RBC Global Asset Management

Private assets in emerging markets

Overcoming the drawbacks of private equity through an exposure to illiquid credit

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"Investing in EM private loans can be a greater diversifier, offering higher returns and a better risk profile than EM private equity."

Given the potential for incremental returns and diversification, emerging markets private equity (EM PE) investments can be appealing. Yet the asset class is not without its challenges and outcomes can be enhanced with an allocation to EM illiquid credit.

EM PE investing can be a favoured way of meeting goals. These include 1) allocating patient capital to long-term strategies; 2) capturing enhanced returns via the illiquidity premium; 3) accessing unique investment opportunities not available on public exchanges; and 4) diversifying exposure to global markets.

However, investing in EM private loans can be a greater diversifier, potentially offering higher returns and a better risk profile than EM PE. Below we set out some of the key considerations for evaluating whether to enhance EM private market exposure with an allocation to EM illiquid credit.

Private equity versus private credit in EM

A successful PE strategy requires three fundamental drivers, but in EM there are risks to all three:

1. **Leverage of the equity portion through LBO debt, relying on credit suppliers (banks, funds etc.).** LBO debt is critical for returns but often unavailable in EM due to unsophisticated credit markets and limited alternative sources of credit.
2. **Exit opportunities via an IPO, sale to another PE firm or to an industry player.** These are limited in EM due to shallow equity capital markets and fewer buyers.
3. **Business value growth from purchase to exit.** In EM this can be dramatically reduced by local currency devaluation, high interest rates, capital controls, and taxes.

Few EM countries meet all three criteria above consistently, making EM PE strategies challenging. Success has been limited to specific country-focused strategies, particularly in EM investors' home markets where the FX risks are less pronounced.

We believe EM illiquid credit is a strong alternative to EM PE, offering the following advantages:

1. **No reliance on local banks or credit providers to leverage the private loan.**
2. **Exit is via contractual amortisations from the company's own cashflows.**
3. **Conservative underwriting (e.g. 2-4x leverage) allows companies to repay loans, even if business growth stagnates.**

Why illiquid credit is attractive in EM

Access to underserved markets

- Traditional banks are often unable or unwilling to lend due to regulatory constraints or perceived risks. Private credit investors can fill this gap, accessing opportunities across EM companies that may not be available to PE investors.
- Favourable supply/demand dynamics: a limited number of dedicated buyers keeps private loan pricing attractive.

Faster capital deployment

- Private loans typically require less due diligence and negotiation than PE, enabling faster capital deployment.
- Shorter durations (e.g. 3 years) compared to 7-10 years for PE.
- Amortising loans allow capital recycling within a fund's lifespan.

Differentiated return profile

- Private credit provides steady income through interest payments, unlike early stage PE/VC which doesn't typically produce income via dividends.
- Faster cashflow distribution versus the J-curve in PE.
- Floating rate structures protect against rate uncertainty, and lower leverage (2-4x) helps companies absorb interest rate hikes.

Controlled risk exposure

- Loans are senior in the capital stack to equity, providing higher claims on assets in case of default.
- Investors can access EM senior secured loans issued under robust legal frameworks, e.g. English law.
- Security packages are comprehensive across the various assets of the underlying borrower, which allows for selective enforcement on the issuer's assets (for example, a lien of a real estate asset can be enforced and sold off separately from the main manufacturing plant).
- With EM PE, investors bear the full risk of the operating currency. Private credit can focus on hard currency (e.g. USD) loans, avoiding local FX devaluation risks associated with EM PE. In our view, combining illiquidity with local currency can greatly increase the risks in holding private assets.

Return of capital

- Private credit returns rely on contractual obligations, not volatile market valuations or exit multiples.
- Investment performance is less dependent on growing the business since this would not be a requirement for the credit to perform.
- EM PE investors face risks from fluctuating valuations and unexpected regulatory or tax changes over time, eroding returns and reducing the capital returned to investors.

What to look for in an EM illiquid credit manager

Dedicated resources in EM

- Deep experience across public and private EM debt markets. This enables managers to have a strong understanding of the issuers and sectors and a clear picture of the illiquidity premium being captured so as to appropriately price the loans.
- Expert insight into sovereign risk, which significantly impacts EM credit.

Clear focus on risk management

- Investments in "national champion" companies with strong operations, minimal leverage, and solid interest coverage offer a more attractive risk profile.
- Hard currency, senior secured loans with comprehensive security packages and rigorous legal protections.
- Realistic exit strategy – amortising loans can mitigate some of the risk in relying on refinancing at the end of a fund's life.

Nimbleness and selectivity

- Ability to uncover niche deals with minimal competition from other investors.
- Diversification across geography, industries, and the capital needs of the issuer companies.
- Expertise in performing secondaries, new money, and stressed opportunities.
- Proven sourcing capabilities.

For more information on how we can help you with EM private markets investing contact marketing@bluebay.com

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