

# MORE YIELD FOR LESS CREDIT RISK IN EMERGING MARKETS (EM): DIVIDEND PAYERS OFFERING BETTER VALUE THAN CORPORATE BONDS

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Valuations in Emerging Markets appear dislocated. Against a deteriorating credit outlook, equities have been disproportionately selling off since H2 2015, with little movement in EM bonds (at least in Investment Grade). Now, amidst signs that decelerating growth in China may be bottoming, commodity prices stabilising, and evidence of some corporate balance sheet restructuring, deep value opportunities for EM equities have opened up. Income investors seeking yield may find EM equities a more compelling yield proposition in this environment for the following reasons:

- + Dividend yields are at a premium to corporate bond yields for liquid issuers in EM. Investors may be too bearish on equities.
- + On the other hand, default risk may not be fully priced-in. The discounted valuations of EM equities relative to EM corporate bonds should therefore close, with equities in favour if bond prices succumb to more pressure.
- + For many corporate bond issuers in non-financial sectors credit metrics are weaker than of dividend paying equities.
- + Deep value opportunities in commodity export-led regions and sectors can diversify the EM equity exposure and improve the risk-adjusted yield premium over corporate credit.

EM is regaining appeal with investors. Following a 15-year absence since it defaulted on its sovereign debt in 2001, Argentina has once again entered the bond markets with a \$16.5bn auction of long dated Eurobonds, yielding between 5% to 7%. So too has Saudi Arabia which is gauging the sentiment in the bond markets via a \$10 billion syndicated bank loan.

Why the sudden activity? [Muted expectations that the Fed will raise interest rates](#) is providing EM currencies with another shot in the arm. Add in stabilising commodity prices, and the revival in sentiment in energy and mining stocks, and EM is back on investors' radar screens. Investors who are in search of higher yield and income should ask themselves – and rightly so – if bonds still offer a better risk-adjusted yield proposition than equities.

## Credit at risk as downgrades surge

Underneath the veil of seemingly easing tensions in EM there are worries over the state of credit markets. While bond yields of quality issuers have barely risen, downgrades of corporate credit in EM are surging. As Chart 1 shows, with 292 downgrades vs 81 upgrades in Q1 2016<sup>[1]</sup>, the outright downbeat assessment is comparable to the height of the financial crisis in 2008 and 2009. Thus far in Q2 the ratio of downgrades to upgrades has already reached the extremes last seen in Q1 2009, with 77 downgrades

versus just 13 upgrades. At this rate there will be 300+ downgrades by the end of Q2 which, while short of an outright 2008 equivalent global financial crisis, is nonetheless set against gradual tightening monetary conditions in the US. It has therefore left dollar debt financed EM companies looking vulnerable.

Despite these headwinds, EM corporates continue to benefit from the benign impact on borrowing costs. Liquid USD denominated EM corporates have yielded around 5% to 6%, with average spreads to US Treasury yields hovering around 400 bps this year –not much higher than post the financial crisis. Set against the backdrop of surging downgrades equivalent to 2008 and 2009, this may suggest that unlike equity risk, credit risk is not fully priced in. Consider Russian energy and mining stocks, one of the worst hit segments in EM amidst crashing commodity prices in the start of the year. Many of these now offer prospective dividends that, compared to redemption yields on their senior unsecured investment grade rated Eurobonds, offer investors a yield premium. For example:

- + *Energy*: Gazprom's CHF quoted bond maturing in 2018 and issued at a 3.375% coupon yields 2.8% when held to maturity. At the same time, consensus expects Gazprom's stock to offer a 4.1 percent dividend yield in the next 12 months.
- + *Energy*: Lukoil's bond maturing in 2023 and issued at a 4.56% coupon yields 5.2%. Consensus meanwhile gauges the forward 12 month dividend yield for Lukoil's stock to be 6.1%.
- + *Materials*: MMC Norilsk Nickel's bond maturing in 2022 and issued with a 6.625% coupon currently offers a 5.3% yield to maturity. But at 8.1% expected dividend yields for the next 12 months, the stock offers one of the highest yields amongst Russian large-cap stocks.
- + *Communications*: MTS (Mobile TeleSystems) offers a 5% coupon on a corporate bond maturing in 2023 and a yield to maturity of 5.1%. However, the 12-month forward dividend yield on the stock is 8%

Investors' expectations of the equity market bailing out the bond market may likely explain the dislocation in cross-asset EM valuations. The restructuring of debt, through write-offs, interest and principle cuts and rescheduling, more often than not ends up taxing equity investors. History shows repeatedly that this is what happens when companies overextend themselves:

- + In the tech bubble the telcos such as BT in 2001 restructured £30 billion debt through cosmetic balance sheet deleveraging, ie through offering a deeply discounted £5.9 billion rights issue of 47% to its original share price to pay down debt. The dividend was cut by 59% in 2001 and by another 78% in 2002.
- + At the height of the financial crisis, Russia's largest corporate debt restructuring in history of the world's leading aluminium producer UC Rusal. The restructuring of \$17bn of debt owed to foreign and Russian lenders was accomplished through 1) the 25% equity stake UC Rusal held in mining giant OAO Norilsk Nickel and used as collateral for securing a \$4.5 loan from state-backed lender VEB and 2) a debt for equity swap with ONEXIM, which assumed \$1.8 billion of debt for 6% increase in UC Rusal common stock.
- + This year, ArcelorMittal offered to buy back \$2.7 billion in USD and EUR denominated bonds through a \$3 billion rights issue, which along with scrapping its dividend, divestitures and cost savings seeks to pay down its \$16 billion of debt.

### Better credit metrics for dividend payers

There is scope for equities in EM to do better in the context of not just the punishing discount many of the dividend paying stocks trade at relative to slower projected global growth, but also if assessed against the credit metrics. The charts below show how the degree of indebtedness, or leverage, and the dividend yield of stocks in WisdomTree's

dividend focused EM equity strategies compare to EM corporate issuers of liquid, investment-grade USD denominated bonds[2].

Chart 2 shows that on average, stocks in [WisdomTree Emerging Market Equity Income strategy \(ticker=DEM\)](#) have, relative to our EM corporate bond universe, lower levels of net debt to EBITDA and offer a higher yield than the liquid EM corporate bond universe. The lower financial leverage and higher yield premium is not skewed towards a select number of stocks but as the chart demonstrates, is across the non-financial sectors. Important to highlight is the lower leverage in the commodity-based sectors such as materials and energy in WisdomTree's EM Equity Income strategy, which at 1.8x and 1.9x Net debt to EBITDA, respectively, is significantly lower than 5.5x and 5.7x Net Debt to EBITDA in liquid EM corporates. While a lot of the high leverage in our EM corporate bond universe is driven by multiple issues of large tranches of bonds by PEMEX (Petróleos Mexicanos), even when excluding PEMEX from the energy bond universe, the average Net Debt to EBITDA of 3.8x still markedly exceeds that of WisdomTree's Equity Income Strategy. The yield premium of the non-financial sector also suggests the extent to which many of the established large-cap EM stocks have been beaten down after commodity prices troughed in March this year. The irony however is that, at least in WisdomTree's Emerging Market Equity Income Strategy, a biased weighting towards commodity exporters has helped several companies soften the cut to dividends as a result of the sharply depreciated currency. That move helped improve their export outlook and defended their dollar-based revenues.

Chart 3 shows a similar tale of higher yields and lower leverage for small-cap dividend payers in emerging markets, held within [WisdomTree's Emerging Markets Small-Cap Dividend strategy \(ticker=DGSE\)](#).

Within the EM small-cap dividend equity universe, Taiwanese IT stocks on average offer dividend yields of 6%, many of which have highly liquid balance sheets, with cash balances more often than not exceeding outstanding debt. Along with Consumer Discretionary, IT and Industrials, DGSE comprises almost 50% of cyclical sectors, making it not just an interesting yield proposition when assessed with the lower leverage against liquid EM corporate bonds, but also a secular play on Chinese infrastructure development, and the fast growing consumer services and technology sectors.

Therefore, positioning in emerging markets today to seek yield may mean assessing equity yield anew as, relative to corporate credit, too much bearishness may be priced into equity markets. While a weakening macro backdrop for EM equities appears justified given the deceleration in growth globally, the plunge in many of the established commodity export players has been disproportionate.

In particular, the deep discount of high dividend yielders, when assessed against credit metrics and compared to EM corporate credit, suggests that many high dividend yielders may now offer a better yield proposition. A dividend focused small-cap strategy can give investors a quality growth proposition alongside a yield premium. Capturing a broad basket of dividend payers to hone in on either high yielders or provide a quality screen on small-cap equities can provide investors a targeted approach to extract maximum value out of emerging markets today.

Investors sharing this sentiment may consider the following UCITS ETFs:

- + [WisdomTree Emerging Markets Equity Income UCITS ETF \(DEM\)](#)
- + [WisdomTree Emerging Asia Equity Income UCITS ETF \(DEMA\)](#)
- + [WisdomTree Emerging Markets Small-Cap Dividend UCITS ETF \(DGSE\)](#)

[1] Number of downgrades and upgrades are based on all ratings types by S&P

[2] Based on WisdomTree Europe's own research for screening the emerging markets corporate bond universe, using Bloomberg data.

View the online version of this article [here](#).

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