Practical Guidance

Market Trends 2020/21: Latin America

A Practical Guidance® Practice Note by Michael L. Fitzgerald and Joy K. Gallup, Paul Hastings LLP

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This practice note examines the 2020–2021 market trends for the largest Latin American economies, including Brazil, Mexico, Argentina, and Colombia, and provides a market outlook for the remainder of 2021, subject to COVID-19-related caveats. Certain trends that began prior to the pandemic seem to have been accelerated throughout the past year, including adverse trends towards greater instability and volatility in certain jurisdictions, as well as market-friendly trends such as greater interest in environmental, social, and governance (ESG) financing. Though we are looking forward to a post-pandemic future, increased uncertainty is likely to continue to affect the markets for some time.

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.

Latin America contains approximately 8% of the world's population, but as of April 15, 2021, the region represented approximately 28% of all the deaths from COVID-19, according to the World Health Organization. Among the main reasons for this disparity are the region's severe income inequality and, in many countries, insufficient funding for social services such as healthcare, making treatment for severe cases and vaccination distribution much more difficult. As a whole, the region experienced an economic contraction of approximately 7.7% last year; however, the impact of the pandemic on the capital markets across the region has been very different from country to country and closely tied to the policies of the governments in each affected country.

This practice note contains a brief analysis of each of the four largest Latin American economies but a broad overview is as follows:

- **Brazil and Mexico.** The Brazilian economy has managed to come out of 2020 only slightly smaller than it was in December 2019, due to a massive fiscal stimulus package in response to the COVID-19 pandemic that helped boost growth in the last quarter of 2020. Not surprisingly, the Brazilian initial public offering (IPO) market has been extremely strong, particularly in the latter half of 2020, and continued even stronger into the first quarter of 2021. Meanwhile, Mexico's government has taken the opposite approach to the pandemic, providing no government stimulus, and there were no IPOs out of Mexico again in 2020. Government attention to the pandemic, including access to healthcare and vaccine distribution, will likely factor into the upcoming elections throughout the region that will affect the kinds of monetary and fiscal policies implemented in the future, and the related impact on the capital markets.

- **Middle class.** While a growing middle class had become a significant factor for market growth in many countries in Latin America over the last decade and a half, the severe contractions in the region's economies as a result of the COVID-19 pandemic exacerbated economic inequality in a region already suffering from great inequality, according to the United Nations Economic Commission on Latin America and the Caribbean. Without a strong middle class, there is less of a foundation for economic development and political stability, leaving open the possibility of further volatility and reduced capital markets activity.
- **Exchange rates.** The significant fluctuation in exchange rates throughout this period has tested the economies of many Latin American countries. During periods of exchange rate 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. While the low interest rate environment in the U.S. has helped to boost opportunistic debt issuance and liability management exercises by issuers with access to the U.S. debt markets, a strengthening U.S. dollar and the prospect of increasing U.S. Treasury rates continue to hurt the emerging markets bond markets, including issuers in Latin America.
- **Commodities.** The rising prices of commodities, including oil, generally will be a boost to the region. Venezuela, which is almost entirely dependent on the price of oil, continues to be in a state of extreme economic chaos, however. 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 and other commodity prices.

Latin America Overview

Brazil

In Brazil, the largest economy in Latin America, the "pro-business" government of President Jair Bolsonaro undertook major fiscal stimulation measures to counteract the pandemic, though these measures are at odds with his economy minister's free market macroeconomic policies. These stimulus measures helped to limit the economic contraction to 4.1% in 2020, which was not as severe as had been predicted. While the amount of the country's public debt ballooned to record levels to finance these stimulus measures, record low interest rates helped to keep the cost of the public borrowing lower as a share of gross domestic product (GDP). As a result, Brazil's capital markets have remained extremely strong, with IPO issuance booming and debt capital markets active as well. However, the country remains one of the worst hit in terms of COVID-19 cases and total number of deaths (second only to the United States), and the government will be challenged during the remainder of 2021 to get the pandemic under control. Despite government handouts to the poor as part of its stimulus packages, the efforts to combat the pandemic are complicated by Brazil's extreme income inequality and difficulty in rolling out its vaccination program. The popularity of its president has waned considerably, even as the economy has continued to perform better than most of its neighbors coming out of 2020, and Brazil's currency exchange rate currently reflects the negative view that investors are taking of the country's very high debt level. The perception by market participants of how the pandemic is handled, as well as the president's efforts to bolster his political position well ahead of the presidential elections in 2022, are likely to affect how robust the capital markets remain for the rest of 2021.

Mexico

Latin America's second largest economy suffered a contraction of 8.5% in 2020, which was consistent with earlier predictions due to the COVID-19 pandemic. The average Mexican peso/U.S. dollar exchange rate was MXN21.466/USD1 for 2020 (well above the average of around MXN19/USD 1 for the prior two years), with periods of extreme volatility. The Mexican peso is particularly vulnerable to volatility due to its liquidity as one of the most commonly traded currencies.

The political positions taken by Mexican President Andrés Manuel López Obrador (often referred to as AMLO) continue to impact exchange rates and the markets as well as the economy. AMLO has refused to provide substantial government economic support throughout the pandemic, which has hurt a number of industries such as aviation and hospitality, and the country's number of COVID-19 cases and death rates is almost as dismal as Brazil's. The outcome of legislative elections in July may turn on the perception of AMLO's handling of the pandemic, as well as his efforts to undo the promarket energy reforms of his predecessor while consolidating the positions of the state-owned energy companies (Pemex and CFE). While the economy has been picking up steam, much of that is due to the effect of the United States-Mexico-Canada Agreement (USMCA), which took effect in July 2020 and replaced the North American

Free Trade Agreement. The USMCA helped usher in a period of relative stability in trade relations, especially for the industries most impacted by the trade negotiations that had been ongoing for the prior year, such as auto parts supply and agriculture.

Generally, Mexican issuers that are stronger credits have been able to access the capital markets but the effects of the pandemic are still being felt throughout the economy. However, the prognosis for the capital markets is much more positive this year, despite the lackluster growth rate of the broader economy. Certain sectors may see IPOs again for the first time in years, and the interest in special purpose acquisition company (SPAC) IPOs generally may also be a factor in bringing more equity deals to market. Interestingly, the Mexican sovereign has continued to do very well in tapping the demand for emerging markets bonds. Mexico came to the markets with bond issuances several times in 2020, and again in January of 2021, including bonds with very long tenors, issuances denominated in Euro and an ESG financing that was very well received.

Argentina

Argentina's economy, the third largest in Latin America, suffered a contraction of 10% in 2020, one of the largest decreases in South America (along with Peru), apart from Venezuela. Along with battling the pandemic, the government spent much of 2020 restructuring its more than $100 billion of sovereign debt, after its ninth default. This time around, the restructuring talks were relatively speedy as the process took only about six months to restructure almost all of the debt involved, significantly reducing the sovereign's interest rate and the debt burden over the next several years. Several major provinces also went through their own debt restructurings or are in the process of doing so. The country is still in debt to the International Monetary Fund (IMF) to the tune of approximately $44 billion, and payment on that debt is under discussion, which remains an overhang on the capital markets. The IMF lowered its GDP growth forecast for next year for Argentina, contrary to its improved predictions for the rest of the region. More significantly, inflation continues to run high, and despite government efforts, poverty still affects a large percentage of the population, which has also made the government's efforts to combat the pandemic more difficult. Argentina's President, Alberto Fernández, recently tested positive for COVID-19 despite having been vaccinated, and the country's infection and death rates remain very high while vaccination levels are still very low. Legislative elections to be held in October may also contribute to market uncertainty.

Colombia

Colombia represents the fourth largest economy in Latin America, and its GDP declined 6.8% in 2020 primarily as a result of the pandemic, although its economy is expected to bounce back in 2021. The government of President Ivan Duque has been praised for being swift to react to the risks posed by the pandemic, and for taking a pragmatic approach to implementing health measures and supporting the economy. Low interest rates and exchange rate stability have helped to create a stable environment for investment, particularly in infrastructure projects and commodities. The ongoing COVID-19 pandemic continues to put pressure on the economy, however, and international capital markets have not been very active.

Notable Transactions

Equity offerings from Brazil dominated the Latin America equity capital markets in 2020, including 28 IPOs. The largest was by hospital group Rede d'Or, raising $2.2 billion in December. However, of those 28 IPOs, only two were listed on The Nasdaq Stock Market, with the others all listing in Brazil. 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, once again there was a scarcity of equity offerings in 2020; though there are several companies working on IPOs currently, the equity capital markets are not expected to be active in 2021 either.

The debt markets were slightly more robust across the region in 2020, particularly for the sovereign and quasi-sovereign issuers that are repeat issuers such as Pemex in Mexico and Petrobras in Brazil (who, like many corporate issuers, continue to engage in liability management exercises to extend out maturities or obtain more favorable interest rates). Chile repeated its sovereign issuance of green bonds in January 2020 (in U.S. Dollar and in Euros) and has continued the trend into 2021 with a $1.5 billion issuance of sustainability-linked bonds on April 15, 2021. Mexico also priced an innovative €750 million ESG bond in September 2020. Although so far none of the other sovereigns that were planning green bonds have done so yet, Brazil, Colombia, and Peru are said to be contemplating them in the next year or two. For additional information on sovereign offerings, see Sovereign Entities Guide for Capital Markets and Market Trends 2018/19: Sovereign Bonds. Sustainability-linked bonds continue to be a growing trend among corporate issuers as well, as the interest in ESG investments continues to increase. For example, the sustainability-linked bonds issued in January 2020 by a

European affiliate of Suzano S.A., one of Brazil's largest paper producers, has become a market standard for sustainability-linked bonds.

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. There has been a rise of populism and autocracy, with strong populist leaders trying to implement reforms broadly based on their electoral mandates. However, the ability of governments to accomplish their regulatory goals has been hampered by their need to respond to the COVID-19 crisis and the resulting fiscal and monetary challenges. In several countries, upcoming elections may determine the regulatory agendas going forward.

For instance, a common theme in the region is tax reform, including in Colombia (which passed reforms at the end of 2019 that were signed into law at the beginning of 2020) and Mexico (where the government is increasingly focused on effective tax collection). The COVID-19 pandemic has highlighted the issue of income inequality and the need for greater tax and welfare reforms, and in many countries left-leaning candidates are campaigning on these issues. 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 intended 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 Mexico, the current administration passed a major overhaul of the country's pension system in December 2020, boosting retirement benefits and reducing workers' mandatory contribution times—in stark contrast to the pension reform passed the prior year in Brazil which set a minimum retirement age, among other things, to help reduce Brazil's huge budget deficit.

Energy and the environment also represent sectors affected by recent regulatory changes. In Mexico, for example, the current administration has passed laws to undo the energy reforms of the prior administration 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 these new laws are subject to legal challenges before they can be fully implemented, 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.

Market Outlook

The outlook for the remainder of 2021 in the financial markets across Latin America will be affected primarily by the ongoing economic effects of the pandemic in each country, and by the following factors:

- Brazil's equity markets are still riding high and expected to continue to do so, so long as commodity prices remain strong and Brazil's currency is appreciating.
- Though interest rates are beginning to rise, bond issuers are likely to continue to take advantage of the still relatively low rates, including in liability management transactions.
- Energy and infrastructure-related financing is expected to increase, whether in the form of asset dispositions, joint ventures, or bonds.
- Investor interest in ESG financing is continuing to build and this asset class is expected to be an increasing portion of the market.
- Venezuela remains a source of uncertainty in the region both politically and economically.
- If the SPAC IPO market remains strong in the U.S., we expect to see an increase in SPAC activity in Latin America (both IPOs and mergers and acquisitions (M&A)).

Below is a discussion of these factors in greater detail:

Brazil's boom in equity deals has been helped by rising commodity prices, stable interest rates, and currency appreciation, all of which are expected to continue given the fundamental economic situation. The large number of IPOs completed in 2020 is expected to be surpassed in 2021, in part because a number of potential issuers who cancelled their IPO plans last year due to the pandemic are hoping to be able to tap the markets this year, and in part because smaller companies are now finding the equity markets more open to them. Though there may be continued market volatility due to the government's inability to contain the pandemic as well as investor concerns regarding President Bolsonaro's tendency to interfere with state-owned companies (for instance, his replacement of the chief executive officer of Petrobras), most prognosticators are bullish on the equity markets in Brazil.

For issuers with U.S. dollar-denominated debt, the low interest rate environment is an opportunity to restructure or refinance their obligations, particularly if the U.S. dollar continues its upward trend compared to local currencies in Latin America. For some issuers, particularly stronger credits, the markets are likely to remain open to new bond issuances as well as 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 in industries hit hard by the pandemic. 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. To date, bank lenders have been more willing than bondholders to defer or restructure interest and principal payments.

The need for infrastructure investment 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, and possibly M&A investment as well. In some countries, government-sponsored projects will take the lead, but in most instances private financing is needed to fill the gap since many governments have incurred significant debt already to finance their pandemic-related spending.

A number of issuers in Latin America are seizing upon the ESG market as an area for future growth and are actively pitching the attractiveness of their ESG capabilities to bankers and investors. So far, the major issuances have been in Mexico, Chile, and Brazil, but other countries are gearing up to expand this investment sector. The use of proceeds of a green bond can vary widely while fitting within the green bond principles known to investors, while sustainability-linked bonds can be tied to sustainable development goals tailored to the issuer or other social and governance criteria applicable to the issuer. There is a great deal of investor demand for ESG bonds that can satisfy these principles or goals, despite some concern regarding oversight or lack of consequences for failure to comply with the stated criteria.

The outlook for Venezuela has become dire over the past year. Despite being the country with the world's largest oil reserve, Venezuela's economic crisis, with quadruple-digit inflation and vast shortages of food and medicine, has been magnified by the pandemic. Neither the government of President Nicolas Maduro nor the alternative administration of Juan Guaido has been able to obtain funds needed to aid the many Venezuelans living in poverty (although some have been able to flee the country). Further, each side is trying to negotiate and litigate on multiple fronts to protect the country's assets from outside creditors and from each other, and not much progress has been made in what investors expect will be a full-scale debt restructuring involving a massive amount of sovereign debt as well as bonds of the government-owned energy company, Petróleos de Venezuela, S.A. (PDVSA). The extremely dysfunctional economic and political situation and the uncertainty of a prolonged debt restructuring in Venezuela remain key factors that could slow growth in the region.

The SPAC IPO market in the United States has been very active in 2020 and the beginning of 2021. Although some see a market correction and a bumpier ride ahead for SPACs, interest in this structure as an IPO alternative has increased in Latin America, and some SPAC sponsors in Latin America are likely to come to market with IPOs in the U.S. if investor interest remains strong. SPAC mergers (or "de-SPAC" transactions) are an indirect way for Latin American companies to become publicly listed in the U.S. With a large number of already-formed SPACs looking for merger targets, there is likely to be an uptick in SPAC M&A activity as well, particularly if exchange rate conditions are stable. 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 activity for the remainder of 2021, though the markets may become more volatile due to the protracted effects of the pandemic and the political measures taken in response. ESG, 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 interest rates and commodity pricing as well as currency volatility; however, investor appetite for investment in the region, including innovative structures and products, remains strong despite the increased risks involved.

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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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Joy Gallup is a partner in the Latin America and Corporate practices of Paul Hastings and is based in the firm's New York office. Ms. Gallup has extensive experience in complex, cross-border debt restructurings in Latin America as well as corporate finance transactions. She regularly represents underwriters and domestic and international issuers in private and public offerings of debt and equity securities. Her areas of concentration include structured debt offerings, Rule 144A/Regulation S high-yield debt and project bond offerings and other structured products (including securitizations and monetizations of energy contracts and other asset-backed instruments). Her focus also includes liability management transactions, corporate restructurings, secured lending transactions, equity tender offers and general corporate matters, including SEC reporting requirements.

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.