JP Morgan. Represents the $USD value of local currencies.
What Can Emerging Markets Corporate Bonds Offer Investors?

Attractive Yields and Superior Returns Relative to Alternative Credit Investments

Emerging markets corporate bonds — both investment grade and high yield bonds — have historically offered more attractive yields than fixed income sectors with similar credit ratings, despite the fact that many emerging markets issuers have similar or stronger credit fundamentals. The key reason for this yield disparity is the “sovereign debt ceiling” imposed by the credit rating agencies. The sovereign debt ceiling caps the credit rating of emerging markets corporate bonds to the credit rating of the country in which they are domiciled. As illustrated below, emerging markets investment grade corporate bonds offered +82 bps more yield over US Treasuries than similar-rated US corporate bonds, as of year-end 2010.

Figure 8
Investment Grade Emerging Markets and US Corporate Debt Historical Spread Levels Over US Treasuries
2002-2010

![Graph showing historical spread levels between investment grade emerging markets and US corporate debt over US Treasuries from 2002 to 2010.](image)

1 JP Morgan JLI Index. 2 JP Morgan CEMBI Index - Investment Grade.

Relative to BB-rated US high yield bonds, emerging markets BB-rated high yield corporates offered +37 bps more yield over US Treasuries as of year-end 2010.

Figure 9
High Yield Emerging Markets and US Corporate Debt Historical Spread Levels Over US Treasuries
2002-2010

![Graph showing historical spread levels between high yield emerging markets and US corporate debt over US Treasuries from 2002 to 2010.](image)

1 JP Morgan Developed Market High Yield BB Index. 2 JP Morgan CEMBI Index - BB.
Emerging Markets Corporate Bonds Have Outperformed Other Credit Sectors

To measure the risk-adjusted performance of emerging markets corporate bonds, we have used the JP Morgan emerging markets corporate index which has data available back to 2002. During this period, emerging markets corporate bonds have offered better risk-adjusted returns than US corporate bonds as measured by the Sharpe ratio, a performance measure that takes into account the volatility, or riskiness, of total returns. As Figure 10 below illustrates, the Sharpe ratios of both investment grade and high yield emerging markets corporate bonds were higher than those of similar-rated US corporate bonds during this period.

We believe there were two main factors driving this superior performance. First, the improving credit fundamentals of emerging markets companies and the robust demand for higher yielding assets by investors narrowed the yield spread of emerging markets bonds relative to the respective yield of sovereign bonds. And second, the improving fundamentals of emerging markets countries triggered multiple sovereign credit rating upgrades, which decreased the risk premium of owning emerging markets debt in general.

Although we don't expect the same speed and magnitude of yield spread compression to be repeated over the near-to-medium term, we believe that the risk premium, or yield spread, of emerging markets corporate bonds has room to compress further as this sector is still under-represented in many investors’ portfolios. The risk premium should decline as stronger inflows from traditional and non-traditional emerging markets investors are directed to the corporate market and corporate issuers are increasingly upgraded with sovereign credit ratings.

Figure 10
Emerging Markets Corporate Debt Returns Outpace US Investment Grade and High Yield Corporate Bonds
2002-2010


Many Corporate Bonds May Be Poised for Rating Upgrades

The creditworthiness of emerging markets corporate issuers has improved notably over the past decade. There are several reasons for the stronger fundamental profile of the corporate sector:

- **Sovereign Quality Has Improved**: Emerging markets governments implemented strict monetary and fiscal controls that led to stronger current account balances, lower debt levels, and higher quality profiles for many sovereign countries. Nearly 60% of emerging markets countries are now rated investment grade, up
from just 2% in 1993. We believe that as the fundamentals of emerging markets countries continue to improve, many of them will receive credit rating upgrades. In turn, the credit ratings of emerging markets companies domiciled in those countries may be subsequently upgraded. This was evidenced in 2010 when there were a total of 50 sovereign rating upgrades and only 11 rating downgrades. In contrast, 18 developed countries received ratings downgrades during the year, with zero rating upgrades.\(^1\)

- **Strong Growth Prospects:** Emerging markets countries represent a growing share of the world’s economic output, are rich in natural resources, and are projected to grow at a faster pace than developed countries at least for the next several years. The International Monetary Fund forecasts an average growth rate of 6.5% for emerging and developing economies in 2011 and 2012, vs. just 2.5% for advanced economies.

- **Stronger Global Practices for Governance and Regulation:** Momentum in the emerging corporate market has also been helped by significant improvements in corporate governance and regulation. Over the past 10 years, many emerging market countries adopted international accounting policies, high standards for corporate governance and regulation, and improved local bankruptcy laws. As emerging markets companies grew and expanded, many listed their shares on local and developed countries’ stock exchanges, a move that required them to follow higher governance and reporting standards. In addition, as the investor base grew, more companies were assigned credit ratings from the major rating agencies. These positive practices have improved the investment climate and transparency for investing in the sector.

- **Stronger Corporate Fundamentals:** Corporate issuers benefited from strong economic growth and more disciplined monetary, fiscal, and governance policies. In addition, issuers have been cutting leverage, extending maturity profiles, and diversifying funding sources. These measures have increased their ability to withstand adverse market conditions and service debt on a sustained basis.

As shown below, emerging markets corporate bonds experienced positive credit rating migration throughout 2010. In fact, the universe delivered consistently positive credit migration from Q3 2003 to 2008, until the global financial crisis. Rating upgrades began exceeding downgrades again in 2010 with 111 net rating upgrades for the year.

**Figure 11**

**Emerging Markets Corporate Debt**

**Net Credit Ratings Changes**

\((\text{Upgrades Minus Downgrades})\)

2004-2010

![Figure 11](image)


\(^1\) *Source: JP Morgan*
Lower Default Rates

Based on recent history, the default rate of emerging markets high yield corporate issuers has been lower than the default rate of US high yield issuers. Over the last 11 years, emerging markets corporate defaults exceeded US default rates only three times — in 1999 and 2002, due to major sovereign defaults, and in 2009, following the financial crisis. Generally, emerging markets corporate defaults move in tandem with sovereign defaults. This is because sovereign defaults are often followed by recessions, currency devaluations, and other factors that negatively impact the business environment. One can see below that corporate default rates fell sharply in 2010 as the global recovery took hold, with emerging markets high yield defaults declining to 1.3% from 11.5% in 2009.

### Table 4
Emerging Markets High Yield Corporate Debt vs. US High Yield Debt
Historical Defaults
1999-2010

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM Corp HY Debt</td>
<td>6.84</td>
<td>1.82</td>
<td>6.05</td>
<td>15.36</td>
<td>3.48</td>
<td>0.75</td>
<td>0.22</td>
<td>0.39</td>
<td>0.18</td>
<td>1.96</td>
<td>11.50</td>
<td>1.30</td>
</tr>
<tr>
<td>US High Yield</td>
<td>5.16</td>
<td>7.25</td>
<td>10.50</td>
<td>7.10</td>
<td>5.48</td>
<td>2.48</td>
<td>1.97</td>
<td>1.34</td>
<td>0.98</td>
<td>4.02</td>
<td>10.30</td>
<td>1.60</td>
</tr>
</tbody>
</table>


### Table 5
Emerging Markets Corporate Debt
Defaults by Region
2009-2010

<table>
<thead>
<tr>
<th></th>
<th>2009 Actual</th>
<th>2010 Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% of Total Outstanding</td>
<td>% of HY Outstanding</td>
</tr>
<tr>
<td>Total EMD</td>
<td>4.0%</td>
<td>11.5%</td>
</tr>
<tr>
<td>Asia¹</td>
<td>2.2%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Emerging Europe</td>
<td>8.5%</td>
<td>19.6%</td>
</tr>
<tr>
<td>Latin America</td>
<td>3.1%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Middle East &amp; Africa²</td>
<td>1.0%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

Source: JP Morgan. As of October 4, 2010
¹ Default estimates for 2009 are calculated based on the amount outstanding in the JP Morgan Asia Credit Corporate Index.
² 2010 estimates as a % of high yield calculated based on the amount outstanding, excluding non-rated issues.

While recent default data for emerging markets corporate debt has generally been positive, it is important to note that the sector does not have a long history of default data available, as US corporate bonds do, to fairly depict the long-term default characteristics of the sector.

### Favorable Recovery Rates

Comprehensive historical data on default recoveries for emerging markets corporate debt is also not currently available. However, the recent recovery history has been surprisingly positive.

Since the beginning of the recent financial crisis, the average recovery rate for senior unsecured emerging markets corporate bonds has been 51%.¹ This compares favorably with the average recovery rate of senior unsecured debt of US corporations of 53.3% in 2007, 33.8% in 2008, and 36.4% for the period 1982-2008.² Recent emerging markets sovereign default recovery rates, at 35%, have also been lower than those of emerging markets corporate bonds. Even over a longer period (1998-2006), average sovereign default recovery rates of 41% have been lower than the recent history of emerging markets corporate recovery rates.¹

(Source: ¹ING, ²Moody’s)
Despite the encouraging recent recovery history, investors should keep in mind that in many emerging market jurisdictions bankruptcy laws are new and untested, e.g. in China. In other emerging countries, a separate bankruptcy legal system may either not exist or may be weak and protective of debtors to the detriment of creditors. In Mexico, for example, intercompany debt has the same voting rights as external company debt. This feature has been recently challenged in Mexican courts but has been historically abused by some controlling shareholders of privately-held companies. In some countries, foreclosing on property used as collateral on defaulted debt may not be possible or is a very lengthy and arduous process, like in Kazakhstan. Thus, the bankruptcy process which functions as an important mechanism to resolve financial distress in developed countries poses one of the biggest challenges for international investors in emerging markets. Investors must be knowledgeable about all facets surrounding the bankruptcy and recovery process in each country. Active management and thorough bottom-up analysis are also essential to effectively manage these risks.

**Emerging Markets Corporate Bonds – Not Without Risks**

Investing in the bonds of emerging markets companies requires an integrated approach that incorporates two distinct analyses: a “top-down” analysis of the macroeconomic environment, political landscape, and institutional framework of a particular country, and a thorough “bottom-up” analysis of a companies’ credit fundamentals and trading value relative to the sovereign entity, as well as similar quality corporate bonds in other emerging and developing countries. We believe this two-pronged approach can help identify relative value opportunities and uncover many of the risks unique to this sector.

For example, compared to corporations domiciled in the US, a relatively larger portion of emerging markets companies are privately held, family-owned enterprises that do not have an extensive history of investor relations or communication with the financial markets. Publicly-available information about the history of these companies tends to be incomplete. Thus, regular meetings with senior management and access to local and/or unique sources of information are essential to understand a company’s philosophy, business strategy, and attitudes towards risk.

A thorough understanding of the macro-economic conditions of a particular country and its growth prospects is also essential, given that some emerging markets countries exhibit more volatile economic growth patterns than developed countries. Understanding each country’s central bank policy, political environment, institutional framework, regulatory environment, and local culture are part and parcel of the research process. Close attention to political processes and their implications for a particular industry and/or company also play a prominent role.

**Our View on the Emerging Markets Corporate Bond Market Today**

Overall, we remain optimistic about the growth prospects and fundamentals of emerging markets countries and corporate bonds. The technical backdrop is also improving steadily with an expanding investor base in search of higher yielding investments. Although liquidity is still below pre-financial crisis levels and prone to decline rapidly during periods of heightened market volatility, emerging markets corporate debt trading volume has been recovering steadily. The Emerging Market Traders Association estimates that trading volume for hard currency emerging markets corporate bonds was $203 billion in Q3 2010, up 16% year-on-year and comprising 44% of total hard currency emerging markets trading volume.

Near term, our Emerging Markets Debt Team is focusing on the following opportunities:

- **Quasi-Sovereign Companies and Commodity Producers:** Currently, we are finding value in quasi-sovereign companies and commodity producers in high-beta countries such as Russia and Kazakhstan. In Indonesia, we like mining companies. In the Middle East, we see value in quasi-sovereign companies with investment grade ratings, involved either in the oil and gas industries or with government mandates to develop the countries non-oil sectors.

- **Solid Companies in Countries with Diminishing Risks:** We believe several fundamentally solid companies in countries with diminishing sovereign risks offer relative value. These include select companies in the...
Ukraine, which recently received support from the International Monetary Fund, as well as Argentina, which has started negotiations to honor some of its defaulted debt. As the risk premiums in these countries decline in response to institutional reforms and better governance, we expect companies in these countries to outperform their peers.

- **Infrastructure:** We see longer term opportunities across the value chain in companies involved in Latin American infrastructure development, specifically construction companies in Brazil, and telecommunications companies in various other countries.

- **Pent-up Domestic Demand:** We favor companies in countries likely to benefit from pent up domestic demand, such as homebuilders in Mexico and property developers in China. We also like issuers in countries with a rising middle class and under-penetrated markets, including banks in Peru.

---

**Nick Ivanov, CFA**, is Principal and emerging markets credit analyst for Prudential Fixed Income's Credit Research Group. Mr. Ivanov follows high yield and investment grade emerging market corporate bonds in the Latin American and Europe, Middle East, and Africa (EMEA) regions. Prior to joining Prudential in 2008, he was a senior credit analyst for the Emerging Markets and US Investment Grade Groups at JP Morgan Asset Management in New York, and, earlier, a senior credit analyst for the European credit team at JP Morgan Fleming Asset Management, London. Previously, Mr. Ivanov was a senior credit analyst and a portfolio manager at Federated Investment Management Company, where he co-managed four global fixed income retail funds and six offshore institutional fixed income funds. Mr. Ivanov also held various positions in credit research and portfolio strategies for Westdeutsche Landesbank and Moody’s Investors Service. He received an MA in Philosophy from Sofia University, a Full Fellowship, Federal Ministry of Science and Research, at Vienna University, and an MBA in Finance from Columbia University. Mr. Ivanov holds the Chartered Financial Analyst (CFA) designation.
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 Prudential Fixed Income is prohibited. Certain information contained herein has been obtained from sources that Prudential Fixed Income believes to be reliable as of the date presented; however, Prudential 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. Prudential 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. 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. Past performance may not be indicative of future results. 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. Prudential Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of Prudential 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.

References to specific securities and their issuers are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such securities. The securities referenced may or may not be held in portfolios managed by Prudential Fixed Income and if such securities are held, no representation is being made that such securities will continue to be held.

Conflicts of Interest: Prudential Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. Prudential 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. Prudential Fixed Income affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. Prudential Fixed Income personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to Prudential 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 II of PIM’s Form ADV.