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Argentina debt exchange: The good, the bad, and the holdouts

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The Argentine government is seeking to renegotiate $20 billion of defaulted debt that creditors kept out of a 2005 restructuring that paid 30 cents on the dollar. Nearly one fourth of bondholders did not participate in the original debt exchange. Since then, they have become a major obstacle for Argentina to regain access to international capital markets. A settlement with the “holdout” investors would give Argentina access to issue debt globally for the first time since the 2001, when it defaulted on $95 billion of bonds.

The latest debt restructuring deal, swaps defaulted bonds for new bonds that will reflect the same 66.7% haircut accepted by most bondholders in the original restructuring deal. The details of the 2010 offer disappointed many investors that had hoped for a better deal, thus weighing on valuations of untendered debt. The haircut was largely expected, as well as the payment (in the form of a seven-year bond) of past due interest on the discount bond issued with the 2005 restructuring (which already reflected the principal haircut, but with interest that started being accrued dating back to December 2003).

Many had hoped that payments on GDP warrants made between 2006 and 2009 would be included in the offer to holdouts. The GDP warrants were new securities included in the package offered to bondholders on the occasion of the 2005 debt restructuring. They make annual payments if nominal GDP growth outperforms a pre-established threshold on a given year, until 2035. By the time of the 2005 exchange, these instruments were valued at only 2 US dollars each. Now the USD-denominated warrants trade at four times that original valuation. The Argentine government has decided to include GDP warrants in the 2010 offer, but will not compensate holdouts for the payments made since 2006. This omission led to a drop in the estimated value of the deal from the high 50’s to only 52 cents on the dollar.

Another complicating factor is that the “holdout” investors are very different. They range from large investors that hold several billion US dollars worth of defaulted debt, to small European retail investors, to hedge funds that have pursued the litigation route. Those who chose litigation are unlikely to accept the current deal as for years they have tried to attach assets of the Argentine government held in foreign accounts, and recently have at least succeeded in achieving court rulings that “freeze” small Argentine Central Bank foreign accounts.

Under the fairly conservative assumption that 1) half of the small retail investors will participate in the exchange; 2) 90% of institutional investors accept the terms of the deal (many of whom bought untendered debt with the sole purpose of participating in the exchange) and that 3) the hedge funds that are pursuing the litigation route will continue to refuse to settle – then overall participation rates could reach 70% of the “holdouts”. This could be good enough for the exchange offer to go through.

The true test is how the market will treat Argentine debt after the exchange. On the positive side, about a third of securities that will be created with the exchange will be USD denominated. This could lead to an increase of Argentina’s weight in the JP Morgan Emerging Market Bond Index to a total of 3%, at the margin attracting investments from asset managers that are benchmarked to the index.

A negative, opposing force could come into play if investors “sell on the good news” and take profits immediately following the exchange. A factor that could trigger this kind of reaction is the fear of excess supply of Argentine paper (including provincial paper) after the restrictions to issue under New York law are lifted and Argentina finally has access to a broader base of investors.

This fear is well founded. Since 2005, Argentina has posted very modest budget surpluses, despite strong growth and heavy taxation of the agriculture during a commodity boom. These small surpluses were not sufficient to ease the shortage of funds required to service outstanding debt. As domestic liquidity (e.g. Central Bank reserves and the national social security system) starts to dry up, it is crucial to regain access to a broader investor base. Our view is that, putting all these factors together, the exchange is undoubtedly a positive development, though maybe temporary, if lower funding constraints are followed by even weaker fiscal discipline.

Given ample global risk appetite, the government might be able to return to private voluntary markets. However, the exchange alone, regardless of its success, will not address many of the obstacles that, in our view, have limited Argentina's access to the global capital markets. Foremost among these are the inflation underreporting, growing fiscal imbalances and rapidly rising (true) inflation. We see further deterioration in all three in the months to come.