EM vs. DM debt: Why the ratings haircut?

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We have long postulated that Emerging Markets (EM) issuers with comparable credit metrics generally receive a lower rating per the standard agencies than developed market issuers. We further believe this contributes to the spread premium per credit notch of EM issuers when compared to comparably rated developed market issuers.

EM Corporate Fundamentals have been Superior to Developed Market Corporate Fundamentals per Rating

Net Leverage – Investment Grade													
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Asia	1.4x	1.4x	1.3x	1.5x	1.7x	1.8x	1.7x	1.5x	1.5x	1.3x	1.2x	1.6x	1.6x
Emerging Europe	0.7x	1.2x	0.7x	0.7x	0.8x	1.0x	1.1x	1.4x	1.8x	1.7x	1.1x	1.4x	2.0x
Latin America	0.8x	1.3x	1.0x	0.9x	1.4x	1.4x	1.8x	2.2x	2.2x	1.9x	1.5x	1.7x	1.7x
Middle East & Africa	1.6x	2.1x	1.7x	1.4x	1.1x	1.0x	1.0x	1.3x	1.7x	1.4x	1.2x	2.0x	2.0x
Global EM IG	1.1x	1.4x	1.2x	1.2x	1.4x	1.5x	1.5x	1.6x	1.6x	1.5x	1.2x	1.6x	1.7x
DM comps													
US HG	1.5x	1.5x	1.3x	1.3x	1.4x	1.4x	1.6x	1.9x	2.2x	2.2x	2.3x	2.4x	2.7x
European HG	2.8x	2.8x	2.5x	2.5x	2.6x	2.5x	2.5x	2.7x	2.9x	2.7x	2.6x	2.8x	3.4x

Net Leverage – High Yield													
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Asia	2.0x	2.0x	1.7x	2.0x	2.2x	2.4x	2.5x	2.9x	2.9x	2.6x	2.5x	2.9x	3.3x
Emerging Europe	1.3x	2.2x	1.5x	1.4x	1.7x	2.2x	1.7x	2.0x	2.4x	2.2x	1.8x	2.2x	1.8x
Latin America	1.2x	2.0x	1.8x	1.8x	3.1x	2.8x	3.3x	3.6x	3.5x	3.0x	2.5x	2.7x	2.6x
Middle East & Africa	0.5x	0.4x	0.4x	0.3x	0.5x	0.8x	1.4x	2.0x	2.4x	2.8x	2.3x	2.9x	2.4x
Global EM HY	1.4x	1.9x	1.6x	1.7x	2.2x	2.4x	2.6x	2.9x	3.0x	2.7x	2.4x	2.8x	2.8x
DM comps													
US HY	3.7x	4.0x	3.1x	3.1x	3.3x	3.4x	3.5x	3.7x	3.8x	3.6x	3.5x	3.6x	5.0x
European HY	5.4x	4.8x	3.8x	3.7x	3.7x	3.7x	4.1x	4.0x	3.7x	3.6x	4.6x	4.4x	6.0x

Source: J.P. Morgan, Morgan Markets Website as of 12/31/2020.

Generally, with EM issuers, we have found country ceilings providing downward pressure on ratings. We are noticing comparable volatility rates and lower net leverage for EM names both in the High Yield (HY) and Investment-Grade (IG) space, implying better credit metrics/credit health. We believe EM corporates are very much best of breed, with lower leverage and healthy EBITDA margins.

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Exhibit A:

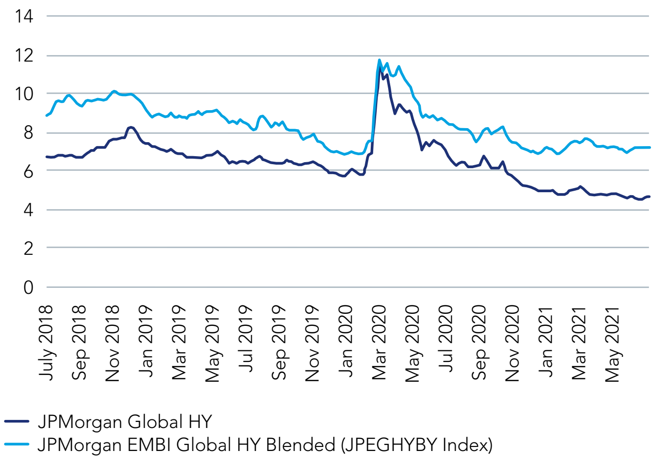
Historical Yield Advantage of EM Corporates

We have noticed…

Attractive yields – positive yield in a low yield environment

- Post the 2008 GRC, the fixed income universe has been dominated by QE and monetary easing.
- As a result, global yields have fallen sharply, and the traditional fixed income investors have had to search for yield.
- EMD is one of the few fixed income market segments that has delivered a positive yield with some cushion to movements in core rates.

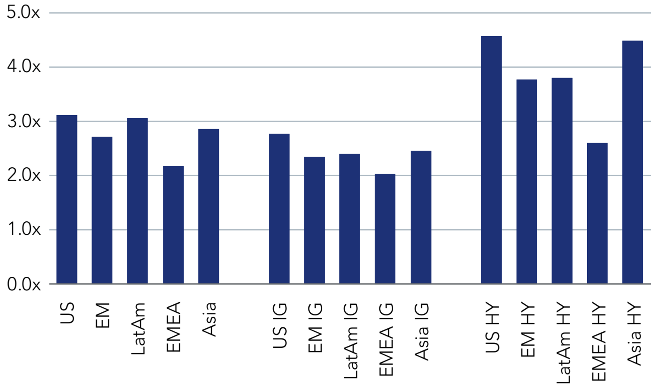
Figure 1. EM offers a compelling yield advantage



Source: J.P. Morgan, as of 7/23/21
Past performance is no guarantee of future results. For illustrative purposes only.

Exhibit B:

Figure 2. Net leverage (x)



Source: Bank of America, 6/30/2020

EMD is one of the few fixed income market segments that has delivered a positive yield with some cushion to movements in core rates.

Exhibit C

First Emerging Markets Oil Company Case Study

Emerging Markets (EM) Oil Company and Developed Market (DM) Oil Company Comparison

Rating factors Emerging Markets Oil Company (South America)				
Methodology: Energy, Oil & Gas – Integrated published on 31 Dec. 2020	**Current LTM (Dec-20)**		**Moody's Forward View Next 12-18 months (as of Mar-21)**	
Factor 1: Scale (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	2,507	Aa	2,735	Aa
b) Proved Reserves (Million boe)	8,796	Aa	8,796	Aa
c) Total Crude Distillation Capacity (mbbl/day)	2,176	Aa	2,176	Aa
Factor 2: Business Profile (20%)				
a) Business Profile	Baa	Baa	Baa	Baa
Factor 3: Profitability and Efficiency (10%)				
a) EBIT/Average Book Capitalization	9.28%	Ba	10.80%	Baa
b) Downstream EBIT/Total Throughput Barrels ($/bbl)	$1.70	B	$1.71	B
Factor 4: Leverage and Coverage				
a) EBIT/Interest Expense	2.74x	Ba	2.01x	Ba
b) RCF/Net Debt	33.25%	A	52.26%	Aa
c) Total Debt/Book Capitalization	59.14%	Ba	52.52%	Ba
Factor 5: Financial Policy (8%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Preliminary Outcome before Notching Factor		Baa2		Baa2
Factor 6: Constraints Related to Government's Policy Goals (0%)				
a) Government Policy Framework (Number of Downward Notches)	3		3	
Rating Outcome:				
a) Scorecard-Indicated Outcome		Ba2		Ba2
b) Actual Rating Assigned				Ba2

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	ba2
b) Government Local Currency Rating	Ba2
c) Default Dependence	Moderate
d) Support	Moderate
e) Actual Rating Assigned	Ba2

Total proved reserves and average daily production do not consider equity method investees. All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Moody's forward view does not represent the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestitures. Sources: Moody's Financial MetricsTM and Moody's Investors Service estimates

Scorecard Factors Developed Markets Oil Company (North America)				
Integrated Oil and Gas Industry [1][2]	**Current FY 12/31/2020**		**Moody's 12-18 Month Forward View as of March 2021 [3]**	
Factor 1: Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	3,460	Aaa	3,450 - 3,550	Aaa
b) Proved Reserves (Mmboe)	8,973	Aa	8,500 - 9,000	Aa
c) Crude Distillation Capacity (Mbbls/d)	2,750	Aa	2,700 - 2,800	Aa
Factor 2: Business Profile (25%)				
a) Business Profile	Aaa	Aaa	Aaa	Aaa
Factor 3: Profitability and Efficiency (10%)				
a) EBIT/Average Book Capitalization	1.90%	Caa	6% - 8%	Ba
b) Downstream EBIT/Total Throughput Barrels ($/bbl)	$8.1	A	$10 - $11.5	Aa
Factor 4: Leverage and Coverage (25%)				
a) EBIT/Interest Expense	1.3x	B	4x - 6x	Baa
b) RCF/Net Debt	23.0%	Baa	38% - 44%	Aa
c) Total Debt/Book Capitalization	41.3%	Baa	36.5% - 37.5%	A
Factor 5: Financial Policy (20%)				
a) Financial Policy	Aa	Aa	Aa	Aa
Rating:				
Scorecard-Indicated Outcome from Factors 1-5		A1		Aa3
Notching Factor: Government Policy Framework		0		0
a) Scorecard-Indicated Outcome After Notching Factor		A1		Aa3
b) Rating Assigned for non-GRIs or BCA Assigned for GRIs		Aa2		Aa2

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. This represents Moody's forward view, not the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestitures.

Source: Moody's Financial Metrics

	EM Oil Company			DM Oil Company		
12 Months Ending	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**
IFRS 16/ASC 842 Adoption	Yes	Yes	Yes	No	Yes	Yes
Total Debt/T12M EBITA	3.15	2.51	3.53	1.44	1.87	4.01
Net Debt/EBITDA	2.59	2.27	2.95	0.94	1.52	2.83

Emerging Market Company Ratings, as of 03/01/2022

Bond	Rating
Moody's	Ba1
S%P	BB-
Fitch	BB-
Composite	BB-

Source: Bloomberg

Developed Market Company Ratings

Bond	Rating
Moody's	Aa2
S%P	A+
Fitch	AA-u
Composite	AA-

Source: Bloomberg

Another item to note-

In this case study, the Developed Market (DM) Company has an Aa rating assigned to financial policy and a 20% assignment to that Aa score through the Financial Policy Line. The Emerging Market (EM) Company, on the other hand, although only having Financial Policy assigned an 8% weight to its rating, is assigned a Ba rating. We feel this bucket provides the most room for qualitative overlays.

For example, board composition may be assigned a qualitative rating. In the case of the DM Company, a high rating is given a 20% weight which has a significant impact on the overall rating. In the case of the EM Company, qualitative factors such as a negative assessment of board composition may weigh on this rating line.

Furthermore, the mere qualitative assessments that drive the divergence in the weightings of the rating grid factors across various companies in the same industry allows qualitative judgments to non-standardized the ratings. These decisions alone may allow some companies with similar metrics to receive better ratings as their higher rated subcomponents may be more heavily rated than their lower rated subcomponents whereas other companies may see the reverse effects.

In the case of the EM Company, we have even postulated that positive factors such as strong banking relationships with large systemically important banks in its home country are not properly captured in the Ba Financial Policy rating. Many EM corporates have strong domestic market relationships, and we consistently feel this is under accounted for in the Liquidity and Financial Policy analysis done by the rating agencies.

Case study examples are for illustrative purposes only and are not a recommendation or an offer to buy or sell securities.

Exhibit D

Example 2 of Emerging Market (EM) Oil Company Comparison to Developed Market (DM) Oil Company Comparison

Scorecard Factors EM Oil Company (Middle East)				
Integrated Oil and Gas Industry [1][2]	**Current FY 12/31/2020**		**Moody's 12-18 Month Forward View [3]**	
Factor 1: Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	12,392	Aaa	12,750	Aaa
b) Proved Reserves (MMboe)	255,155	Aaa	246,066	Aaa
c) Crude Distillation Capacity (MMbbls/d)	3.6	Aaa	4.0	Aaa
Factor 2: Business Profile (26%)				
a) Business Profile	Aa	Aa	Aa	Aa
Factor 3: Profitability and Efficiency (10%)				
a) EBIT/Average Book Capitalization	25.8%	Aaa	35.4%	Aaa
b) Downstream EBIT/Total Throughput Barrels ($/bbl)	-$4.4	Ca	$5 – $7	Baa
Factor 4: Leverage and Coverage (25%)				
a) EBIT/Interest Expense	33.9x	Aaa	42.2x	Aaa
b) RCF/Net Debt	8.8%	B	26.7%	Baa
c) Total Debt/Book Capitalization	32.5%	A	32.3%	A
Factor 5: Financial Policy (20%)				
a) Financial Policy	Aaa	Aaa	Aaa	Aaa
Rating:				
Scorecard-Indicated Outcome from Factors 1-5		Aa3		Aa2
Notching Factor: Government Policy Framework		2	2	2
a) Scorecard-Indicated Outcome After Notching Factor		A2		A1
b) Rating Assigned for non-GRIs or BCA Assigned for GRIs				a1
Government-Related Issuer	**Factor**			
a) Baseline Credit Assessment	a1			
b) Government Local Currency Rating	A1			
c) Default Dependence	Very High			
d) Support	Very High			
e) Actual Rating Assigned	A1			

[1] All calculations are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations
[2] As of 12/31/2020; Source: Moody's Investors Service, Aramco audited financials
[3] This represents Moody's forward view, not the view of the issuer. The average oil price assumptions used for 2021 and 2022 are $58/bbl and $55/bbl respectively.
[4] For the forward view: Proved Reserves conservatively assume no reserve replacement. Equity share Crude Distillation Capacity is expected to increase in 2021 to 4,000 Mbbl/day (4.0 MMbbl/day) because of the completion of the Jazan refinery project.
Source: Moody's Investors Service

Ratings

Category	Moody's Rating
EM OIL COMPANY (Middle East)	
Outlook	Negative
Issuer Rating	A1
Senior Unsecured	A1

Source: Moody's Investors Service

Scorecard Factors DM Oil Company (Western Europe)				
Integrated Oil and Gas Industry [1][2]	**Current FY 12/31/2020**		**Moody's 12-18 Month Forward View [3]**	
Factor 1: Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	3,761	Aaa	3,700	Aaa
b) Proved Reserves (MMboe)	15,212	Aaa	19,000	Aaa
c) Crude Distillation Capacity (Mbbls/d)	4,770	Aaa	4,770	Aaa
Factor 2: Business Profile (25%)				
a) Business Profile	Aaa	Aaa	Aaa	Aaa
Factor 3: Profitability and Efficiency (10%)				
a) EBIT/Average Book Capitalization	-0.3%	Ca	10%	Baa
b) Downstream EBIT/Total Throughput Barrels ($/bbl)	$1.2	B	$8	A
Factor 4: Leverage and Coverage (25%)				
a) EBIT/Interest Expense	-0.4x	Ca	12x	A
b) RCF/Net Debt	-0.6%	Ca	28%	Baa
c) Total Debt/Book Capitalization	32.1%	A	30%	Aa
Factor 5: Financial Policy (20%)				
a) Financial Policy	Aa	Aa	Aa	Aa
Rating:				
a) Scorecard-Indicated Outcome		A3		Aa2
b) Actual Rating Assigned				Aa2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 12/31/2020
[3] This represents Moody's forward view, not the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Although rated A1 at Moody's, the EM Company's size and scale map to a Aaa rating bracket. With proven reserves of 255 billion barrels of oil and daily production of 12 million barrels, it compares extremely favorable to higher rated DM majors. When viewed through a fundamental lens, The EM Company's balance sheet and its profitability stats point to a much higher rating. The EM Company has lower gross debt levels than its DM peers, a better EBITDA Margin, and stronger cashflows.

We believe the only conceivable reason for the lower rating on the EM Company stems from its zip code. Being an EM quasi, questions over the opaqueness in decision making will always be present. However, in our opinion, these issues are a source of EM-DM arbitrage that help us build a constructive case for the value proposition of EM corporates.

Case study examples are for illustrative purposes only and are not a recommendation or an offer to buy or sell securities.

Appendices

A) Country Ceilings from Moody's

Moody's assigns what are known as "Country Ceilings" to each short-term and long-term foreign or local currency bond or note for each country which it rates. Country Ceilings are themselves indicated pursuant to an alphanumeric global rating scale. Specifically, the purpose of Country Ceilings is to identify the highest rating that can generally be assigned to a non-sovereign issuer or non-sovereign debt obligation (i.e. corporate issuer or issuance) of that specific country. In practice, the Country Ceiling expresses the non-diversifiable risk incurred by investors as a result of the idiosyncratic country risk in which a company is domiciled or operates. As a result, the ceilings serve as a cap for issuances based on individual country exposures. With that being said, however, a non-sovereign issuance can achieve a rating higher than the respective sovereign rating. Such instances normally occur under special circumstances when there are lower risks associated with negative governmental externalities including unique support mechanisms by the sovereign, greater geographically diversified assets, strategic operating structure, and significant cash flow generation from a different jurisdiction. It is important to note that the determinations can rely on intrinsic characteristics of the individual issuer, Moody's own viewpoint of a particular credit in different economic scenarios, or a combination of the two.

B) Wharton Paper Excerpt

According to a Wharton Paper, there is a linear relationship between Sovereign Rating and Corporate Rating in Emerging Economies. The implication is that lower rated sovereigns cap corporate ratings.

Sovereign Ceilings "Lite"? The Impact of Sovereign Ratings on Corporate Ratings

EDUARDO BORENSZTEIN, KEVIN COWAN AND PATRICIO VALENZUELA†

† Borensztein is with the Inter-American Development Bank, Cowan is with the Central Bank of Chile and Valenzuela is with the University of Chile. We have benefited from helpful comments from Franklin Allen, Li-Gang Liu, Sergio Godoy, Ugo Panizza, Jun Qian and seminar participants at the Inter-American Development Bank, the Central Bank of Chile, the European University Institute, the Conference on Credit Ratings, Credit Rating Agencies and their Development in Asia, the Latin America and the Caribbean Economic Association Annual Meeting, the Annual International Conference on Macroeconomics Analysis and International Finance, and the Chilean Economists Association Annual Meeting. We would also like to thank Hites Dhanabhai for excellent research assistance.

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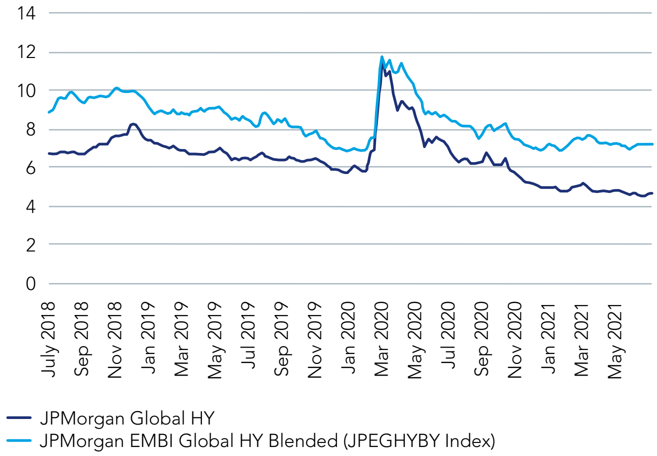
C) Historical Yield Advantage of EM Corporates

We have noticed…

Attractive yields – positive yield in a low yield environment

- Post the 2008 GRC, the fixed income universe has been dominated by QE and monetary easing.
- As a result, global yields have fallen sharply, and the traditional fixed income investors have had to search for yield.
- EMD is one of the few fixed income market segments that has delivered a positive yield with some cushion to movements in core rates.

Figure 3. EM offers a compelling yield advantage



Source: J.P. Morgan, as of 7/23/21
Past performance is no guarantee of future results. For illustrative purposes only.

D) EM Corporates more resilient than anticipated. Part of Anticipated default rate stems from pre-crisis rating.

- Default Rates in 2020 lower than expected
- Corporates are recovering faster than expected

Source: Bank of America Research 2021. February Publication.

E) Additional Example

As mentioned in the case of the first EM Oil Company, the Financial Policy line, which allows for the introduction of negative assessments on governance and additional qualitative factors, weighs on the rating.

Rating factors
EM Steel Company (South America)

Steel Industry Scorecard [1][2]	Current FY 12/31/2020		Moody's 12-18 Month Forward View As of 3/24/2021 [3]	
Factor 1: Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenue (USD Billion)	5.9	Ba	$6 – $8	Ba
Factor 2: Business Profile (20%)				
a) Business Profile	Ba	Ba	Baa	Baa
Factor 3: Profitability (16%)				
a) EBIT Margin	25.1%	Aa	20% – 30%	Aa
b) Return on Tangible Assets (EBIT/Tangible Assets)	15.2%	Aa	10% – 20%	Aa
Factor 4: Leverage and Coverage (36%)				
a) Debt/EBITA	3.6x	Ba	1x – 3x	Baa
b) RCF/Net Debt	75.1%	B	55% – 65%	Ba
c) Total Debt/Book Capitalization	25.8%	Ba	10% – 15%	B
d) EBIT/Interest Expense	2.6x%	Ba	4x – 6x%	Baa
Factor 5: Financial Policy (10%)				
a) Financial Policy	B	B	B	B
Rating:				
a) Scorecard-Indicated Outcome		Ba1		Baa3
b) Actual Rating Assigned				Ba3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 12/31/2020
[3] This represents Moody's forward view, not the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Financial MetricsTM

F) Science Direct Article

Research in International Business and Finance

Volume 38, September 2016, Pages 286-298

Pernicious effects: How the credit rating agencies disadvantage emerging markets

Authors: PrabeshLuitelabRosanneVanpéeaLievenDe Moorb

Abstract

This paper provides a synthesis of the literature on biases in sovereign credit ratings. Credit rating agencies favor their home countries and the homes of their major shareholders to the detriment of foreign countries. These home and foreign biases have multiple sources, each of which is especially at the disadvantage of emerging markets. While the characteristics of emerging debt markets make these countries particularly vulnerable to a downward bias in their sovereign credit rating, the consequences of a bad rating are especially severe here. A low credit rating increases borrowing costs, hampers access to international capital markets and inflates risk.

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Past performance is no guarantee of future results.

Views are as of March 2022 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

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The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

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