Sovereign Debt Investing: A Distress Investing Approach

The credit quality of sovereign debt is the subject of current scrutiny and debate.

The business of government is a complex one with multiple objectives and indeed philosophies.

Some believe that governments are inherently inefficient and therefore should have their mandate clearly defined and limited. Others see government as an arbiter that corrects market imperfections.

Unable to deal with such complexities, I have decided to look at how government fund’s itself and the implications arising. I have also decided to take an even narrower view, that of an investor in sovereign debt. What would I look for, what would I demand and what would I avoid?

I would like the issuer to be solvent. Given that governments can print money, I am less worried about default, however, I do worry about the debasing of the issuer’s currency (the FX rate) and the erosion of purchasing power (inflation.)

I would like the issuer to be profitable. This needs clarification. Governments derive profits from two sources, profits from investments and enterprise, and tax revenue. I would like to see the issuer’s economy in a state of healthy growth as this is positive for tax revenue. I am a firm believer that tax revenue is highly elastic and therefore would subscribe to having a lower tax rate and higher economic growth than a higher tax rate and lower economic growth. I would prefer that a government derives a significant proportion of revenues from investment and enterprise. There is a substantial risk that this can crowd out private enterprise. A sovereign wealth fund with a good deal of independence is a helpful vehicle towards this end. Governments should be investors and not operators of enterprise. They are simply poor allocators of resources and lousy businesspeople. A segregation of the investment decision is important.

Government must be a going concern. If we assume that governments do not create wealth from resource reallocation, the only creation of wealth and cash flow must come from ongoing operations. A separate analysis of the available assets for sale of a government including non income yielding assets should be done but a government can only sell so much of the family silver before it decimates its assets. A sovereign wealth fund can, however, engage in acquisitions and divestitures, hopefully on a profitable basis. They often do that by investing in private equity directly or through funds. Land sales, licensing and other rent extraction are other ways of raising cash. I would be wary of governments who raise cash this way as it either reduces its stock of potentially productive assets or is simply ad hoc taxation and is sometimes a sign of desperation.

I would like to see a government with a good handle on its operational expenses. This is a complicated concept. What are the operational expenses of government? Provision of law and order, state sponsored healthcare, social security, public education, are examples of operational expenses. We discuss capex separately as it is an investment despite being a negative cash flow. A judgment needs to be made whether a public service is provided efficiently or not. A service may be efficiently provided yet represent a substantial operational expense if the service provided is of a high quality or value. The decision to provide such service is a democratic decision and not a commercial one. As a creditor I would like to see efficient execution of the non-commercial decision. The execution of the establishment and operation of the business should be done on a commercial basis. Government can and will in all probability have to subsidize the service but should do so at arms length in such a way that it interferes as little as possible with commercial pricing and allocation within that market.

From the above, I would seek to arrive at the equivalent measure of an EBITDA of a government. Note that taxation is a source of revenue for government. All the usual adjustments should be made to handle capitalization of leases, adjustment of depreciation for the true and economic cost of maintaining capital for use as a going concern. The Enterprise Value of government needs to be estimated. I will not go into more detail here as it would be an entire body of work. The idea is to arrive at some comparable valuation for the sovereign issuer. Valuation should be made on a going concern basis as well as a liquidation basis even though it is inconceivable that a government would file for Chapter 7 or Chapter 11 liquidation. While not 100% relevant, the exercise would draw one's attention to off balance sheet liabilities, intercreditor guarantees, and the complex capital and legal structure of the issuer.

Ultimately, any good or service has to be paid for wherever it is provided by the private sector or by government. The role of government is to redistribute cost and wealth through taxes and the socialization of certain goods and services. Then there is the cost of that redistribution. As a creditor I would like to see an efficient redistribution from a cost perspective. Efficient redistribution from a welfare perspective is something best left to academics.

Theoretically, and in some senses practically, governments have a distinct advantage over private enterprise in raising debt capital. We see this in the yield on government debt relative to private enterprise debt. Unless government are fraudulent, grossly incompetent or simply act in bad faith, capital markets are open to them. The question is at what price. Governments financial planning therefore needs to centre on profitability and not cash flow (unless fraudulent, grossly incompetent or dastardly).

It seems therefore that as long as governments are run reasonably poorly, but not unreasonably poorly like some clearly are, debt capital markets are open to them and its a matter of price.

As I said in the beginning, default in the sovereign currency is not an issue. The issue is exchange rate and inflation. The higher is inflation expected to be, the higher the yield a creditor will demand for compensation. Anything that threatens the stability of that expectation, even to the downside, will increase the yield in the form of an option premium over base compensation. Government’s inflation fighting abilities therefore impact pricing. Now FX. If the exchange rate is expected to deteriorate, the external investor or creditor will demand a compensatory premium. Any attempts to hedge currency is likely to be self defeating or duration mismatched.

Arbitrage investors in sovereign bonds do so on the basis of no default, technical implications for inflation expectations priced in the TIPS market, technical no arbitrage conditions in the swaps and repo markets, liquidity premia in on and off the runs and in the convexity of the term structure.

Long term liability based investors invest in sovereign bonds based on a macro view, on the fundamental economic strength of the underlying economies.

The above is a distress investors’ point of view of analysing the investment proposition in sovereign debt. No one approach is right but understanding all approaches, understanding which constituents are the marginal driver of pricing, can lead to interesting investment opportunities.