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INVESTMENT NOTE **19 May 2014**

Emerging markets sell-off didn't stop positive high-yield stories

Poor overall performance of emerging-market high-yield debt is masking the positive fundamentals of individual companies, says Jon Brager, Senior Credit Analyst at Hermes.

EM growth: The March issue of Spectrum showed how the emerging market (EM) high yield sector is growing rapidly and driving greater performance dispersion within major benchmarks. Adjusting for longer duration or a higher spread – or both – among bonds, we calculated that EM issuance grew to 22.5% of the global high-yield market from 2008 to last March, compared to 21.5% for Western Europe and 55.4% for North America.

No man's land: EM high yield fast became a no-man's land in 2013 as investors retreated on tapering fears. Absolute spreads of 686bps indicate that valuations are falling to extreme levels and now there are murmurings of a turnaround. Since the primary force behind the sell-off was driven by US central bank policy, rather than the credit fundamentals of EM high-yield issuers, investors looking closely at this growing section of the market can find positive credit stories.

Pulp fiction: In our view, Sappi, the South African paper producer, is one of them. It is the world's largest manufacturer of glossy paper and throughout 2013 continued to transform its business to become the world's largest producer of chemical cellulose as well. The material, which is derived from dissolving wood pulp, is used in luxury clothing and sportswear. Sappi sources it from its eucalyptus hardwood plantations.

Recent results tell the story:

- Cellulose provides a margin of about 30%, compared to 4%-6% for paper, and delivers 50% of the company's EBITDA – up from zero last year.
- In Q2 Sappi generated $171mn EBITDA, a 36% year-on-year increase.
- Now that it has finished converting its mills to prioritise cellulose production, management aims to reduce net debt by $200mn to £2.2bn by the end of the year.
- This aim, combined with the higher cellulose margins, make it likely that net debt will fall and free-cash-flow should increase in the coming quarters.

Sappi faces short-term obstacles: margins for its North American business were almost halved by harsh weather and trucker strikes, and it is still negotiating with Dutch unions about shifting production to other mills in Europe. But we think these are bumps in the road, not a divergence.

Paying attention: We don't think Sappi is the only positive story – or the best – from the EM high-yield sector. But it shows that opportunities exist in this market beyond tapering's toll. To us, this makes sense, since not only does the EM high-yield sector contribute more to index returns than Western Europe, but many securities in this universe are undervalued too.

-ENDS-

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Notes to Editors:

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