Investing in emerging markets

Argentina: Debt reprofiling

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- Argentina announced a plan to "reprofile" USD 101bn in outstanding sovereign liabilities. We think the plan is negative for the financial stability of the country. The key risk is that this further erodes public and investor confidence, leading to accelerated withdrawals of peso and USD deposits from the banking system, and more aggressive dollarization of savings.
- We think authorities will find it fairly straightforward to generate savings from the extension of maturities of local-law short-term debt. A voluntary reprofiling of local-law long-term debt could also yield savings. But we are skeptical that the proposal for voluntary reprofiling of external-law long-term debt will succeed. A credible and comprehensive macroeconomic plan is a necessary condition to regain investor trust and for such a proposal to be successful, which is lacking.
- With the door now open for bond reprofiling or restructuring, in this piece we review the small print of bond prospectuses. We conclude that restructured bonds, those issued in the context of Argentina's 2005 and 2010 debt restructurings, are marginally more difficult to restructure than Macri-era bonds. Argentine-law bonds would be the easiest to restructure considering the country's ability to change the rules of the game.
- At current valuations, Argentine sovereign bonds are discounting fairly dire restructuring conditions. We therefore keep the majority of Argentine sovereign bonds in our bond lists rated as Fair until more clarity arises on the political and debt restructuring process. We expect YPF to remain current on its financial obligations and therefore maintain all YPF bonds rated as Fair. We reiterate that following the dramatic change in Argentina's outlook, Argentine sovereign, quasi-sovereign, and YPF bonds are no longer suitable for a hold-to-maturity strategy. Investors with a relatively low risk appetite who are not in a position to tolerate high volatility and a likely debt restructuring should steer clear of Argentine bonds.

What happened?

Argentina's Economy Minister Hernan Lacunza announced on Wednesday a plan to "reprofile" outstanding sovereign debt, roughly USD 101bn according to Bloomberg: USD 57bn in short- and long-term debt raised in capital markets, and USD 44bn in loans received from the IMF.

The announcement comes at the end of an IMF mission to assess the country's current economic condition and meet with the two leading presidential candidates ahead of a planned disbursement of USD 5.3bn in loans, which is needed for Argentina to close its 2019 financing program. Alberto Fernandez, the opposition candidate who obtained the most number of votes in the 11 August primary elections, said this week that the IMF should not make such disbursement. The IMF issued a statement saying it will review the impact of the government's existing measures and that it will stand by Argentina throughout this crisis.

Argentine authorities have used the term “debt reprofiling” to describe a transaction in which its debt maturities are extended for a prescribed period without attempting to reduce the principal or interest rates of the affected securities. The goal is to improve the country's liquidity position and preserve its international reserves.

More specifically, the plan Lacunza announced has the following four main parts (see also Fig. 1):

1. **Local-law short-term debt:** Extend maturities of approximately USD 7bn held by institutional investors. Retail bondholders will be paid on time, in full. This would de facto constitute a default on local-law short-term debt held by institutional investors.
2. **Local-law long-term debt:** Initiate a voluntary reprofiling of approximately USD 20bn of bonds. The government plans to send a bill to Congress mandating the legal framework to pursue such a reprofiling.
3. **External-law long-term debt:** Initiate a voluntary reprofiling of approximately USD 30bn of bonds, leveraging collective action clauses (see glossary at the end of this report). The government will coordinate with banks to send a proposal to investors.
4. **IMF loans:** Initiate discussions for a reprofiling of IMF debt.

The authorities also said that interest and principal payments will continue to be made during negotiations with bondholders and the IMF.

The reprofiling plan excludes, for now, a number of specific securities: provincial bonds; Plan Gas bonds; Bonte bonds (2020, 2021, 2023, 2026); all Discount bonds issued in the 2005 and 2010 restructurings in all currencies and applicable laws; and Bocon bonds (2022, 2024). Given the lack of an immediately evident pattern in the selection of excluded securities, this list may be subject to adjustments.

Lacunza stressed that savings from these debt-relief initiatives would be used to protect the value of the peso.

Fig. 1: Terms of bond maturity reprofiling

Reprofiling does not include changes to principal or interest amounts

	Holders	Treatment
Short-term (Lecap, Letes, Lecer, Lelinks)	Retail investors (90% of holders)	Full payment, on time
	Institutional investors (10% of holders)	15% on time 25% delayed 3 months 60% delayed 6 months
Long-term*	International investors	Voluntary reprofiling: extension of maturities
	Local investors	

Source: Argentina Finance Ministry, UBS, as of 28 August 2019

*Excludes: Provincial bonds, Plan Gas bonds, Bonte bonds (2020, 2021, 2023, 2026), all discount bonds issued in the 2005 and 2010 restructurings in all currencies and applicable laws, and Bocon bonds (2022, 2024).

Our view

Overall, we think the plan is negative for the financial stability of the country. Our concern is that it is unlikely to regain market confidence as the public and investors may interpret the country's liquidity situation to be tougher than they originally believed, that the IMF's multi-billion USD disbursement may be at risk, or that the authorities are prioritizing currency market interventions over bond payments.

In our view, the key risk is therefore that the plan could trigger a further erosion of public and investor confidence, leading to accelerated withdrawals of peso and USD deposits from the banking system, and more aggressive dollarization of savings. In our 19 August note titled "Argentina: Post-primary scenarios and investment implications," we took a detailed look at the Argentine financial system and concluded that it stands on relatively solid footing, according to a range of liquidity and solvency metrics. But there is a limit to how much even a healthy banking sector can withstand.

Of the four steps outlined in the plan, we think the authorities will find it fairly straightforward to generate savings from the extension of maturities of local-law short-term debt. Conditional on the support of the opposition—which is far from guaranteed in the current fractured political environment—a voluntary reprofiling of local-law long-term debt could also yield savings, considering that various government agencies have sizable holdings of these securities and can combine with other bondholders in case collective action clauses are employed.

We are skeptical that the proposal for voluntary reprofiling of external-law long-term debt will succeed. A credible and comprehensive macroeconomic plan—one that attempts to put Argentine debt on a sustainable path—is a necessary condition to regain investor trust and for such a proposal to be successful. In our view, the current administration of President Mauricio Macri is in no position to offer such a program alone, since the 11 August primary elections have led most investors to believe that the opposition will be in charge in three months' time. To stabilize Argentina's economic and financial conditions, Macri, Fernandez, and the IMF must agree on basic policy principles as the country transitions into a new four-year presidential term.

Here we go again; focus on bond terms

With the door now open for bond reprofiling or restructuring, it's time to look at the small print of bond prospectuses, again.

Table 1 summarizes bond-level information on grace periods, the characteristics of collective action clauses, cross-default provisions, and bond acceleration provisions, for external-law bonds across currencies. The glossary at the end of this report explains the meaning of these terms.

Table 1: Key bond terms

Regime	ISIN	Bond	Issue Date	Maturity	Currency	Governing Law	Grace Period: Principal	Grace Period: Coupon	% of face value to accelerate	% of face value to waive default	Cross-default	CACs: % of principal needed
Macri-era bonds	US040114GW47	ARGENT 6 7/8 04/22/21	4/12/2017	4/22/2021	USD	NY Law	30 days	30 days	25%	50%	Yes. If any event or condition occurs that results in the acceleration of the maturity of any public external debt with aggregate principal amount of over USD 50m	- To modify a single series, holders of more than 75% of the aggregate principal amount of that series must agree to the proposal. - To modify two or more series, with a proposed modification that meets the "uniformly applicable" standard (a condition where all holders are given the same restructuring options), holders of more than 75% of the aggregate principal amount of all series must agree to the proposal. - To modify two or more series, with a proposed modification that does not meet "uniformly applicable" standard, holders of more than 2/3 of the aggregate principal amount of all series, and holders of more than 50% of the aggregate principal amount of each series must agree to the proposal.
	US040114HK99	ARGENT 5 5/8 01/26/22	4/12/2017	1/26/2022	USD							
	US040114HP86	ARGENT 4 5/8 01/11/23	1/11/2018	1/11/2023	USD							
	US040114GX20	ARGENT 7 1/2 04/22/26	4/12/2017	4/22/2026	USD							
	US040114HL72	ARGENT 6 7/8 01/26/27	4/12/2017	1/26/2027	USD							
	US040114HQ69	ARGENT 5 7/8 01/11/28	1/11/2018	1/11/2028	USD							
	US040114HF05	ARGENT 6 5/8 07/06/28	4/12/2017	7/6/2028	USD							
	US040114HG87	ARGENT 7 1/8 07/06/36	4/12/2017	7/6/2036	USD							
	US040114GY03	ARGENT 7 5/8 04/22/46	4/12/2017	4/22/2046	USD							
	US040114HR43	ARGENT 6 7/8 01/11/48	1/11/2018	1/11/2048	USD							
	USP04808AN44	ARGENT 7 1/8 06/28/17	6/28/2017	6/28/2117	USD							
	XS1503160225	ARGENT 3 7/8 01/15/22	10/12/2016	1/15/2022	EUR							
	XS1715303340	ARGENT 3 3/8 01/15/23	11/9/2017	1/15/2023	EUR							
	XS1503160498	ARGENT 5 01/15/27	10/12/2016	1/15/2027	EUR							
	XS1715303779	ARGENT 5 1/4 01/15/28	11/9/2017	1/15/2028	EUR							
	XS1715535123	ARGENT 6 1/4 11/09/47	11/9/2017	11/9/2047	EUR							
	CH0361824458	ARGENT 3 3/8 10/12/20	4/12/2017	10/12/2020	CHF							
Restructured bonds	US040114GL81	ARGENT 8.28 12/31/33	11/29/2005	12/31/2033	USD	NY Law	30 days	30 days	25%	50%	Yes. If any event or condition occurs that results in the acceleration of the maturity of any public external debt with aggregate principal amount of over USD 30m	- To modify a single series, holders of more than 75% of the aggregate principal amount of that series must agree to the proposal. - To modify two or more series, holders of more than 85% of the aggregate principal amount of all series and holders of more than 2/3 of the aggregate principal amount of each series must agree to the proposal.
	US040114GK09	ARGENT 3 3/4 12/31/38	11/29/2005	12/31/2038	USD							
	XS0205537581	ARGENT 3.38 12/31/38	11/29/2005	12/31/2038	EUR							
	XS0205545840	ARGENT 7.82 12/31/33	11/29/2005	12/31/2033	EUR	English Law						

Note: Restructured bonds were issued in the context of the 2005 & 2010 Argentina restructurings

It is clear from the table that there are some differences in bond terms between the two main groups of external-law bonds: **restructured bonds**, those issued in the context of Argentina's 2005 and 2010 debt restructurings, and **Macri-era bonds**. Looking at these differences, the restructured bonds seem to face a marginally lower hurdle for holdout investors to block a proposal when compared to Macri-era bonds, given the different structure in their collective action clauses, making them marginally more difficult to restructure. Marginally different thresholds for cross-default triggers also become apparent. Argentine-law bonds, not included in the table, would be the easiest to restructure considering the country's ability to change the rules of the game.

Investment implications
At current valuations of close to 40 cents on the dollar, Argentine sovereign bonds are discounting fairly dire restructuring conditions. We therefore keep the majority of Argentine sovereign bonds in our bond lists rated as Fair (such as the 5.875% coupon bond maturing in 2028) until more clarity arises on the political and debt restructuring process.

We expect YPF to remain current on its financial obligations, unless a political decision is made, something we do not anticipate at this stage. As described in our 19 August piece titled "YPF: Messy outlook," company fundamentals are relatively sound. We expect greater government meddling, and note that the current administration decreed a 90-day fuel price freeze in an effort to curtail inflation. YPF has estimated that the measure will cost the company between USD 100mn and USD 120mn in EBITDA per month, in which case we would expect leverage to deteriorate to an arguably still-sound multiple of between 2.6x and 2.7x. We also note that all the political camps competing for the presidency have stressed the importance of the Vaca Muerta fields for Argentina, and the development of those vast resources will require a clear set of rules for the company and the sector.

We maintain all YPF bonds, including the 8.5% of 2025, as Fair, as we still believe they should perform in line with similarly rated securities, although we acknowledge that further deterioration in Argentina may hurt company valuations.

We reiterate that following the dramatic change in Argentina's outlook, Argentine sovereign, quasi-sovereign, and YPF bonds are no longer suitable for a hold-to-maturity strategy, in our view. Investors with a relatively low risk appetite who are not in a position to tolerate high volatility and a likely debt restructuring should steer clear of Argentine bonds.

Glossary
Acceleration: A clause that allows bondholders to demand full payment of principal and interest immediately should the issuer miss a payment.

Collective action clause (CAC): A clause aimed at providing an orderly voting process when an issuer intends to restructure its debt. It allows a supermajority of bondholders to agree to a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring. The ICMA version of CACs can be found here:

http://www.icmagroup.org/resources/Sovereign-Debt-Information/

Cross-default: A clause in which a default in one bond with the same issuer triggers a default in all other bonds under the issuer.

Grace period: A pre-specified period of time in which an issuer can delay a principal or coupon payment without officially triggering a default.

Pari-passu: An equal-treatment clause that stipulates all creditors should receive similar treatment. The interpretation of this clause has been hotly debated in recent years, and newly issued bonds include a more detailed description of what this means in their prospectuses. For context, see:

https://ftalphaville.ft.com/2016/04/19/2159507/the-clause-that-wouldnt-die/

Guidance on CIO WM bond recommendations

All bonds in this publication are flagged by one of the following labels: 'attractive', 'fair', 'expensive', or 'sell'. These labels reflect our assessment of the relative attractiveness of a bond when compared to issues with a similar credit rating, similar time-to-maturity and

Attractive attr.

Bonds rated "attractive are expected to generate a total return exceeding the average return of a broad bond benchmark consisting of instruments with a similar credit and duration risk, and issued in the same currency.
Our recommendation can stem from a positive view on the issuer's credit profile not fully reflected in the price, unduly high risk premiums, the probability of the issuer calling the instrument or deferring interest payments, and external factors like regulatory intervention.

Fair fair

Bonds that we view as fairly valued are expected to produce a total return in line with the average return of a broad bond benchmark consisting of instruments with a similar credit and duration risk, and issued in the same currency.

Expensive exp.

We anticipate bonds that we designate as expensive to earn a total return that lags the average return of a broad bond benchmark consisting of instruments with a similar credit and duration risk, and issued in the same currency.
Our recommendation can stem from a negative view on the issuer's credit profile not fully reflected in the price, unduly tight risk premiums, the probability of the issuer calling the instrument or deferring interest payments, and external factors like regulatory intervention.

Sell sell

While we expect our relative value preferences to produce a positive excess return, avoiding positions that default or incur large total return losses is of primary importance for a bond portfolio, in our view. When we think the risk of an adverse outcome for an instrument exceeds what is reflected in its current valuation, we issue a Sell recommendation. Such situations can include those in which the instrument appears likely to post negative total returns until redemption, either due to a highly negative yield to maturity or an imminent call at a price below market valuations. Depending on the specific situation, we may refrain from publishing a general Sell recommendation on all bonds of an issuer and only do so for individual bonds, for all bonds of a specific ranking or for all bonds with a specific remaining term to maturity.

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