MetLife Investment Management

# Against the Headwinds—Delving into Global Corporate Analysis

October 29, 2020

## Introduction:

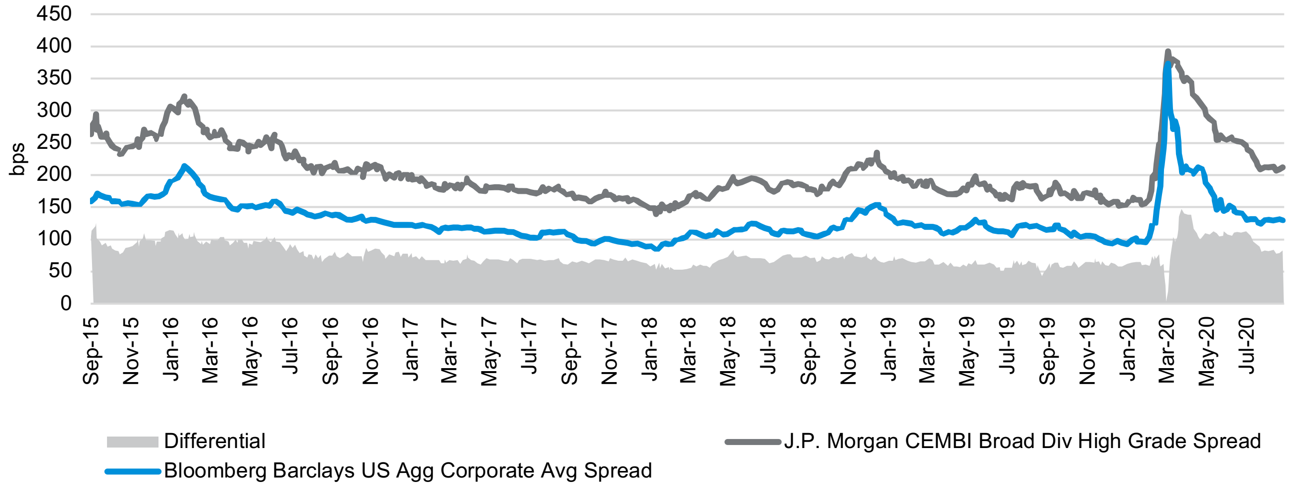
Entering 2020, emerging market (EM) corporate fundamentals were generally healthy. Although some sectors witnessed a mild deterioration in 2019, the asset class was overall in good shape. Leverage levels were generally lower than developed market (DM) counterparts and cash flow appeared like it would be supportive given the outlook for better emerging market growth in 2020, especially relative to developed markets. Our base case, however, was challenged by the COVID-19 pandemic that triggered significant market turmoil across the globe. Asset prices across DM and EM credit tumbled as the demand shock combined with energy and commodity price plunge, sparked by the Russia-Saudi spat, increased volatility, and forced policy makers and management teams across the globe to act. Through the early stages of the crisis, liquidity was almost non-existent across fixed income. The economic shock combined with an investor community that was full in a work from home mode, forced a significant widening of not only bid-ask spreads but also an underperformance of assets with a growth bias. Central banks were quick to react, aggressively providing backstops, actively buying corporate bonds in an effort to restore market functioning, while management teams have drawn bank lines, tapped capital markets when available and revised capex budgets in an effort to survive.

Our analysts across the globe have been especially busy this year, conducting rigorous research on the impact of COVID-19 on their respective companies of coverage, not only focusing on short-term buffers but longer-term viability of their businesses. The goal continues to be to identify opportunities across the globe where valuations compensate investors for owning emerging market corporates and where fundamentals are better than valuations would imply. Before we dive into our analysis, we should highlight key trends in corporate valuations and fundamentals during this period.

## A Look at Valuations:

During the crisis, global credit spreads blew out with EM corporate spreads moving in line with U.S. counterparts. EM high yield (HY) corporate spreads reached 1,100 basis points and EM high grade (IG) spreads widened by 237 basis points, both in similar context if not a little better than U.S. credit at the extremes (see chart overleaf). However, the differing central bank reaction altered the rebound with the Federal Reserve's moves to support corporate credit leading to a more aggressive bounce in developed markets. Emerging market corporates were left to fend for themselves with the market taking more time to digest the "trickle down" impact of central banks' liquidity as well as monitor access to liquidity at the company levels.

**EM IG vs. DM IG spread moves**



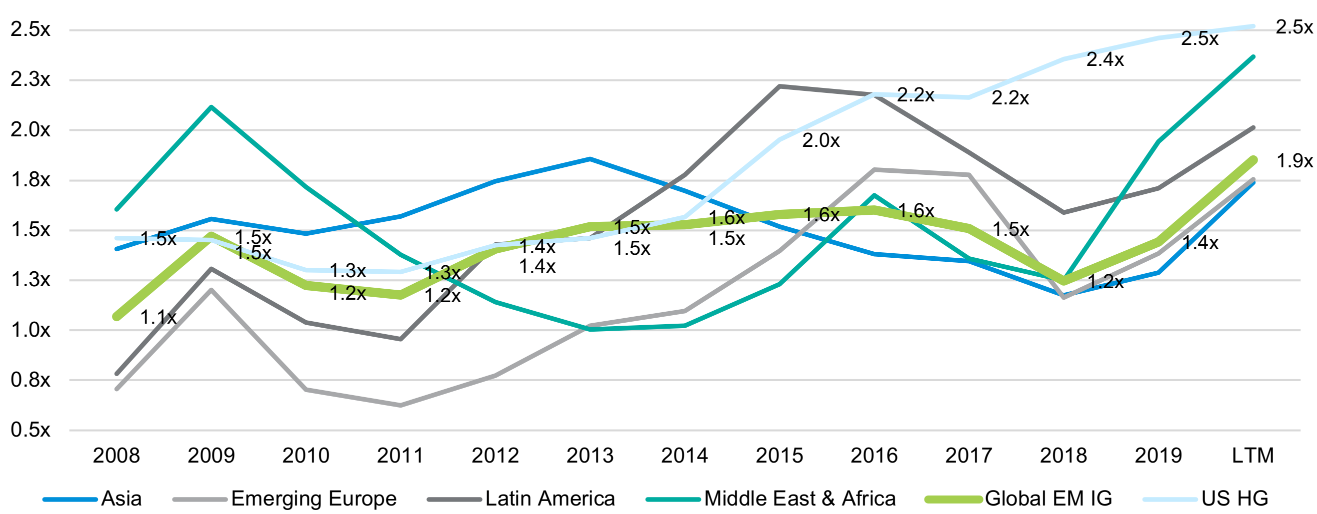

*Source: Bloomberg, Barclays, J.P. Morgan, as of 10/2020.*

As we write this, EM spreads have reacted to not only developed market policy but also to independent management teams effectively navigating the crisis, accessing liquidity, extending maturities and showing better resilience than what we believe was priced in. Some sectors have weathered the storm well and others may have been permanently altered, but overall we feel corporate management teams have shown the ability to react to an ever-changing global environment, with our investment team continuing to focus on where asset values in EM are attractive versus developed markets.

## Bracing Against the Headwinds – Corporate Fundamentals:

Liquidity and valuations are still paramount in the current environment, but so are fundamentals and the outlook for each business as EM economies begin to normalize. The growth trajectory, however, is hard to predict, with divergence between sectors, and countries expected. As we noted, EM has entered the crisis period with relatively lower leverage compared to DM (see chart below).

**Net Leverage - IG comparison**

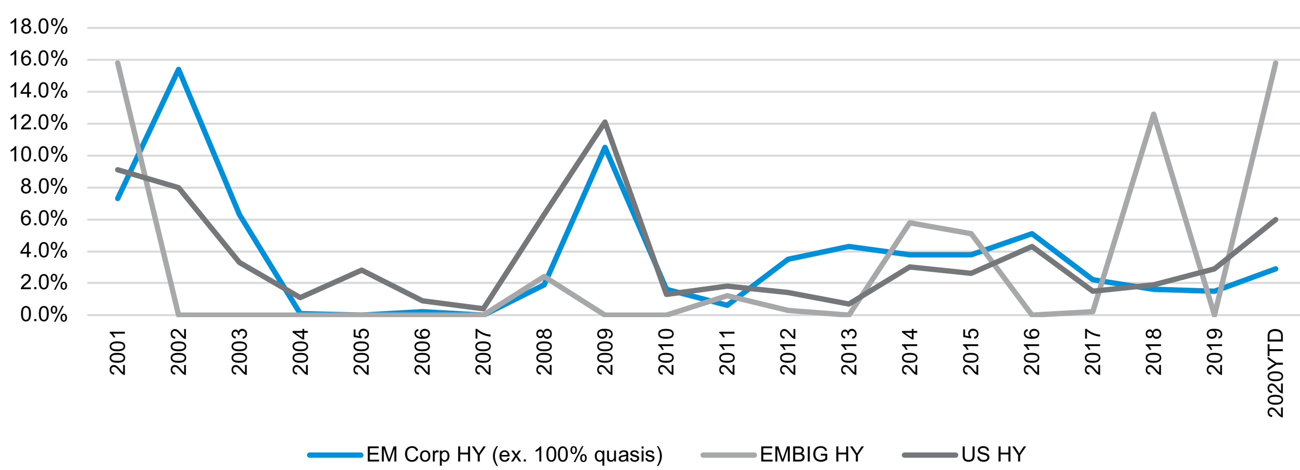



*Source: J.P. Morgan, as of 9/2020.*

However, for many, maintaining manageable levels of leverage may prove to be more challenging now, given certain factors that may not be under their control (e.g. direction of commodity prices, from oil to pulp, economic recovery of importers, such as China or further shutdowns, impacting their labor force and consumer base). The largest three sectors in terms of market weight in the CEMBI Broad Diversified Index are Financials (over 30%), Oil & Gas (13%), and Utilities (over 11%). Any material changes in non-performing loans and contingent liabilities would impact the former, while the supply / demand dynamics for oil could have a significant bearing for the commodities-linked credit. With so many unknowns, it is truly a balancing act between fundamentals and valuations and avoiding a surprise to the downside remains key.

At this point, EM corporates have withstood the headwinds comparatively well in our view, with default rates at 2.9% YTD vs. EM sovereigns (15.8% YTD) as well as U.S. HY (6.0% YTD) (see chart below).[1] The default forecast for 2020 now stands at 3.5% by JP Morgan, which has been reduced several times since the earlier part of the year.[2] To compare, the default rate during 2016, mainly spurred by the commodities crisis, was 5.1%. Looking ahead, the prospect of monetary and fiscal support withdrawal could put pressure on corporate fundamentals, and hence we are monitoring for any such disruptions. And while avoiding troubled credits is key, it is important to analyze the overall value, in event of default and subsequent recovery.

**EM corporate HY default rates - lower compared to EM sovereigns and U.S. HY**




*Source: J.P. Morgan, as of 9/2020.*

## Analyzing Corporates:

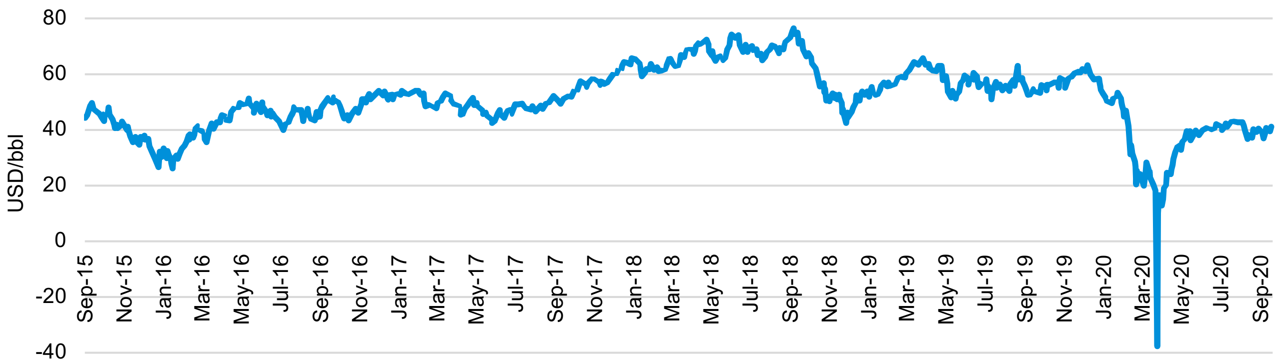
The change in consumer behavior and global demand remains uncertain which leads asset managers to rely heavily on their ability to evaluate the fundamentals of a business in all parts of the globe. Will transportation survive? What's the outlook for low cost energy? How will the current crisis change the way management teams handle balance sheet liquidity going forward? These are some of the questions, among others, that our analysts have been working to address given the lingering uncertainty.

Our investment team across the U.S., Latin America, Europe and Asia has been focused on delving deep into credit, from asset analysis and intrinsic valuation to relative value dynamics between emerging and developed markets. Here we highlight some of the work our credit team has been doing, starting with the much-impacted commodity sectors, with focus on corporate credit in Latin America, then taking the next leg of our trip to Europe with a discussion of the telecommunications sector and rounding out our journey in Asia with an overview of financials.

## Analyzing Commodities, with a Focus on Latin America (LatAm):

Commodity sectors including oil & gas and metals & mining were among the fastest and hardest hit with the onset of global lockdowns as the spread of COVID-19 accelerated in March 2020. WTI oil prices briefly went negative (see chart below), while copper and aluminum prices dropped 20-25%.[3]

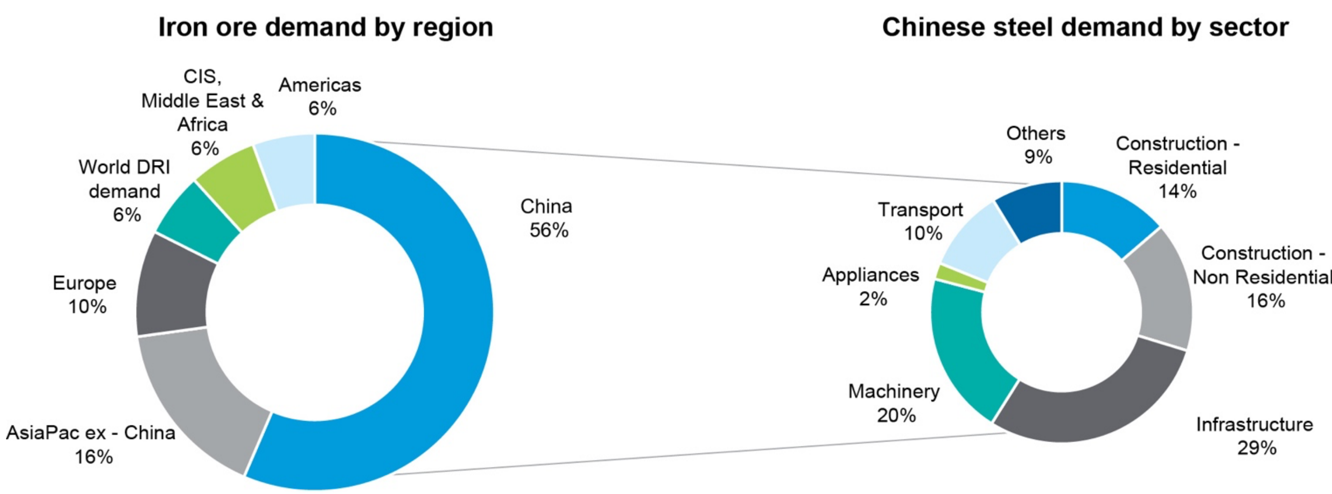
**WTI price per barrel**




*Source: Bloomberg, as of 10/2020.*

With transportation comprising 60%+ of oil demand, and China alone counting for more than 50% of the consumption of base metals and iron ore (see chart below), these pullbacks were easily justifiable.[4] Oil in particular was heavily pressured as limits were approached on physical storage capacity. And a circular relationship played out with equities, oil and other commodity risk assets. As shelter in place mandates passed their peak and with some help from the Fed, commodities began a strong rally by the latter part of April. Most of the metals complex is now hitting new highs as China's recovery strengthens, while oil markets are recovering, albeit at a slower pace. Oil production cuts from OPEC+ and U.S. shale have stabilized the market, but further gains in transportation demand are needed to return global oil demand to pre-COVID-19 levels. U.S. vehicle miles driven have recovered to almost 90% of the five-year average,[5] while global airline traffic still remains depressed at around 50% of pre-COVID-19 levels.[6] Specifically, a protracted return to historical levels of air travel, which comprised 6-7% of 2019 oil demand,[7] will likely keep oil demand below 2019 levels through at least all of 2021.

**Global iron ore demand**




*Source: J.P. Morgan, as of 10/2020.*

As the pandemic began to evolve in March and market volatility increased drastically, our investment team was already well-equipped with the necessary resources to react and respond accordingly. MIM's research analysts across regions regularly analyze supply / demand fundamentals and collaborate with one another to build a complete global view across their respective sectors and then assess relative value on a global basis. Within the energy and basics material sectors, this is especially important due to the global nature of these commodity producers. Rather than attempting to predict the exact prices of certain commodities over the next 6-24 months, our research team took an intense focus on asset quality and where specific credits and production regions sit on the global cost curve.

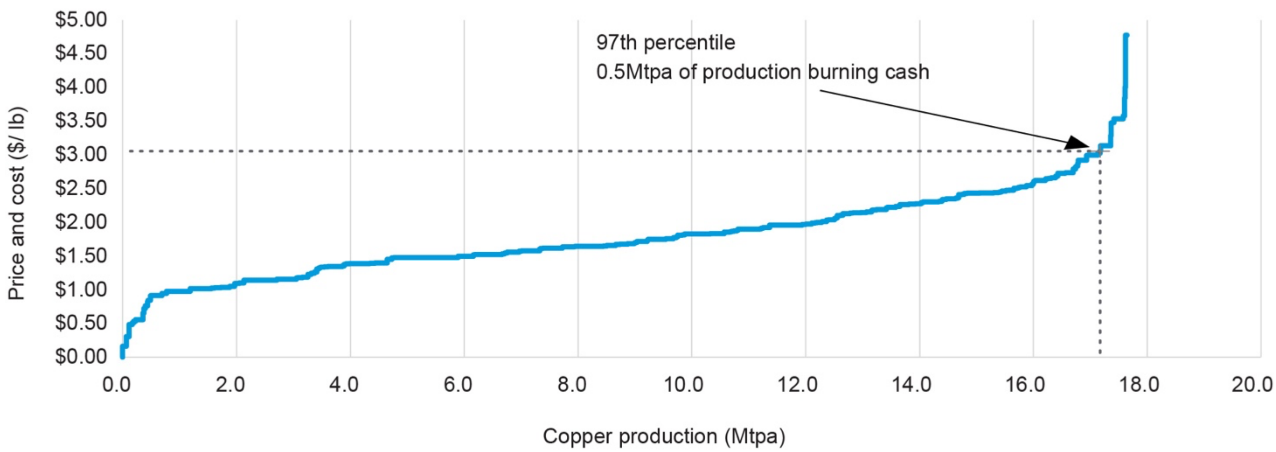
Mining operations require heavy capital investment in infrastructure such as rail lines and heavy machinery, among other factors. Additionally, many management teams continue to adapt and replace traditional mining methods with greater technology and automation helping to reduce overall costs. LatAm hosts many of these low-cost producers benefitting from large-scale operations and high-quality assets. The correlation between LatAm FX and commodity prices acts as a buffer against downturns, particularly in countries where opex and capex are tied to local currencies. Producers which reside in the lower quartiles of the global cost curve, in our view, should remain better protected if a severe commodity price shock were to occur such as what we experienced in 2015/16, as well as more recently with COVID-19.

Given the unique nature of COVID-19 and its impact on regions of the world at different time periods and in varying degrees of severity, our analysts were also tracking testing capacity and case counts where large mining operations might be impacted. From March to July governments in various mineral-rich regions throughout Latin America, South Africa, and Canada ordered certain mining operations to be shut down. Therefore, geographic and product diversity with no reliance on only one or two large mines in one region of the world was of the utmost importance as operations had to be shut for a period until case counts diminished. Leading up to COVID-19, the metals & mining sector was, and remains, much less leveraged than it was during the 2015/2016 commodity crash. Debt has been paid down through a combination of cash generation, asset sales and equity raises with a major focus on quality production over quantity. Overall, most of the companies in this sector have been conservative from a balance sheet standpoint. Management teams remained prudent as the sector saw capex guidance cuts in the 10-30% range on average, with many investments being pushed into the back half of 2020 or into 2021. As for actions taken to bolster liquidity, this mainly came in the form of revolver drawdowns to safeguard cash on the balance sheet, most of which have since been termed out due to favorable capital market conditions.

The oil and gas (O&G) space had a similar dynamic, affected not only by lower oil prices but also by the decline in fuel demand due to mobility restrictions. The industry in LatAm is characterized by the dominance of major national companies with integrated operations in each country, exposing them to the influence of political decisions. For example, some of them like a large Colombian integrated oil company, and more recently, a Brazilian oil and gas company with operations across the globe, enjoy a certain degree of independence and tend to be managed like private companies, while on the other end, some oil producers, including a large Mexican state-owned company, may be more heavily influenced by their respective governments, in our view. Our team of analysts living in the region combines their knowledge of the industry, the political landscape, its influence on the O&G sector, and the sovereign view to come up with a comprehensive assessment of these companies. This allows MIM to try and anticipate changes in the trends that will shape the environment where these companies will develop their operations.

So while the sharp plunge in commodities prices rattled many investors, MIM remained confident in its existing positions within these sectors, maintaining the ability to buy on weakness given the extensive focus on producers that we believe can continue to generate positive free cash flow and maintain balance sheet strength even in a lower commodity price environment. For example, MIM has been constructive on both copper and iron ore supply / demand fundamentals but has remained disciplined by looking for relative value among companies and capital structures with more favorable global cost curve dynamics. Among the copper producers, this would include those which are in the lower-middle quartiles.

**Copper cost curve**




*Source: Barclays Research, as of 10/2020.*

As for the iron ore producers, we find attractive relative value in select issuers, including a large metals & mining player in Brazil, which we believe continues to trade at a substantial discount to other large, global, low-cost iron ore producers.

Environmental, social, and governance (ESG) is an important consideration in our investment process, as we are wary of the financial consequences that poor ESG practices can have on corporates. We understand that complying with regulations is sometimes not enough to develop sustainable activities as companies must also obtain the “social-licensing” from surrounding communities who fear the environmental stresses that extractive activities may have on their lives, while also wanting to benefit from their development. For example, in Latin America there’s a history of environmental issues, that have impacted mining-related companies and which our team has been able to evaluate, including applying potential liabilities to assess cash flow, liquidity and balance sheet impacts, as well as the efficacy of management’s response. Given our comprehensive understanding of securities under coverage and knowledge of the institutional, political and cultural landscape of each country provided by our team of analysts with diverse backgrounds, we are able to not only focus on determining the long-term creditworthiness of these issuers, but also seek to take advantage of investment opportunities.

## Analyzing Technology, Media & Telecom (TMT), with a Focus on CEEMEA[8]:

The global telecommunications sector held up relatively well during the recent lockdowns instated worldwide as a result of the pandemic caused by the COVID-19 virus. If anything, this crisis ended up showing the need for well-invested and good-quality networks, as the world moved to an online presence given social distancing measures put in place across the globe.

MIM’s U.S. based TMT credit research working in collaboration with our London-based EMEA credit research, have maintained a constructive view on tower companies (TowerCos), and particularly two independent telecom players operating in Africa. The TowerCos' primary business is leasing tower space for communications equipment to Mobile Network Operators (MNOs) and other customers, who in turn provide wireless, voice and data services to their end users. They provide their customers with leased space on existing towers alongside current tenants (colocation), commission new towers for construction to the customer's specifications (build-to-suit or BTS), and provide managed services such as maintenance, operations, marketing and leasing services for towers owned by third parties.

TowerCos, in our view, typically present attractive investment opportunities, with infrastructure-like characteristics: (i) high revenue visibility (supported by long-term, typically inflation-linked contracts), (ii) high margins and strong cash flow generation (given the relatively low cost base and low capex needs), (iii) high barriers to entry (due to the capital intensity of the sector, with a large upfront investment needed) and (iv) long asset lives. Towers can also be qualified as "critical" infrastructure given the need for communication lines (mobile, wi-fi) to be constantly up-and-running.

There are, however, differences between TowerCos in emerging and developed markets, which end up being reflected in market valuations and financial policies. In EM, TowerCos may be exposed to currency risk, with a mismatch between hard currency debt and revenues / costs exposed to local currency. Some of this is mitigated by contracts having CPI / power price escalators linked to U.S. dollars (USD). Scarcity of hard currency in countries of operations is another risk, as shown by the recent difficulties to convert naira to USD in Nigeria. Additionally, EM countries in less developed sub-Saharan Africa regions generally have lower sovereign ratings and may be considered high-risk business environments, given the unpredictability of political decision-making, which could impact the ability to repatriate / extract cash from these countries.

To balance the aforementioned risks, EM TowerCos exhibit strong liquidity (with either undrawn committed lines of credit or high cash balances), operate with lower leverage levels (typically around 3x, as compared to DM operators in Europe and the U.S. with leverage around 5x-6x) and provide investors with a considerable pick-up in yield with 5-year USD-denominated paper trading at around 4.5%-5% vs. just under 2.5% for independent European operators and around 1% for investment grade rated U.S. operators.[9]

From an ESG lens, the social benefits of independent TowerCos in emerging countries are wide. As highlighted earlier these are critical to the communications sector, and tower demand is expected to be driven by growing populations and economies, rising cell phone usage, and increased smartphone penetration. Environmental risks appear minor and we note that some use diesel consumption to power their generators due to the frequent electricity disruptions that occur in the company's markets, although they are currently trying to optimize power consumption and to reduce reliance on these. Corporate governance is a key risk for EM TowerCos, however. For example, fraud, bribery and corruption have been more common in their countries of operations than in more developed nations, although many companies have put procedures in place to ensure compliance with relevant legal requirements on these issues. We also highlight the regulatory risks the TowerCos face, particularly when it comes to offshoring cash and obtaining permits and licenses, but for the most part regulation in these markets has been supportive of tower operators.

## Analyzing Financial Institutions, with a Focus on Asia:

Unlike the Global Financial Crisis (GFC), when banks were the source of the problem, we have viewed the Banking sector as part of the solution during the COVID-19 pandemic. Measures taken to de-risk the banks including stress tests, liquidity coverage ratios, Basel capital standards, G-SIB capital buffers, etc. have positioned the sector well, in our view, for the current crisis. For example, much of the riskiest lending moved to the non-bank space where we have seen the greatest value declines. In the U.S., the Federal Reserve also acted quickly by rolling out programs used effectively in the GFC and granted critical regulatory relief.

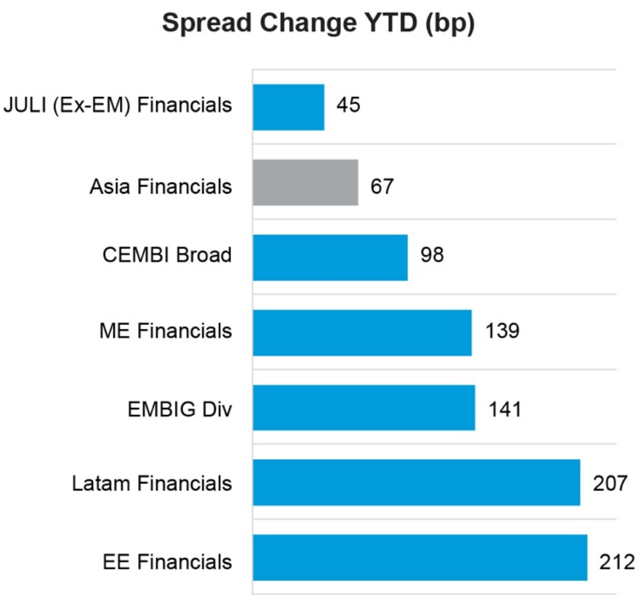
We observed a similar trend in Asia, especially with banking systems in major economies. After the Asia Financial Crisis in late 90s, regulators in the region helped to improve the banks' balance sheets, risk management and regulatory framework consistent with global standards and hence, Asian banks were able to navigate through the GFC without material weaknesses. Major banking systems in Asian EM, Greater China, Korea, Malaysia, and Singapore, went into the COVID-19 pandemic with healthier balance sheets and strong governmental support, including sizable fiscal spending and monetary easing. India has been the exception. Despite better underwriting, improved problem loan recognition, and capitalization following a central bank directed asset quality review in 2015, the Indian banking system buffers still look weaker relative to Asia-Pacific peers. Also, with limited fiscal headroom, fiscal support measures have been constrained. As such, we expect India's banking system to remain under significant pressure.

In the U.S., despite coming into the crisis with relatively strong balance sheets, banks have never encountered a virtual shutdown of the global economy. Liquidity stress scenarios never contemplated so many corporate borrowers drawing lines of credit in order to ride out the crisis. In Asia, funding and liquidity remain a key strength of banks. Banks in the region have funded credit supply with deposits and have not relied on wholesale funding. Strict lockdown measures lowered credit demand and reduced consumer spending led to strong deposit inflows.

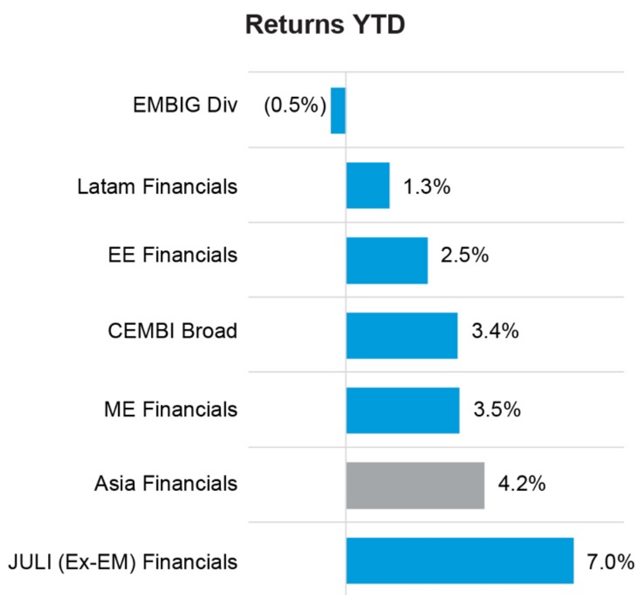
Fundamentals remain mixed, as globally, low interest rates have compressed net interest margins, but higher trading revenue has been an offset for banks with trading operations. Liquidity and capital also appear strong. Looking forward, the focus will likely be on credit costs as direct stimulus measures to borrowers and the pandemic fade. Banks have taken large provisions for expected losses in 2020 but actual losses are difficult to estimate at this time due to fiscal stimulus and forbearance. In Asia, the diversity in economic development stages, regulatory frameworks and government strength is a feature of the region. On one side of the spectrum, there are countries comprising large and more advanced economies in the world such as China, Korea, Singapore, and Hong Kong, and on the other, there are those in early stage of modernization of economies such as Vietnam. As a result, fundamentals of banking systems in the region seem mixed with national champions in each system more resilient than other domestic peers. National champions appear to have healthier balance sheets, better access to funding sources, and more supportive regulators and governments. However, there are growing pockets of weakness among smaller and regional banks exposed to more vulnerable sectors such as small and medium enterprises (SMEs) and have more susceptible funding access. In general, banks in Asia are more dependent on net interest income and are facing pressure on profitability due to monetary easing.

There is optimism. Governments and regulators across the globe have moved quickly and massively to try and offset the economic impact of COVID-19. As the pandemic fades, these efforts could lead to a more rapid economic recovery, allowing banks to reduce reserves. In Asia, major economies in the region have contained the outbreak relatively well and have begun to recover, notably in China and Korea. Other economies in the region are gradually recovering as well. We expect banks in the region to remain resilient reflecting sound balance sheets with strong government support.

Amid the pandemic, we moved quickly to reassess our positions and sector views. We performed stress tests under various economic scenarios and identified potential fallen angels and downgrades to exercise our risk management and sell discipline process. Even prior to the COVID-19 outbreak, we were focused on national champions' ability to weather extra systemic shocks as geo-political risks have grown. We have positioned our bank holdings in an effort to be more resilient to the pandemic and its lasting impacts. To note as a whole, Asia financials outperformed other EM financials (see chart below).




*Source: J.P. Morgan as of 9/2020. YTD (September 30, 2020).*




*Source: J.P. Morgan as of 9/2020. YTD (September 30, 2020).*

South Korea and Singapore proved to be better relative performers YTD, and China has appeared especially resilient, given onshore investor backing, in our view (see chart below).

**JACI Financials Index Performance**

| | Asia | China | South Korea | India | Singapore | Hong Kong | Thailand | Malaysia |
|---|---|---|---|---|---|---|---|---|
| **Jan-Feb** | 2.0% | 2.0% | 2.1% | 2.1% | 1.7% | 2.4% | 2.8% | 1.2% |
| **Mar-Apr** | -2.5% | -1.2% | -2.7% | -8.9% | -1.9% | -4.1% | -7.1% | -2.9% |
| **YTD** | 3.9% | 3.6% | 4.5% | 3.7% | 4.5% | 4.0% | 3.5% | 2.0% |

*Source: J.P. Morgan, as of 9/2020, YTD (September 30, 2020).*

On the ESG front, Asian banks are, in general, in an evolving stage compared to DM peers, especially as it relates to the U.S. We focus on governance as the most important factor affecting credit profiles of banks in the region. China is the country demonstrating the widest governance and transparency gap, in our opinion, between the “big four” state-owned national champions and the rest of the sector within the country. These four banks (Agricultural Bank of China, Bank of China, China Construction Bank and Industrial & Commercial Bank of China) are under stringent requirements for governance and benefit from these policies. Public sector banks in India, however, have weaker governance compared to private sector peers or peers in major economies in Asia, based on our analysis. Overall, we believe that governments are focused on improving governance standards in Asia, but a wide gap relative to DM banks will likely to persist, at least in the near-term.

## Looking Forward:

The length and shape of the recovery will be key to sustainable corporate fundamentals. The rating migration is skewed to the downside. However, the proactive steps companies take during the pandemic, along with economic recovery would help serve as a mitigant. As revenue growth and EBITDA has come down for corporates, we believe attention needs to be paid to large increases in leverage and potential offsets. There are a number of buffers that many corporates have, including in some cases the feasibility of sovereign support, although the uncertainty of that support manifesting has increased during the pandemic.

In this environment fundamentals matter, especially given the heightened level of uncertainty. But it is a fine balance between fundamentals and valuations, as we have seen companies with solid fundamentals, a durable asset base, and strong product-mix get penalized earlier in the year. While early on, the spread widening was extensive, as time went on, we have observed bifurcation among credit, and we expect that theme to continue. We remain focused on balance sheet liquidity and asset quality as the main driver of major portfolio shifts.

[1] EM Corporate Default Monitor (Taking our 2020 default rate forecast further down to 3.5% from 4.5%). JP Morgan. October 2020.
[2] EM Corporate Default Monitor (Taking our 2020 default rate forecast further down to 3.5% from 4.5%). JP Morgan. October 2020.
[3] Bloomberg
[4] Barclays Capital Research; Moody's Investor Service, June 2020
[5] Bloomberg
[6] flightaware.com
[7] Goldman Sachs Research
[8] Central and Eastern Europe, Middle East and Africa
[9] Bloomberg, company reports.

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# About MetLife Investment Management

MetLife Investment Management (MIM),[1] MetLife, Inc.'s (MetLife's) institutional investment management business, serves institutional investors by combining a client-centric approach with deep and long-established asset class expertise. Focused on managing Public Fixed Income, Private Capital and Real Estate assets, we aim to deliver strong, risk-adjusted returns by building tailored portfolio solutions. We listen first, strategize second, and collaborate constantly as we strive to meet clients' long-term investment objectives. Leveraging the broader resources and 150-year history of the MetLife enterprise helps provide us with deep expertise in navigating ever changing markets. We are institutional, but far from typical.

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