Emerging Market Sovereigns' Frequent Indulgence for their Quasi-Sovereigns

By: **CHARLES-ANTOINE WAUTERS** *and* **PATRICK ESTERUELAS**

The difference between the credit spreads of non-domestic law bonds issued by quasi-sovereign issuers[1] and the credit spreads of the bonds of such issuers' controlling sovereigns has attracted our attention.[2] These credit spreads suggest that the market does not view quasi-sovereigns as benefiting from timely, sufficient and unconditional support of the sovereign. Instead, the market seems to assume a different treatment by the controlling sovereigns of the quasi-sovereigns' debt versus the sovereign's own debt. Our research suggests that, except for some extremely limited cases, this market view is unfounded. Below, we explore a series of questions that illustrate the faults in the market's view, and show that quasi-sovereigns do benefit from sufficient support from, or follow the same course as, their controlling sovereigns.

Has the quasi-sovereigns' debt been restructured without the controlling sovereign's debt having also been restructured?

While there are numerous examples of debt of quasi-sovereigns being restructured alongside and under similar terms as the debt of their controlling sovereigns[3], our research has not produced any example of emerging market quasi-sovereigns' non-local bond debt being restructured outside of the context of a restructuring of its controlling sovereign.

Why are there no such cases?

We see a number of reasons why there are no such cases. First, sovereigns may have avoided the need for a restructuring by providing support to quasi-sovereign issuers in subtle ways that are inconspicuous to the market. Equity injections or taking advantage of certain tax measures are examples of such support that the market may not necessarily associate with sovereign support, specifically for the debt of a quasi-sovereign. Second, quasi-sovereign bond buybacks can be used by a sovereign to lessen the burden of a maturity or interest payment and to avert a distress situation. Third, as we will discuss below, a quasi-sovereign default will likely present many potential negative repercussions that the sovereign would rather avoid. Finally, there is not a long history of emerging market quasi-sovereigns with bonds outstanding in times of market distress, as historically their debt has mostly consisted of bank debt.

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What are a sovereign's motivations for avoiding a default or restructuring of its quasi-sovereigns?

There are two main reasons why a sovereign would be motivated to support its quasi-sovereigns in order to avoid a default or restructuring.

A default by a quasi-sovereign could be very disruptive for the sovereign in a number of ways:

1. Quasi-sovereigns typically perform essential services or tasks for its sovereign and do so on more favourable terms for the sovereign than a private sector counterparty would. Examples of such quasi-sovereigns might include commodity producers that generate significant revenues for the sovereign, companies involved in distribution of electricity, water, and other essential services to the population, or key actors of the banking system;
2. Quasi-sovereigns are often 'brain children' of political regimes, and it may be symbolically difficult for the regime to turn its back on them without discrediting the regime and its policies;
3. Quasi-sovereigns have a corporate form, and do not benefit from sovereign immunity. This means that their assets can be vulnerable to creditor attachments;
4. Quasi-sovereign restructurings can be messy, time consuming, costly, and have an unpredictable outcome;
5. Quasi-sovereigns are usually counterparties to various contractual arrangements, most of which will contain customary termination provisions triggered by a default on their debt;
6. Finally, a default may limit the quasi-sovereign's market access, and market access for the sovereign itself may be negatively impacted as a result, as the default could generate doubts as to the sovereign's willingness to pay its own debt (see, for example, recent Moody's ratings reports on Petrobras and Brazil).

In addition, while a default of a quasi-sovereign would be disruptive to its sovereign, sovereign support that is provided to prevent such a default is relatively inexpensive. For example, a sovereign guarantee doesn't require a cash outlay, but it sends a signal to the market that is salvatory for both the sovereign and the quasi-sovereign.

Examples of restructurings in a similar (but not identical) context

We have seen a few restructurings of companies with close ties to their sovereign that support the findings discussed above, but these are not exact examples of stand-alone quasi-sovereign restructurings. In particular, **Naftogas**, **Dubai World** and **BTA** have been restructured in the recent past.

NATIONAL JOINT-STOCK COMPANY NAFTOGAZ OF UKRAINE

Naftogas, a gas company controlled by the Ukrainian government, restructured approximately USD 1.6 billion of term loan facilities from foreign banks, including USD 500 million of loan participation notes, in 2009. While this was a standalone restructuring, the notes were exchanged, within two weeks of the default, for new government-guaranteed bonds with a higher coupon and a 5-year maturity extension. In NPV terms, the new bonds provided an 85-90 cent recovery and the restructuring presented no NPV loss relative to the then current trading price. Coupled with the value provided by the guarantee, this restructuring barely affected the value of the notes.

DP WORLD

Dubai World, a large real estate investment firm owned by the Emirate of Dubai, restructured its bank debt in 2015, while its non-domestic law bonds were not restructured.

BTA BANK

BTA, a Kazakhstan-based bank, restructured its bonds in 2009 and a follow-up restructuring was conducted in 2012. BTA's restructuring does not qualify as an example for our purposes because (1) in 2009, the government was not a controlling shareholder of BTA (that only happened as a result of the 2009 restructuring); and (2) in 2012, the controlling sovereign did not have non-local law bonds outstanding. It is still useful to note, however, to show the breadth of the research that has been done on these types of cases.

Takeaway

One example may come to play in the coming months or years: Petroleos de Venezuela S.A. (PDVSA). For the reasons already discussed above, we think that PDVSA will follow the fate of Venezuela; we apply those reasons to PDVSA below. There are other PDVSA or Venezuela-specific reasons the discussion of which would fall outside of this article.

— *Essential services*—Oil constitutes 95% of the country's exports and >50% of its GDP. The slightest disruption of its activities would be fatal to the government, its policies and its market access.

— *Brainchild of regime*—PDVSA is not the archetypal example of a brainchild of a regime because (1) it was created by a prior regime and (2) the government has floated the idea of creating a "side-car" and leaving PDVSA as a shell (which may well be challenged by creditors based on fraudulent conveyance rules in the U.S.). On balance, it still is very close to the regime's heart because of its Maduro regime-laden governance.

— *Attachments of assets*—PDVSA is a corporation whose assets (e.g., oil sale receivables; refineries, in particular those outside of Venezuela) could be attached — we do not discuss here the likelihood of success of attachment efforts. In addition, there is no realistic chance of a U.S. bankruptcy proceeding offering a stay that protects assets located in the U.S. whether through a main proceeding (Chap 11) or recognition of a foreign one (Chap 15).

— *Unpredictability of restructuring*—restructuring PDVSA debt without restructuring Venezuela debt will likely run into a quagmire due to intercreditor fights (most bondholders own debt of both, compounded by the involvement of various powerful creditors like China). This unpredictably is increased by the uncertainty of the outcome of litigation along the lines of the Argentina holdout case or as a result of the possible use of exit consents.

— *Contractual arrangements*—Offtake or hedging agreements (which we cannot verify as they are not public) will likely contain customary termination provisions triggered by a default on PDVSA.

— *Defaults*—The government's reliance on PDVSA for revenues joins by the hip the quasi-sovereign with its controlling sovereign. As an example, PDVSA's recent exchange offer (aka, the "swap") generated almost the same volatility on the sovereign bond trading prices as it did on PDVSA's. ■

1. A quasi-sovereign is a corporate entity, legally separate from, but controlled by, a sovereign. Bonds issued by quasi-sovereigns do not cross default to bonds issued by the respective sovereigns. This is a key difference from bonds benefiting from a guarantee of a sovereign.

2. This article only examines non-local law bonds. Bonds and bank debt are sometimes treated differently in a restructuring because bank debt can more easily be renegotiated with its creditors. Banks may receive other consideration to entice them in a restructuring, for example, contracts or other business from the sovereign or other quasi-sovereigns. Banks may also be subject to certain pressures from the sovereign as to their business in the sovereign's jurisdiction. Bonded debt, on the other hand, represents a key source of financing that a sovereign does not often have the luxury of foregoing. Also, in cases were the bonded debt represents a smaller portion of total debt than bank debt, remaining current on the bonded debt payments is less problematic.

3. For example, in certain past debt restructurings of the Mexican Government, Petroleos Mexicanos S.A.'s (Pemex, a Mexican quasi-sovereign) external indebtedness was treated on the same terms as the debt of the Mexican Government and other public sector entities

▼ **Charles-Antoine Wauters** is portfolio counsel and research analyst at EMSO and based in London, covering investments in both the sovereign and corporate areas that are driven by legal considerations. Prior to joining EMSO in October 2013, Charles-Antoine was an associate at the law firm of Cleary Gottlieb Steen and Hamilton LLP in Brussels (2006) and New York (2007-2013). His practice was focused on financing transactions. He represented domestic and foreign issuers and financial institutions in acquisition financings, high yield securities offerings, debt restructurings and liability management, and he also advised clients on questions relating to covenants and credit support of debt instruments. He represented domestic and foreign corporations or financial advisors in domestic or cross-border transactions. Charles-Antoine completed a LLM in corporate law at New York University, in connection with which he was offered a Fulbright fellowship and was a Belgian American Educational Foundation Fellow. He also holds a Master's in Financial Management from the Vlerick Leuven Gent Management School. He is a law graduate from the Université Catholique de Louvain and the Facultés Universitaires Notre Dame de la Paix of Namur, and studied at the University of Ottawa as an Erasmus honors student. Charles-Antoine is a member of the Bar in New York.

▼ **Patrick Esteruelas** is the senior analyst, sovereign credit at Emso, focusing on political risk analysis. Patrick started his career in 2000 at the Inter-American Development Bank, where he served in various consulting capacities. He then joined Eurasia Group as director for Latin America where he actively supported the Latin American investment strategies of multiple hedge funds, mutual funds and money managers. Prior to joining Emso, he was a Vice President at Moody's Sovereign Risk Group, where he covered multiple countries across the ratings space. His deep knowledge and experience in political risk analysis complements the portfolio management team's market experience in Emso's investment process. Patrick earned an MA in International Relations and Economics from Johns Hopkins School of Advanced International Studies (SAIS) and a BA in European Studies from the London School of Economics.