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Market Trends 2019/20: Latin America

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This market trends article examines the 2019–2020 trends for the largest Latin American economies, including Brazil, Mexico, Argentina, and Colombia and provides a market outlook for the remainder of 2020, subject to the obvious COVID-19 related caveats. From the vantage point of the second quarter of 2020, with the COVID-19 pandemic still curtailing normal economic activities, it is difficult to see what the trends from the past year or years can tell us about the future of the capital markets in Latin America. Nonetheless, there are several major factors that consistently influence the markets, and though we may be looking at the future through a different lens, those factors are still likely to play an important role in shaping the future trends as well.

For other market trends articles covering various capital markets and corporate governance topics, see Market Trends. For an overview of practical guidance on COVID-19 covering various practice areas, including capital markets, see Coronavirus (COVID-19) Resource Kit.

The capital markets in 2019 throughout Latin America were in many ways a reaction to the major political events that shaped the largest Latin American economies in 2018 and into 2019. With new presidents elected in each of Brazil, Mexico, and Colombia in 2018, and in Argentina in 2019, there was an adjustment period for each of those new administrations, as discussed further below. The shift in policies of the new governments played into several of the most important macroeconomic trends from the prior year. Movement in currency exchange rates, interest rates, and commodity prices, sovereign developments, and the emergence of a middle class in many countries continued to be major factors; however, the effect of these continuing trends was exacerbated by the volatility created by the political changes. Many of these macroeconomic forces intersect in the various Latin American countries with different effects. This article contains a brief analysis of each of the four largest Latin American economies but a broad overview is as follows:

- The significant fluctuation in exchange rates throughout this period has tested the economies of many Latin American countries. During periods of volatility, the capital markets have generally been adversely affected, while during periods of stability, issuers have been able to take advantage of windows of opportunity for financing in various currencies. In certain markets, the rising value of the U.S. dollar against the local currency has greatly diminished the attractiveness of U.S. dollar-denominated debt for issuers (and, conversely, has boosted local currency debt markets).
- While the oil and gas industry in the region had been starting to recover (though not as quickly as elsewhere), the recent fall in the price of oil will again be a significant

strain on the economies of many countries in Latin America. Notably, Venezuela, which is almost entirely dependent on the price of oil, continues to be in a state of extreme economic chaos. In addition, Brazil, Colombia, and Mexico remain sensitive to the price of oil, particularly as their government-owned oil companies are major drivers of their economic growth and are tied very closely to government policy. It is likely that those economies will continue to be sensitive to fluctuations in energy prices.

- The presidential elections held in Latin America in the last couple of years created market disruptions both before and after the elections. The volatility caused by the uncertainty of the election process meant that issuers and investors stayed out of the market for some time in advance and after each of these elections. For example, Latin America bond issuance, especially high yield bonds, fell off dramatically after the first quarter of 2018 (prior to the elections), and the Brazilian IPO market opened up again in 2019 following the electoral results. Further, once the new administrations were in place (or in Mexico's case, even prior to the inauguration), the new leaders of these countries were making their presence felt through changes in policies which directly impacted the capital markets.
- While a growing middle class has become a significant factor in many countries in Latin America over the last decade and a half, the recent volatility and the likely severe recessions ahead as a result of the COVID-19 pandemic are likely to slow the growth of the middle class and result in greater economic inequality. Without a strong middle class, there is less of a foundation for economic development and political stability, leaving open the possibility of further volatility.

Latin America Overview

Brazil

In Brazil, the largest economy in Latin America, the election of Jair Bolsonaro in 2018 was seen as pro-business, and the markets responded accordingly, particularly the local markets. After a period of very little international capital markets activity, Brazil's equity capital markets reopened in 2019. A number of issuers came to the international markets for the first time, along with several follow-on equity offerings, as investors saw Brazil on an upward trajectory.

Brazil's annual gross domestic product (GDP) growth rate was close to flat through 2018 after a severe recession in the middle of the decade, but this growth rate was expected to increase in 2019 and 2020 following the "free market" economic reforms that were expected to be implemented by the new administration; however, the rate of growth was again only 1.2% in 2019, and the inflation rate was not as low as the prior year. While the government was able to pass landmark pension reform legislation in October 2019 as well as some earlier privatization measures, other major pieces of its reform plans were postponed, including the so-called administrative reform, which aims to amend the overly generous terms and conditions of employment for Brazil's federal employees, and tax reform which is a very complex and ambitious undertaking.

Now that the COVID-19 pandemic is the main threat to the economy, despite Mr. Bolsonaro's reputation as "coronavirus denier," his government is primarily focused on fiscal stimulation measures to counteract the pandemic, though these measures are at odds with free market macroeconomic policies. While inflation is expected to be lower this year due in part to the drop in oil prices, the range of forecasts for GDP growth for 2020 all predict another severe recession, with the **International Monetary Fund** (IMF) expecting the economy to shrink 5.3% this year. In addition, since the beginning of 2020, the Brazilian real has experienced a record decline against the U.S. dollar of more than 30% (at the time of writing), and the currency's weakness will hurt the country's efforts to recover from the economic impact of the pandemic.

Mexico

Latin America's second largest economy has been in decline and is facing an uncertain future. Mexico went from a 2.1% annual GDP growth rate in 2018 to a decline of -0.1% in 2019, and the outlook for 2020 looks even more dismal, with forecasts predicting a plunge in GDP ranging from -7% to -12%. While the average Mexican peso/U.S. dollar exchange rate has hovered around MXN19/USD1 for each of 2018 and 2019, there has been extreme volatility throughout those periods, and for the first quarter of 2020, the average exchange rate was over MXN21/USD1 and is expected to get worse. These fluctuations in the peso value have had and continue to have an adverse effect on the Mexican economy, and on the capital markets, particularly for international investors. The Mexican peso is particularly vulnerable to volatility due to its liquidity as one of the most commonly traded currencies.

Some of the volatility in the currency has been due to certain actions and positions taken by Andrés Manuel López Obrador (often referred to as AMLO) following his election in 2018. Even prior to his inauguration, AMLO's announcement of plans to cancel the building of the new Mexico City airport caused a significant drop in the Mexican stock exchange and in the value of the peso, and it took some time for international investors to recover confidence in Mexico.

For the first part of 2019, the Mexican capital markets were less active than usual, as investors and issuers stayed on the sidelines while the new administration settled in and while the North American Free Trade Agreement (NAFTA) renegotiations were ongoing. By late 2019, the three countries involved in NAFTA had worked out a new agreement, the **United States-Mexico-Canada Agreement** (USMCA), that each announced as a success. Once the USMCA was signed, it helped usher in a period of stability for the markets and for companies that rely on the close trade relationships between the U.S. and Mexico. The agreement has since been ratified by each country and will take effect this July.

More recently, issuers that are stronger credits have been able to access the capital markets but the effects of the pandemic are being felt throughout the economy. Interestingly, the Mexican government has done very well in tapping the demand for emerging markets bonds. Mexico came to the markets first in January with a $5 billion issuance and then again in April with a $6 billion issuance, this time to provide liquidity to the government to support its efforts against the pandemic. While the forecasts for 2020 are dire, the IMF is expecting Mexico's GDP growth rate to rebound in 2021 to 3.0%, so investors appear to be taking the long view.

Argentina

Argentina's economy, the third largest in Latin America, experienced a short-lived market upswing during the early years of the presidency of Mauricio Macri, with the capital markets opening up and new issuers coming to market. However, Mr. Macri's inability to deliver on his economic promises and to control inflation sent the economy and the currency off track. The so-called "notebook" scandal detailing government corruption that came to light in the summer of 2018 caused greater volatility for the Argentine peso, and put more pressure on the government to impose austerity measures and go to the IMF for what eventually became a $57 billion loan. Though it was the largest IMF loan program in history, Argentina's loan has generally been considered a disaster, because Argentina failed to curb inflation or create enough investment in the private capital markets. The 2018 currency crisis triggered a severe recession throughout the rest of 2018 and 2019.

Thus, despite his popularity among investors, it was not surprising when Mr. Macri lost in the primary elections in August 2019 to the leftist candidate Alberto Fernández, who ultimately won the presidency. President Fernández, together with his vice president, Cristina Fernández de Kirchner (who was president from 2007 to 2015), have gone back to the Peronist policies of her prior administration, which had previously left the Argentine economy in dire straits.

Currently, the government is again in the midst of restructuring its more than $100 billion of sovereign debt, having failed to pay the coupon on three series of bonds in May resulting in its ninth default. Several major provinces are also struggling with their own debt burdens and are restructuring them. Even if the restructurings are ultimately successful, the country is expected to continue to experience a deep recession and a difficult recovery, although current indications suggest the pandemic may not be as devastating in Argentina as in other parts of Latin America.

Colombia

The fourth largest economy in Latin America, Colombia also boasts the fourth largest stock exchange, behind Brazil, Mexico, and Chile. Colombia's economy was one of the few bright spots in Latin America in 2019, having been in a positive trend following the election of Iván Duque in 2018. The growing middle class, and the so-called "peace dividend" from the 2016 accord between the government and the FARC rebels are considered to be driving this increase in stability and growth, even though that peace is somewhat fragile. Direct foreign investment, including infrastructure investment, has been quite robust, though the international capital markets are not as developed as in Brazil and Mexico. The center-right government of Iván Duque was able to pass an ambitious tax reform plan in December 2019, despite earlier setbacks and public protests that helped to alter the plan that was ultimately adopted.

In 2020, the Colombian government has been praised for being swift to react to the risks posed by the pandemic, and for taking a pragmatic approach. So far Colombia looks like it may be the least hard hit of the economies in Latin America, though the entire region is likely to be impacted for the next several years.

Notable Transactions

As mentioned previously, political events in Latin America had a strong effect on market access over the prior years. Many companies planned ahead to meet their financing needs and took advantage of market windows in advance of predicted market uncertainty in 2018 and 2019 due to presidential elections. This led to a paucity of notable transactions in 2019, and naturally there have been fewer still in recent months.

In Brazil, the international equity markets got a boost both before and after the elections, and a number of first-time and follow-on offerings were placed in 2018 and 2019. A notable example was the IPO of Brazilian financial services company XP Inc, which raised $2.25 billion in December 2019. The deal was the largest U.S. IPO by a Brazilian company since

the offering of fintech provider PagSeguro Digital LTD of $2.3 billion in early 2018. It was also the fourth-largest U.S. IPO by any company in 2019. For more information on cross-border issues, see Top 10 Practice Tips: International Securities Offerings. For additional information on international IPOs, see Initial Public Offerings in International Jurisdictions.

In Mexico, there were only three cross-border IPOs in all of 2018, and they were all structured transactions: two were Fibra-E financings and one was a SPAC IPO. The number of such IPOs in 2019 was even sparser, with only one successful international equity offering, which was in the oil and gas sector. Several other transactions were pulled before pricing.

The debt markets were more robust in 2018 and 2019, particularly for the sovereign and quasi-sovereign issuers that are repeat issuers such as Pemex in Mexico and Petrobras in Brazil. Green bonds in particular continue to be attractive to international investors, with 2019 seeing a new record amount of issuance. Chile became the first sovereign issuer from Latin America to issue green bonds, with two deals in June 2019 (in USD and in Euros). Mexico, Peru, Colombia, Costa Rica, and the Dominican Republic were all planning sovereign green bond issuances for 2020; it remains to be seen if any of those plans will come to fruition. For additional information on sovereign offerings, see Sovereign Entities Guide for Capital Markets and Market Trends 2018/19: Sovereign Bonds.

Marfrig Global Foods SA, the world's second-largest producer of beef, went a step further in the green bond arena by selling so-called "sustainable transition bonds" in 2019, to help it finance more sustainable cattle ranching practices and control deforestation. Though these bonds do not qualify as green bonds, investors were nonetheless enthusiastic to invest in $500 million of these bonds, and this class of "transition" bond is expected to grow.

Legal and Regulatory Trends

Across Latin America, there has been a common thread of regulatory changes and reforms driven by political polarization, with new governments coming into power and either overturning or reinforcing the policies of their predecessors. In some countries, there has been a rise of protectionism while other countries are trying to leave protectionist policies behind. However, regardless of the political and economic ideology, in Latin America there has recently been a rise of populism and autocracy, and this trend coupled with the decreasing economic growth accentuated by the COVID-19 crisis is likely to result in further regulatory changes ahead.

For instance, a common theme in the region is tax reform, some of which was already on the agenda in certain jurisdictions (as mentioned above). Additional reforms will likely be necessary going forward to face the large public debt being assumed by many countries to cope with the public spending to counter the economic damage caused by the pandemic.

Worker pensions (particularly for government workers) is another target for regulatory change in the region. In countries with rightist leaders such as Chile and Brazil, pension reforms have been initiated to provide more flexibility in government spending to boost the local economies. Meanwhile, in Mexico, the current administration has indicated its intention to nationalize the pension funds, a system which has been a major contributor to the economic growth of Mexican companies and Mexican capital markets during the last couple of decades.

Energy and the environment also represent sectors affected by recent regulatory changes. In Mexico, for example, the current administration is slowly dismantling energy reforms that allowed the participation of private investment in the oil and gas industry as well as in the power generation industry, promoting clean energy sources. The administration's main objective is to strengthen and increase the role of the state-owned companies at the expense of private sector participation. Though the effectiveness of these policies is yet to be seen, they impact the markets by skewing the level of public versus private funding in the energy industry. In Brazil, the current administration is weakening environmental protection laws and budgets in the guise of promoting development, which is another trend that affects the economy and the markets profoundly.

Colombia has recently completed the process to become a member of the Organization for Economic Cooperation and Development (OECD). During that process its government introduced major reforms to align its legislation, policies and practices to those of the OECD, including regulations aimed at reducing the proportion of the informal sector of its economy, which is an issue for many Latin American countries. If Colombia is successful with its recently adopted tax reform and with these other measures, it may become a standard for regulatory trends throughout the region.

Market Outlook

The outlook for the remainder of 2020 in the financial markets across Latin America will be affected mostly by the economic effects of the pandemic in each country, and by the following factors:

- The continued volatility in exchange rates, especially the pressure on the Mexican peso, could result in more restructuring transactions, particularly for those issuers with large U.S. dollar-denominated debt burdens.
- Energy and infrastructure related financing is expected to increase, whether in the form of asset dispositions, joint ventures, or bonds. The year 2020 has already seen a new Fibra-E issuance (discussed below) in Mexico, and possibly more will follow.
- At the moment, the market for green financing and other innovative structures are less active due to the pandemic, but investor interest is expected to pick up again for this asset class when the pandemic is brought under control.
- Venezuela remains a source of uncertainty in the region both politically and economically.
- Cross-border mergers and acquisitions (M&A) should continue to be attractive so long as the U.S. dollar remains strong, which is likely to reduce the number of equity IPOs and may instead provide a boost to the cross-border loan market to facilitate funding for acquisition financing.

Below is a discussion of these factors in greater detail:

Although the currency volatility in 2018 and 2019 was often due to political headlines and election issues rather than underlying macroeconomic pressures, the results of that volatility are still felt by issuers with U.S. dollar-denominated debt unless they also have matching U.S. dollar revenues. The pressure in 2020 for issuers with U.S. dollar-denominated debt to restructure or refinance their obligations is likely to increase if the U.S. dollar continues its upward trend compared to local currencies in Latin America, and if issuers are unable to generate the income to service these debt obligations. For some issuers, the markets will be willing to accept exchange offers or the functional equivalent in the form of new bond issuances with related cash tender offers; however, other issuers may not fare so well, particularly if the markets for new bonds are also unstable. Such issuers may be forced into full-scale restructuring negotiations and possibly bankruptcy filings if they cannot agree with their bondholders and other creditors on terms that are acceptable to all parties. Market outcomes will vary widely depending on the sources of revenue to finance the U.S. dollar-denominated debt.

The need for infrastructure across Latin America is a driving force for project financing. Increasing investor appetite for bond risk in this segment is expected to result in the issuance of more project bonds and structured bonds. In addition, the Fibra-E asset class is another option for investors in this segment, having been introduced to investors in 2017, with additional deals coming to market in each of the past few years. The Fibra-E structure combines elements of a Mexican real estate investment trust (known as a Fibra) and a U.S.-style MLP (Master Limited Partnership) structure and is designed to encourage tax-efficient investment in energy and infrastructure.

A number of countries in Latin America are seizing upon the green bond market as an area for future growth and are actively pitching the attractiveness of their green bond capabilities to bankers and investors. So far, the major issuances have been in Mexico and Brazil, but other countries are gearing up to expand this investment sector. As can be seen in prior green bond issuances, the use of proceeds of a green bond can vary widely and still fit within the green bond principles known to investors. These principles are intended to promote integrity and transparency in investment opportunities that contribute to environmental sustainability, including in areas of environmental concern such as climate change, natural resources depletion, loss of biodiversity, and air, water, and soil pollution, among others. There is a great deal of investor demand for green bonds that can meet those principles.

The outlook for Venezuela continues to be dismaying. Despite its oil wealth, Venezuela has been undergoing a major crisis, with quadruple-digit inflation and shortages of food and medicine, and after several years this crisis seems no nearer to a resolution. Both Venezuela and its government-owned energy company, Petróleos de Venezuela, S.A. (PDVSA), are in payment default on their respective bonds. With the alternative administration of Juan Guaido and the government of President Nicolas Maduro trying to negotiate and litigate on multiple fronts to protect the country's assets from outside creditors and from each other, not much progress has been made in what investors expect will be a full-scale debt restructuring. Because of the massive amount of debt involved, the uncertainty of a prolonged debt restructuring and the economic and political situation in Venezuela remain key factors that could slow growth in the region.

Some Latin American issuers may choose to dispose of assets to increase liquidity as an alternative to issuing securities in the capital markets, especially during times of market volatility. The M&A market may continue to be active for the remainder of 2020 across the region, but particularly in Brazil and Mexico due to the historic strength of the U.S. dollar and uncertain local economies. Opportunistic investments by U.S. and other international buyers may reduce the need for equity and debt offerings by Latin American sellers of those assets.

In sum, the Latin American capital markets should expect to see continued volatility for the remainder of 2020, though activity may be slower as issuers and investors focus in the near term on dealing with the effects of the pandemic and there is likely to be more refinancing and restructuring than new issuance for some time. Energy and infrastructure-related financings are likely to continue to be robust in the market notwithstanding distressed conditions in certain areas. Investors will be monitoring developments on trade issues as well as currency volatility; however, investor appetite for investment in the region, including innovative structures and products, remains strong despite the risks involved, perhaps due to the stabilizing effect of a growing middle class in many of these economies.

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Michael Fitzgerald heads the Latin America practice group at Paul Hastings and is based in the firm's New York office. Mr. Fitzgerald was one of the first US corporate lawyers to focus on capital markets work in Latin America and his first-mover advantage has led to his numerous representations of a wide range of international and domestic underwriter and issuer clients in debt and equity financing transactions and merger and acquisition activities. Mr. Fitzgerald and his team were recently honored by LatinFinance for Syndicated Loan of the Year and Structured Financing of the Year, in relation to their work on deals related to Mexico City's New International Airport project. He has been recognized as a Top Innovative Lawyer by the Financial Times and one of The American Lawyer's Dealmakers of the Year. Mr. Fitzgerald is also recognized as a band one leading lawyer by Chambers USA, Chambers Global, and Chambers Latin America; and is recognized by Legal 500 US as one of the four leading lawyers in the US for Global Offerings and other corporate financings. Mr. Fitzgerald is a thought leader on a variety of issues involving international finance markets and has authored articles and presented seminars on related legal and business challenges and opportunities.

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Ms. Gallup is a leader of the team that was recently honored by LatinFinance for Syndicated Loan of the Year and Structured Financing of the Year, for their work on deals related to the New International Airport of Mexico City project, including the largest "green bond" offering in Latin America at the time. The project has been lauded by the publication for an innovative financing plan of bonds and loans that has "set new benchmarks for creativity and innovation in infrastructure financing." She was named a 2016 Dealmaker of the Year by The American Lawyer for her innovative work representing GE Capital as lender and agent in an approximately $3 billion seller financing loan facility, one of the largest real estate financings ever in Latin America. She has also been recognized as among the top lawyers in Latin America by Latinvex and as a leading lawyer by IFLR1000. She has written extensively on the topics of Latin America capital markets and debt restructuring.