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Emerging Markets Corporates: High Yield Default Outlook 2021

After a moderate spike in defaults, we anticipate an improving financial environment for the next year.

The COVID-19 pandemic has deeply stressed many economies, with significant impacts on broad areas of the corporate landscape. Among fixed income investors, it has created an urgent need to understand the prospects of corporate issuers in emerging markets. In this paper, we present our inaugural annual default outlook for EM corporate high yield.

At this point, we calculated the 2020 default rate for emerging markets corporate high yield at 3.8% YTD through December—higher than 1.5% in 2019, but still considerably lower than previous crisis years. Although most distressed cases are idiosyncratic in nature, accommodative monetary policies and fiscal packages have improved the refinancing environment for many issuers since the early stages of the global pandemic. We expect further improvement in overall credit conditions in 2021, with a default estimate of 2.9% for 2021, which is in line with the average over the past 10 years.

EM CORPORATE HIGH YIELD: DEFAULTS FOR 2020 AND 2021

	2020 Default Rate YTD (as of Dec. 9, 2020)	NB FY2021 Default Estimate
Asia	3.2%	2.5%
CEEMEA	2.8%	1.9%
LatAm	5.6%	4.4%
Total EM	3.8%	2.9%
LatAm ex. Argentina	5.4%	2.8%
Total EM ex. Argentina	3.7%	2.4%

Source: Neuberger Berman.

Methodology

Our default estimate is derived from bottom-up inputs from our analysts across Asia, CEEMEA (Central Eastern Europe, Middle East and Africa) and Latin America. In making our assessments, we place extra emphasis on evaluating: (1) issuers with weak ratings, (2) bonds trading at stressed levels (cash price of less than 70), (3) issuers with weak cash to short-term debt coverage, (4) issuers with maturity within the next 15 months, and (5) large high yield issuers. The approach is geared toward identifying vulnerabilities that might not be apparent based on trading, news flow or more broadly available metrics and analysis.

Looking Back at 2020

The EM corporate high yield default rate of 3.8% (year-to-date through December 2020) is better than many forecasts from earlier in the year. It includes 45 corporate defaults in emerging markets with a notional value of \$28.7 billion. Default cases have been spread out across countries and sectors, with some concentration in EM airlines and commercial state-owned enterprises in China.

From a historical perspective, the current default rate is considerably lower than levels in previous crises—for example, 10.5% in 2009 in the aftermath of the global financial crisis, and 5.1% in 2016 at the end of the commodities super-cycle. We believe the lower rate in 2020 is due to corporate earnings and cash buffers built up during 2016 – 19, as well as bold and rapid monetary and fiscal interventions across major economies.

The default rate across EM sovereigns has been considerably higher at 8.1%, driven by defaults of three major sovereign issuers: Lebanon, Ecuador and Argentina. While stress at the sovereign level could certainly pressure corporate refinancing in the same country, defaulted sovereigns in 2020 are, with the exception of Argentina, mostly frontier countries with limited corporate issuances.

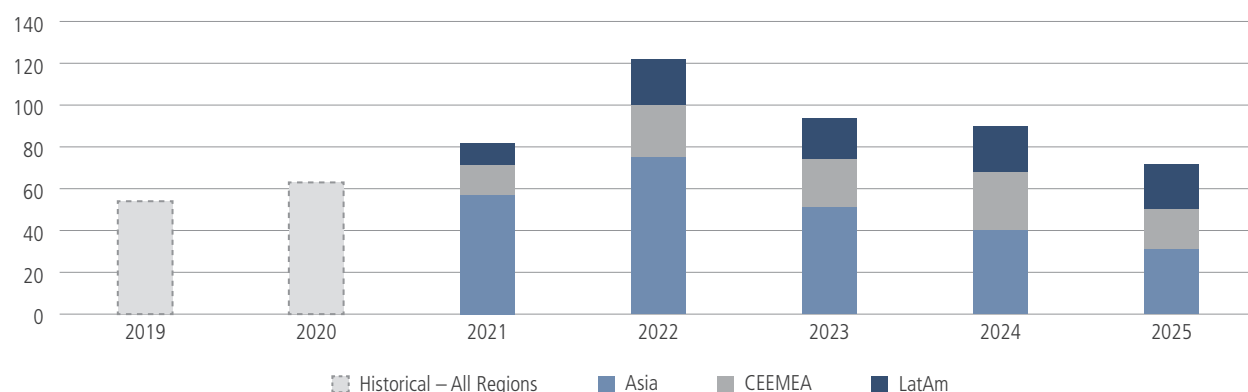
Outlook for 2021: Lower Stress Reduces Prospects for Defaults

The EM corporate high yield universe is transitioning into 2021 with relatively low levels of systemic stress. As of December 2020, only 3.5% of the market was trading at a dollar price less than 70, compared to 15.5% at the peak of market turbulence in March 2020, and 58.8% during the global financial crisis in 2008. We expect a relatively benign debt refinancing environment and general recovery of EBITDA in 2021.

Debt refinancing: Monetary policy and low system stress remain supportive. We expect U.S. and most major EM economies to maintain favorable monetary policies, given that the economic recovery post-COVID remains in its early stages (except in China, which began its recovery in the second quarter). This will likely mean low rates and easy refinancing, which should prove supportive for EM high yield corporate issuers to manage 2021 maturities. Although high yield maturities reach \$80 billion+ in 2021, many companies have taken advantage of the low-rate environment to refinance, build up cash reserves and extend duration in 2020. These preemptive liquidity management exercises should limit default risk for EM high yield corporates overall. We also expect record issuance in 2021 due to a continued low-rate environment, which is supporting overall refinancing in 2021.

EM CORPORATE HIGH YIELD: MATURITY PROFILE

USD Billion by Notional Value

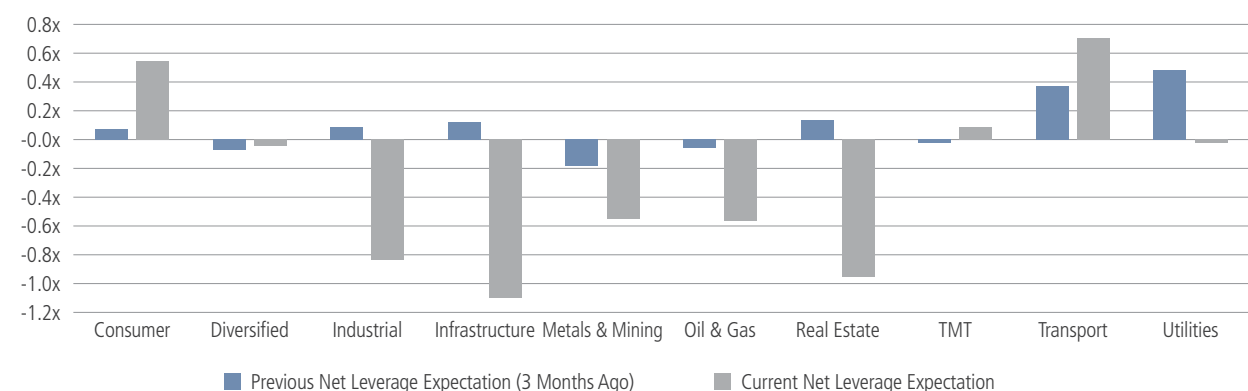


Source: Neuberger Berman.

Corporate earnings: Post-COVID world, vaccine and recovery path. We expect general corporate EBITDA to rebound in 2021, due to a low base in 2020 and increasing hope of gradual distribution of vaccines. Even if vaccines/COVID containment are delayed, the world is more accustomed to the “new normal” and thus is unlikely to see the level of disruption experienced in the second quarter. All of this should translate into EBITDA growth and gradual normalization in 2021. That said, the path to recovery for some sectors remains more sensitive to recovery scenarios, particularly for transport and aviation value chain, retail and services sectors and companies with tight financial conditions.

Sector view: Transports remain relatively weak. We expect the airline sector to remain challenged in 2021, as the restart of international air travel is likely to require complicated cross-border COVID coordination efforts and successful commercialization of vaccines. EM airlines without a strong parent company continue to deplete their cash balances, while costs have already been reduced to minimal levels, in our view. That said, the airline sector represents only a small portion of our universe weight (<0.5%), meaning that the net impact to the EM corporate universe is contained. Other than airlines, we have not identified significant cross-region sector-level stress for 2021.

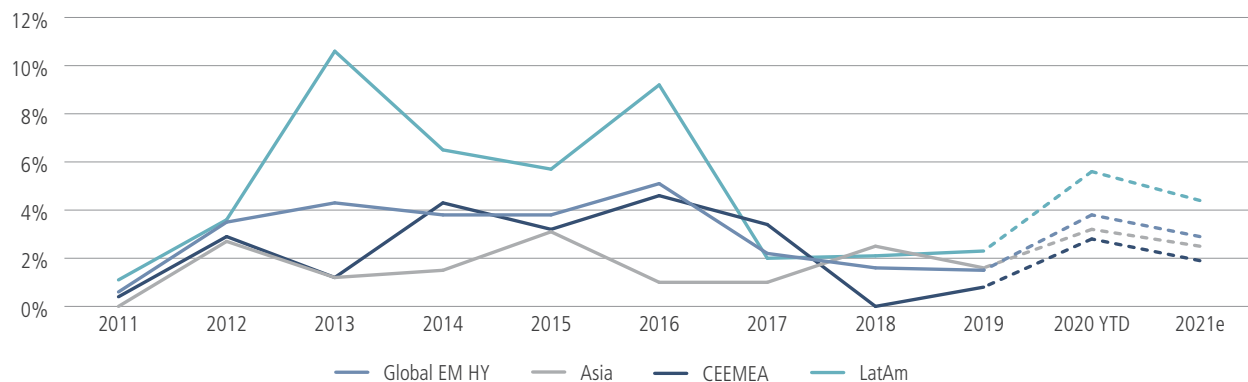
EMERGING MARKETS CORPORATE HIGH YIELD: CHANGE IN NET LEVERAGE EXPECTATIONS



Source: Bloomberg. Represents 257 issuers, or 46% of CEMBI Broad Index weight. Gray bars show current forward expectations of change in net leverage. Blue bars show expectations as of three months prior.

Recovery rate: Likely to remain higher than U.S. levels. The recovery rate on defaulted debt in the EM corporate high yield space has been in the range of 35 – 50% over the past 10+ years (excluding outliers, a 12-year simple average of 41%), which is considerably higher than the historical recovery rate of U.S. high yield at 16%.¹ The EM recovery rate reflects a higher weight of distressed exchanges versus restructurings and liquidations. The recovery rate for 2020 is on track to be 40 – 45%, and we expect it to remain in a similar range in 2021 as several potential default cases emerge as distressed exchanges.

REGIONAL DEFAULT RATES



Source: Neuberger Berman and JPMorgan. Current-year figure and forward-looking estimates are based on bottom-up analysis from our research team. The CEEMEA default rate combines EM Europe and ME&A default rates at a ratio of 53:47. Data as of December 9, 2020.

Regional Analysis

Asia: Defaults mainly in China industrial and Indonesia high yield. We expect Asia to incur a default rate of 2.5% in 2021, versus 3.2% year-to-date through December 2020, with the level largely driven by conditions in the China high yield market.

China Privately Owned Enterprises: Industrial weakness remains, property sector continues to show resilience.

POE defaults are likely to continue to be concentrated in the China industrial space, as a number of issuers have unsustainable capital structures and a somewhat impaired ability to refinance domestically. That said, defaults of these few stressed industrial issuers should not surprise the market, given their high leverage level and hiccups in refinancing onshore in the past. As for China properties, we expect relative resilience among the offshore USD issuers, which are mostly the top 50 developers in China. While the government's recent "three red lines" policy is a clear regulatory signal to curb property sector leverage, we expect the larger high yield developers to continue to manage near-term maturities well.

China Sovereign-Owned Enterprises: Implicit government support for commercial SOE declines. We view the reemergence of China SOE defaults in late 2020 as a continuation of a government effort to rein in system leverage that started in 2019, with a temporary pause from late January to May due to pro-growth policies to support COVID-19 recovery. Although we are likely to see more domestic local SOE default headlines, the total notional value of China local SOE in the USD high yield bond space is only about \$22 billion (or roughly 15% of the high yield China country weight); thus, the impact to our universe will likely be contained. It is important to note that China's overarching policy stance remains systemic risk prevention, even as authorities test the market response to allowing more SOE defaults. Hence, we do not expect SOE defaults to "blow up," but rather experience a gradual increase over time. The gradual exit of zombie enterprises should be positive for the overall China credit market in the long run.

Idiosyncratic risk in other Asian countries. Elsewhere, the level of system stress is slightly higher in Indonesia (based on the percentage of bonds trading below 70). We expect some distressed liability management exercises in 2021 prior to actual maturities in 2022 for the high yield Indonesian corporate space. Other potential default cases are expected to be largely idiosyncratic in nature in India and Hong Kong.

¹ Source: JPMorgan.

On-the-Ground Views: Key Trends for China Onshore Defaults in 2021

- Our Shanghai colleagues expect a moderate increase in default rates in China onshore corporate bond markets in 2021, driven by both SOE and POE defaults.
- Among private enterprises, the property sector faces higher redemption pressure in 2021. Selective smaller developers with higher leverage, worse land banks and limited access to offshore funding may run into distressed situations in 2021. Risk in other sectors remains idiosyncratic in nature.
- Government tolerance of SOE defaults may trend higher. Orderly exits of zombie enterprises at the local government level will gradually replace previous assumptions of government bailout behind the door.
- It's useful to note that local government financing vehicles and SOEs represent about 89% of the onshore non-AAA universe versus 15% for the China USD high yield space.

For details, see the onshore team's upcoming *Insights* on China defaults.

Central and Eastern Europe Middle East and Africa: Relative resilience. We expect the CEEMEA default rate to be 1.9% for 2021 (versus 2.8% in 2020), the lowest across the three EM regions, supported by our outlook on sovereign and oil prices, and a generally supportive refinancing environment. In addition, many stressed cases in the region have already been realized in 2020, with the remaining universe largely healthy, in our view.

Systemic pressures are relatively moderate in the major CEEMEA economies, with only 2.6% of the CEEMEA universe currently trading at stressed levels (<70), the lowest among all three EM regions. Among sovereigns, we do not expect defaults out of the top five corporate-issuing countries, which rules out any large-scale corporate default scenario in the region. We will continue to observe the mixed COVID-19 developments, which will impact the path of corporate earnings recovery.

Any risk will likely emerge on an idiosyncratic basis, in our view. Thus far, the region's various higher-stressed cases have been across countries and sectors. Two companies in the oil and gas value chain may face increasing restructuring risk if oil prices fall below \$40 per barrel. We are also monitoring a Dubai property player and a Turkish bank, but these have limited systemic implications.

Latin America: Argentine corporates could lead the story in 2021: We estimate LatAm's default rate at 4.4% in 2021 versus 5.0% through December 2020, with fewer jumbo issuer defaults than in the current year. Our default estimate is lower, at 2.8% for LatAm ex-Argentina in 2021, which is about in line with the relatively stable performance of other regions.

In an attempt to protect Argentina's international reserves, the country's central bank imposed new currency restrictions that limit access to FX at the official rate to 40% of principal coming due on September 15, 2020, applicable until March 2021. The remaining 60% of the principal is to be refinanced in either restructuring or overseas funding. The restriction and potential extension of the policy clouds the refinancing prospects of many USD corporate issuers. Hence, the potential risk for Argentine corporates to default next year has risen, and potentially will drive up the regional default rate of LatAm. That said, we expect many of these corporates to opt for exchanges at or close to par and a handful of distressed exchanges, which should translate into a higher recovery rate, as opposed to distressed restructuring or liquidation.

Our 2021 default forecast for LatAm ex-Argentina of 2.8% is not only in line with other EM regions, but is lower than the region's 10-year historical average of 4.8%. We attribute this improvement to more conservative corporate balance sheet management in recent years in the wake of previous crises, such as the recession in Brazil in 2015 and its subsequent sovereign downgrade to high yield. For 2021, we expect stress to remain in the airlines and for some idiosyncratic cases in the oil and gas and non-bank financial segments.

Conclusion: Improving Default Fundamentals

The past year has seen extreme challenges across the corporate landscape, with highly varied impacts depending on region and sector tied to the path of COVID-19 and existing stresses and vulnerabilities across issuers. However, generous accommodation by central banks and loose borrowing conditions have enabled many issuers in emerging markets to solidify their financial positions to ride out the storm. With the potential for wide vaccine distribution next year and the continuation and acceleration of the recovery, we anticipate an improved outlook for EM corporate defaults in 2021, which should in turn lead to a more favorable environment for the EM USD high yield corporate market.

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