In Search of Distress Risk in Emerging Markets

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Summary

Although the non-financial corporate sector accounts for the lion's share of the post-Global Financial Crisis surge in emerging-market leverage, there is little systematic research on factors that impact corporate distress risk in emerging markets. Existing bankruptcy risk models developed using US data have low predictive power when applied to emerging market firms. This paper introduces a measure of probability of corporate default specific to emerging market firms and uses it to examine the pricing of distressed stocks. Using a novel dataset of corporate defaults along with accounting, market, and macroeconomic variables, we find that global financial variables contribute more predicting power than domestic macroeconomic variables. Specifically, corporate distress in the broad emerging markets sample is affected by changes in US interest rates and shifts in global liquidity and risk aversion, while changes in the exchange rate against the US dollar help predict default of Asian firms. In addition, controlling for whether a company has defaulted in the past improves the model's forecasting power substantially. We also document a positive distress risk premium in emerging market equities and show that the impact of a global "risk-off" environment on default risk is greater for firms whose returns are more sensitive to a composite global factor.