Ecuador meets torn investors in frothy market

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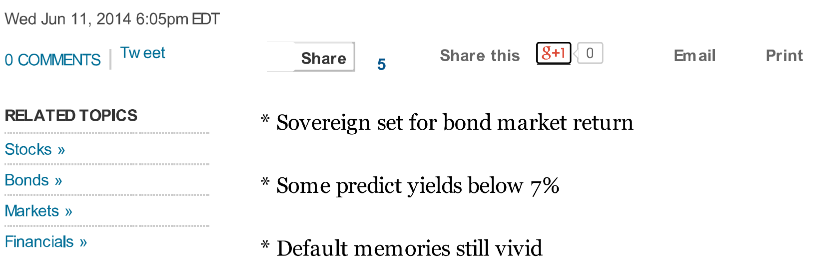

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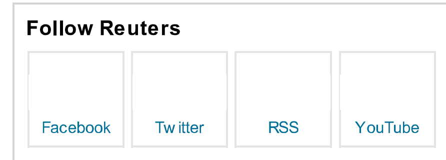

By Davide Scigliuzzo

NEW YORK, June 11 (IFR) - Ecuador's pending bond issue will help gauge how emerging market risk gets repriced in an increasingly frothy market, especially if the serial defaulter can get away with a yield under 7%.

The country, which defaulted on US$3.2bn of foreign debt in 2008, is meeting investors in the US and UK this week ahead of what's expected to be its first bond in close to a decade.

The deal has generated considerable interest, not least because the sub-7% yield predicted by some would be a coup for a Caa1/B/B rated sovereign with such a troubled credit history.

"In addition to a poor track record in debt repayment, Ecuador faces refinancing risks going forward," said Sarah Glendon, the lead analyst for Ecuador at Moody's.

"To the best of our knowledge, the authorities do not currently have sufficient resources to repay the bond coming due in 2015, although the government has strong willingness to repay this bond, and a successful return to the market will increase the likelihood of repayment."

That USD650m 9.375% note is seen as a key reference for pricing on the new issue, which is expected to carry a 10-year tenor.

It was trading at a cash price of 107.5 to yield 4.2% mid-market, or 370bp over US Treasuries, before details of the investor meetings were announced Monday.

Based on that, investors said, the sovereign could price a new 10-year as tight as 6.5%.

"Anything with a 7% handle would see a lot of demand," said Jim Barrineau, co-head of emerging market debt relative at Schroders.

"It would still look cheap compared to other credits in the same category."

RISKY PEERS

Borrowers are benefiting from the distortions brought about in part by accommodative monetary policies in Europe, the US and Japan.

Looking at prior pricings in the region, for example, Mexico paid mid 7% yields on 10-year money in 2002 when it carried a higher Baa3/BB+ rating.

It is a similar story for Brazil, which printed 10-year bonds in the low 7s in 2009 when it carried ratings of Ba1/BBB-/BB+.

Yet in a global rally that has lifted even the riskiest credits, yields of 7% or lower make sense, as investors venture further down the credit spectrum to boost returns.

Rwanda's (NR/B/B) 6.625% 2023s climbed to a record 104.75 on Tuesday to yield 5.93% mid-market, while Pakistan's (Caa1/B-/NR) 8.25% US$1bn 2024s were quoted at 107.25 mid-market to yield 7.17%.

And while similarly rated Venezuela (B2/B/B) and Argentina (Caa1/CCC+/CC) have bonds trading in the double digits, Ecuador has strengths that separate it from its high-beta neighbors.

"Ecuador's scarcity value and index inclusion puts them in a different category, closer to double B credits," said Siobhan Morden, head of LatAm strategy at Jefferies, who thinks Honduras is perhaps a better comparable. That Central American sovereign, rated B3/B, now has 10-year bonds trading in the high 6s.

Though some accounts are reluctant to reward one of the few sovereigns that was unwilling - rather than unable - to pay its debt, many believe technicals will prevail.

"There is the issue of what yield the bond could come at, and then there is fair value," said Matthew Murphy, a portfolio manager at Boston-based Eaton Vance, which owns some of the sovereign's 2015s but was not involved in the 2008 default.

He reckons fair value for Ecuador's new issue would be at a spread of around 650bp over US Treasuries, equivalent to a yield of roughly 9% for a 10-year tenor.

But he said strong demand for high-yielding bonds in emerging markets could push pricing tighter.

"Most of the work we are doing is to understand [Ecuador's President Rafael] Correa and get into his mindset," Murphy said.

"If the country needs capital he will be pragmatic and do what is necessary, but there is always the risk of him changing his mind."

OPEN WOUNDS

Many in the market are torn between turning their back on a sovereign that selectively defaulted just six years ago and welcoming Ecuador's positive changes and efforts to make amends.

"It is hard to forgive Ecuador's track record," said Morden at Jefferies.

"It carries a clear stigma, especially when it is the same president, but you have to recognize their economic performance is better and they are making attempts to improve investor relations. They have agreed to an Article IV review [with the International Monetary Fund], which is more than Argentina is doing."

Investors hit by the 2008 default are less forgiving.

"I still remember the default vividly. We were invested in Ecuador at the time and I certainly remember how they deal with bondholders," said one US-based portfolio manager.

"There isn't much to have an investment thesis on. I know there is a price for everything, but as long as Correa is president, Ecuador should have no place in this market."

And reforms introduced in 2008 - including the stipulation that sovereign debt can only be used to fund infrastructure investments or refinance existing debt at better terms - have done little to improve perceptions.

"I don't think anyone who has been in the market for a while believes those provisions would be worth the paper they are written on if Ecuador were in a stress situation," said Barrineau at Schroders.

CHINESE LOANS

Should the skeptics carry the day, Ecuador may pay more than 7% for the new bond -

though the government could find cheaper funding elsewhere.

Since the 2008 default, Ecuador has relied on China and the domestic market to finance its budget deficits, while also receiving bilateral loans from CAF and the IDB.

The government's outstanding debt with China rose to US$4.6bn as of August 2013, with annual interest payments ranging between 6% and 7%, according to Moody's.

Still, diversification of funding sources may be worth a premium at a time when the government is thought to be keen to wean itself off a reliance on Chinese loans.

(Additional reporting by Paul Kilby; Editing by Marc Carnegie)

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