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FINANCE & ECONOMICS

Emerging-market debt

Stylish haircut

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An unexpected bonus for investors in Argentina's debt

ARGENTINA'S \$80 billion debt restructuring, completed in February 2005, looked like a catastrophe for investors in emerging markets. Bondholders had little choice but to accept the loss of two-thirds of their capital—a haircut, in the jargon, of unprecedented severity. The financial press was filled with fears that other borrowers struggling to service their debts might follow Argentina's example. Yet there was no wave of defaults. What might be copied, in fact, is a little-noticed component of the paper Argentina issued in its debt exchange that could do both lenders and borrowers some good, giving governments a less risky method of financing themselves and lenders a new source of higher yields.

In addition to payments of interest and principal, the new bonds contained a second potential income stream, called a GDP warrant. The prospectus envisaged a course for Argentina's economic growth rate over the life of the bonds, starting at 4.2% in 2005 and declining to 3% in 2015 and thereafter. In any year when the economy grows faster than expected, creditors will receive 5% of the difference between the size of GDP in that year and that predicted by the prospectus. The payments will continue until the bonds mature or the government has spent a total of \$40 billion on the warrants, or 48% of the face value of the defaulted debt.

For some reason, the Argentine government laid little emphasis on the warrants in its roadshow to promote the restructuring. Investment banks found their worth difficult to assess. As a result, last year most analysts reckoned them to be worth practically nothing. But last November, as set out in the prospectus, the warrants were decoupled from the bonds and began to be traded independently on the secondary market. By then it was clear that in 2005 Argentina's GDP would grow by about 9% for the third straight year and that the peso would appreciate by 10% or so in real terms against the dollar (under the terms of the warrants, this also boosted the payout).

This not only meant that creditors were due to receive around \$1.2 billion from the warrants, but also established a healthy gap between the economy's actual size and the path laid down in the prospectus. Because warrant holders are entitled to a percentage of this gap, even if Argentina exceeds its target growth rates by the merest fraction of a percentage point every year until the bonds mature, they can expect to receive similar payments annually. As it happens, economists have raised their forecasts for 2006 and 2007 and the payouts seem likely to increase. Because emerging markets continued to rally in 2005, lowering interest rates, the present value of those income streams increased even further.

Buried treasure



As a result, the warrants' price doubled in just four months, rising from 4.74 cents on the first day of trading to 9.4 cents last week. A recent report by analysts at HSBC bank suggests they have even more room to climb. Assuming that the Argentine economy grows by 7.5% in 2006, 5.7% in 2007 and an average of just over 3% subsequently, and that the still-undervalued peso strengthens against the dollar by 6.2% a year in real terms, they estimate that the dollar-denominated warrants are worth 15.7 cents apiece. And supposing that Argentina can somehow sustain growth comfortably above 3% in the long run—by no means certain, given the country's economic history—the warrants' value will soar yet again. The 48-cent ceiling would therefore be hit well before the new bonds mature.

The warrants' effect may not be limited to the unexpected relief they are providing for Argentina's aggrieved creditors. According to Walter Molano, an emerging-markets analyst at BCP Securities, the warrants' success may lead to a new class of variable-income securities, one with characteristics more similar to a share (where price and dividend payments are tied to future cashflows) than to a traditional bond (where payouts are fixed at the start). A market in such paper would enable governments to raise money without fear of default in a recession, because interest payments would decline or disappear when the economy was weak, and give creditors a windfall if growth was unexpectedly strong. Having cursed the Argentines only a year ago, moneylenders may yet find reason to thank them.

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