CBL Asset Management

Why Eastern European Corporate Bonds Are an Attractive Investment Alternative Within the Fixed Income Universe

By Andris Kotans and Edgars Lao[1]

Since there is no consistent definition of what represents Eastern European (EE) countries, it is useful to start this discussion by stating CBL Asset Management's (CBL AM) definition of Eastern European countries. To us the Eastern European investable universe covers large part of Eurasia – from the Czech Republic in the west to Kazakhstan in the East, from Turkey in the South to Russia in the North. Non-sovereign capital debt markets have been developed in 21 countries out of 30 that fall under CBL AM's definition for Eastern Europe. The latest country in the region that has entered the non-sovereign Eurobond market is Uzbekistan, as several SOEs have started to benefit from access to the international debt markets since late 2019.

Attractive Corporate Credit Fundamentals and Undervalued Credit Opportunities

The structural case for investing in Eastern European debt is primarily related to issuers' superior credit quality and attractive valuations. From a macroeconomic perspective, the region is less leveraged than other regions or countries in the developed and emerging markets. Plotting the aggregate public (government) and non-financial private (corporate) debt against the level of wealth (measured by GDP per capita), it is clear that richer countries (e.g., Switzerland, US and Eurozone) have higher ability to bear relatively higher debt to GDP ratios. On the other hand, poorer countries can borrow relatively less, as their debt service capacity is lower. Eastern Europe compares very well in this fundamental metric for debt investors, as it is significantly less indebted compared to the level of wealth (left chart). The same holds true from a microeconomic perspective. In fact, according to CBL AM's calculations, the region's corporates tend to be less leveraged than issuers in other emerging markets and in the developed markets' high-yield space (right chart).

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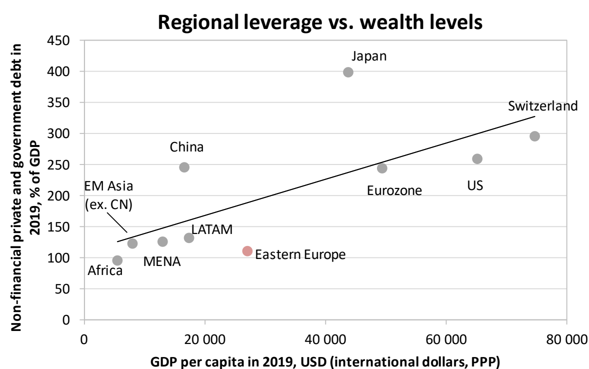
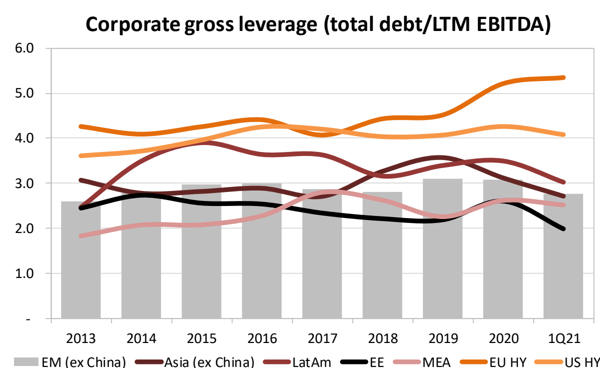
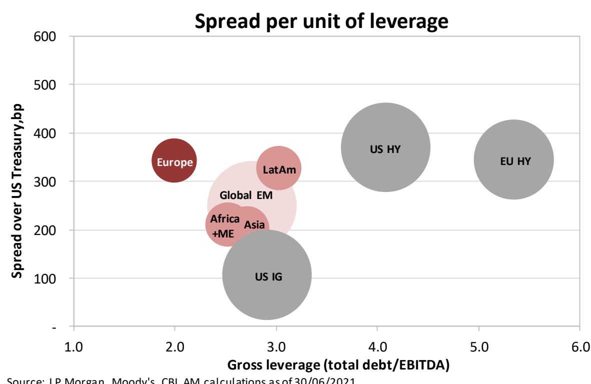




However, the fundamental position is only one side of the coin; the other is valuations. To illustrate both sides of the coin, asset managers are using spread-per-leverage metric that shows how much an investor is being compensated for taking credit risk (measured by total debt/EBITDA ratio for corporate issuers). In general, developed market high yield is the riskier segment given issuers' leverage and it is consistent with their lower credit ratings and thus higher risk premia or spread over risk-free US Treasuries. On the other hand, corporates in emerging markets are less indebted and have slightly lower spreads. At the same time, Eastern European corporate debt has the best from both worlds: it has the lowest risk and it provides one of the highest potential returns. As a result, Eastern European corporates have one of the best risk/return characteristics among other investment alternatives.

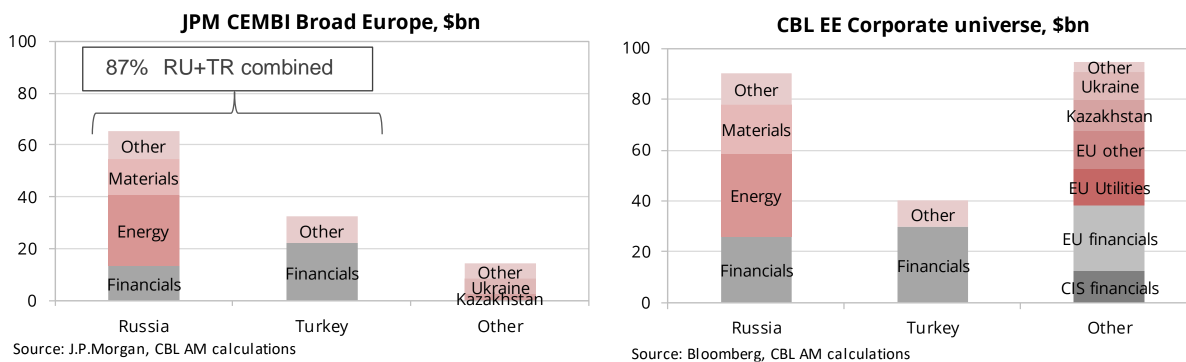


Poor Representation in EM Indices

Many bond fund managers are benchmarking their performances against chosen index; hence they tend to align their investment portfolios to the index's structure to reduce deviation in the performance. One of the most important features of a good benchmark is a proper representation of the broad market. The most popular index in EE corporate market is J.P. Morgan CEMBI Broad Europe. However, this benchmark currently covers only 14 countries in Eastern Europe amid restrictive inclusion criteria. The most attentive readers may have already noticed the problem of imperfect market representation by the index. Going more into details, J.P. Morgan CEMBI Broad Europe index covers only 81 issuers from 14 countries with an overall bond market value at $113bn. At the same time, CBL AM's Eastern European corporate bond universe[2] includes 190 issuers from 21 countries with the overall bond market value at $225bn. The lion's

[2] Universe selection run on the Bloomberg Terminal using such criteria: currency – EUR&USD; issue size - at least $100mn equivalent; excludes – convertible bonds and 144A series.

share of difference lies in the fact that the index includes only USD-denominated bonds, thus excluding EUR-denominated issues, which in many cases reflect the issuer's functional currency. Hence, in practice, the Eastern European bond market is broadly two times bigger than suggested by the index, creating under allocation to the Eastern European region by global emerging market bond investors that invest according to the index structure. In practice, the imperfect index composition creates several problems. First, looking at the index's geographical composition, the Eastern European Eurobond market appears significantly concentrated in just two countries as combined weight of Russia and Turkey constitutes almost 90% of total (left chart). Obviously, rational investors would not like to have such a high exposure in just two countries; hence they might exclude this region as a whole from their emerging market bond investments. However, the EE bond universe is much more diversified across countries, as Russian and Turkish corporate issuers represent even less than 50% of the overall count and around 58% of the market value in the universe (right chart).



Secondly, investors who choose to invest in Eastern Europe, would necessary allocate less than 10% of their global allocation into EM corporate debt, mimicking the region's share in the index. Considering that the investible market size is two times larger, this creates misallocations in capital markets. Overall misallocations in capital markets create mispricing in valuations. Put in simple words, over allocation creates excessive valuations and even market bubbles, while under allocation creates attractive valuations and, thus, investment opportunities. In contrast to equity investments, bond investors can profit from under allocation and attractive valuations even if these imbalances are persistent. By holding undervalued bonds till maturity, fixed income investors can extract excess return as they will receive the fixed amount of cash upon the maturity, while equity investors can realize the capital appreciation only if there is another investor that is willing to pay higher price.

Summary

In conclusion, the Eastern European debt market is a rapidly developing asset class covering a wide geographic area and is suitable for investments on a stand-alone basis. Eastern Europe compares well to other EM regions because of its relatively low debt burden and attractive valuations, translating into one of the best risk/return profiles among other investment alternatives. Currently, Eastern European debt is mispresented in the broadest and most popular global EM Corporate indices, creating undervalued investment opportunities. The good news is that early investors into this market can benefit from excess returns by holding undervalued bonds till maturity.

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