Q & A

Multi-Asset Class Opportunities in Latin America: A Local Perspective

December 2011

With an investment history of local investment management dating back to the mid-1990s, offices in Brazil and Chile, and activity spanning listed equity, fixed income and private equity, PineBridge Investments offers a distinct perspective on Latin America. We recently gathered some of our senior investment professionals from across asset classes to share their individual perspectives and exchange ideas on current and emerging opportunities across Latin American markets. The discussion was dynamic with topics ranging from the macro implications of the European debt crisis for the region to specific local investment conditions. The following Q&A provides select highlights of the discussion.

Q. How do you see the overall economic picture in Latin America, particularly in view of the ongoing issues in the euro zone?

MARKUS SCHOMER
Managing Director,
Chief Economist
New York

A. The European debt crisis has dominated the financial news in recent months, reminding us of a history of similar events in Latin America during the 1980s and 1990s. However, government reforms, economic liberalization and the emergence of Asia as the continent's main source of export growth have served to protect Latin America from external shocks over the past few years and allowed the region to show a considerable degree of resilience.

Government reforms, economic liberalization and the emergence of Asia as the continent's main source of export growth have served to protect Latin America from external shocks over the past few years.

However, events in Europe continue to have global implications, more so should the European sovereign debt crisis worsen. We all remember what happened in emerging markets in 2008 when the global financial system ran into trouble and trade finance evaporated. This proved particularly harmful for export-focused emerging markets, so that is a clear risk on our radar screen. But I believe the likelihood of a banking crisis is still relatively low given the fact that central banks are providing ample liquidity to the systems right now.

I think one of the biggest implications for Latin America is related to infrastructure; one of the great selling points for the region over the next several years. All the projects planned for the region will require some external capital investment and I think what is happening in Europe at the moment is impacting the willingness of financial institutions to provide and raise capital and channel that capital into markets throughout Latin America.

Q. How do you explain the resilience of Latin American fixed income markets over recent months, and how serious is the risk of contagion from any worsening of the crisis in the European banking system?

ANDRESSA TEZINE
Managing Director,
Head of Research,
EM Fixed Income
London

A. Sovereign spreads in Latin America overall are currently running at around 384 basis points (bps) against US Treasury bonds, so we are far from the levels experienced in 2008 when spreads reached 900 bps. Spreads look even more attractive when we compare them to levels across Europe, with Greece at 4,700 bps, Portugal at 1,030 bps and Italy at 422 bps, for example. In fact, the fixed income local market index is standing at about 70% higher than it was in October 2008, which means that investors are seeing emerging markets as a safe haven amid this European turmoil.

The key reason for the current market resilience in Latin American fixed income markets is the relatively low correlation between fundamentals in Latin America and those in Europe. On the fiscal side, debt levels in Latin America are just one third of those in the European markets. Additionally, growth in the region has been outpacing developed markets consistently and has been benefiting significantly from China's strong growth.

There is a vast sum of money from Spanish and Portuguese banks invested in Latin America. I recall the 2002 banking crisis in Brazil that quickly engulfed Argentina, then spread to Uruguay, a country in which Argentina was heavily invested and therefore suffered huge capital outflows. These days most of the banks in Mexico, Chile and Brazil derive a sizable portion of their profits from domestic sources, so they do not depend as much from money outside the region. These banks also run fairly good balance sheets, so I see any contagion via the banking system as very contained at the moment.

European banks have about EUR 1.2 trillion of exposure in subsidiary banks in emerging markets, split into cross border lending and local claims. Most of it is in Eastern European banks (EUR 445 bn), which represents 31% of CEE (Central and Eastern Europe) GDP. However, in Latin America, the percentage of European banks' exposure is low, at just 13.3% of GDP. Not only that, but in all Latin American countries, the loans to deposit ratio is just 85%, compared to a ratio of over 100% in CEE. Moreover, most of the European loans that come to Latin America, are in the form of trade finance, which is considered to be the last source of lending to dry up in the event of a financial meltdown. So in summary, although the deleveraging of the banks in Europe is substantial, the impact to Latin America should be quite limited.

Q. Brazil seems to dominate the discussion on investment opportunities in Latin America. But what other areas of opportunity are you seeing in the region?

STACY STEIMEL
Managing Director, Head of Latin America Equities
Santiago

A. Latin America is characterized by a young population with access to increasingly inexpensive credit, fueled further by a widespread reduction in inequality, increased social mobility and aspirational-type consumption behavior. This is a potent mix, especially if you factor in new job creation and wage increases, and although there are vast investment opportunities in Brazil, there are also many in other parts of Latin America. We like to find unusual ideas, we like to think outside the box and we find many good opportunities right after the private equity stage.

One country that appears to be escaping under the radar for many is Ecuador, where we are seeing very strong growth.

One country that appears to be escaping under the radar for many is Ecuador, where we are seeing very strong growth. There are some really good public policies there, such as a program called 'Welcome Home' or 'Bienvenido a Casa', which provides loans to people who have lived outside of Ecuador to come back and start new businesses, reversing the brain drain they have suffered. They also have a so-called 'decent wage' policy, whereby the government offers companies tax incentives to pay over the minimum wage.

Bolivia is not usually at the forefront of investors' minds in Latin America, but we are seeing plenty of opportunities there too. For example, Bolivia is one of the world's largest sources of lithium, used in batteries of all types including car engines. There are also opportunities in the Andean region where I have lived for the last 18 years. The stock markets of Colombia, Peru and Chile are integrating this year and that is going to increase liquidity for the individual companies in each one of those markets, particularly important for those that are a little less developed.

We are also seeing a lot of agri-business opportunities in Argentina right now. Viewed on a global scale, growing a hectare of soy beans in Argentina is literally the cheapest place to grow soy in the world, partly because of the high quality of the soil. It is half the cost of doing the same thing in Brazil. Of course, Argentina's President Kirchner will tax away a hefty chunk of the price differential between Brazil and Argentina, but nevertheless the Argentinean advantages in various related industries remain.

Q. How has corporate governance improved in Latin America in recent years, both from a private and listed equity perspective?

GUIDO PADOVANO
Managing Director, Head of Latin America Alternative Investments
São Paulo

A. As minority investors in the private equity space, there are many corporate governance safeguards that we put in place to mitigate some of the risks. Obviously it changes a little bit from country to country but the environment in my home country of Brazil, for example, has improved tremendously.

The size of the so-called informal economy has fallen significantly, which makes it much easier for us from a due diligence perspective.

Back in the early 2000s there was a lot of investing in very small internet companies that nevertheless had relatively sophisticated corporate governance, preferred shares and contracts that included arbitration clauses. It's now very difficult to find any company without such clauses in their contracts. Even the courts have got more used to the concept of an outside investor with certain minority rights and vetoes, so I think that the environment has vastly improved over the past 10 or so years.

One of our biggest challenges used to be off the book activity, but this is no longer such an issue. The taxman has become much tougher and electronic checking of the economy in general has become so commonplace throughout the region that the size of the so-called informal economy has fallen significantly, which makes it much easier for us from a due diligence perspective. Being a minority investor is always going to pose a challenge to some extent but the situation is vastly improving in this region.

STACY STEIMEL
Managing Director, Head of Latin America Equities
Santiago

A. People don't generally associate good corporate governance with Latin America. However, Brazil made great strides in this area in 2006 when they introduced the Novo Mercado, or New Market, which is a listing segment of the BOVESPA stock exchange for the trading of shares issued by companies that commit themselves voluntarily to adopting corporate governance practices in addition to those that are required by law.

Other countries in the region have begun to move in the same direction, such as the Andean countries with the integration of their stock markets. Recently, I was speaking at a public forum in Chile and suggested to our regulator that they should allow some of the 277 companies listed in Chile to adopt more stringent corporate governance practices and get recognised for it. These are all important trends in the region and fantastic for us on the listed equity side.

Q. What opportunities are you seeing in the region in the private equity space?

ALEJANDRO RODRIGUEZ
Senior Associate, Latin America Private Equity
New York

A. The two key themes of consumption and investment apply just as well to opportunities in private equity as they do to the listed equity space. At the private funds level, as we look for funds to invest in we are seeing remarkable growth dynamics combined with the right structural conditions for private equity as well as good quality fund managers, not only in Brazil but also in countries such as Mexico, Colombia, Peru and Chile.

Mexico, for example, has more than US $1 trillion in GDP and one of the highest levels of purchasing power parity GDP per capita in the region and a population in excess of 110 million. So we view it as a very interesting market, one that presents some very attractive growth dynamics and opportunities for private equity investors, but without the competition for deals at the company level that we're seeing in other countries.

Of particular interest to us at the moment is the small and middle market space, in which funds being raised for Latin American private equity have increased significantly over the last three years. We estimate that only 15% of the capital raised for private equity investment in Latin America over the last three years has focused on small and middle sized companies, even though these companies represent about 90% of the opportunities for these fund managers to invest. These are exactly the type of businesses that lack financing options from traditional lenders locally and the ones that private equity managers can influence the most by providing financial solutions, growth capital and operational expertise to take them to the next level. So the small and middle market space represents a very interesting dynamic when you combine the growth of many specific sectors in the region with the scarcity of capital for those sized companies.

Q. With roughly 70 to 80% of Latin American private equity investment still going to Brazil by some estimations, is there now too much capital chasing too few opportunities?

GUIDO PADOVANO
Managing Director, Head of Latin America Alternative Investments
São Paulo

A. Although we are based in São Paulo, we look for opportunities throughout Latin America where the industry tends to be less developed, so the question of whether there is now too much capital in Brazil chasing too few opportunities is less relevant for us. But viewing the private equity market in Brazil from a local perspective the strong capital inflows here are being absorbed by continued growth in the number of viable investment targets here, fueled by industry consolidations and domestic consumer strength. We're seeing a lot of situations in which regional industry champions are beginning to have to compete with each other nationally and there are many opportunities for private equity there. We're also seeing more and more opportunities in structured vehicles where people are trying to create more opportunities for private investors in a space that over the centuries has been dominated by families.

We're seeing a lot of situations in which regional industry champions are beginning to have to compete with each other nationally and there are many opportunities for private equity there.

Where some level of crowding in the industry does exist, it is in the larger buyout space. These companies tend to be much more visible and are typically companies that are publicly traded or larger, privately held companies that can comfortably write a check for a few hundred million dollars. But compared globally, the amount of private equity investment as a percentage of GDP in Brazil is low relative to markets like the US, UK and even India, so we are expecting a lot of continued activity over the coming years.

Although the market environment in Brazil has become more competitive, it is still far less than in markets like the US or Europe and it is also becoming easier here for us to operate from a legal and governance perspective. Gone are the days when managers can parachute in from London and New York and expect to find good quality opportunities so it certainly helps that we have a local presence and a good sense of the nuances and direction of the market ■

Biographies

MARKUS SCHOMER, CFA

Managing Director,Chief Economist New York

Mr. Schomer joined the firm's predecessor company in 1996. As the Chief Economist for PineBridge Investments, Mr. Schomer is responsible for providing economic forecasts, analysis and commentary for all groups of PineBridge Investments. He is a member of various strategy committees and is responsible for coordinating the firm's interest rate and currency strategies. Mr. Schomer transferred to the U.S. in 2002 from the firm's London office, where between 1996 and 2001 he also managed various fixed income portfolios. Prior to joining PineBridge Investments, he was a Fixed Income Analyst at Commerzbank in Frankfurt, Germany. Mr. Schomer holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia, in the UK. He also studied at the London School of Economics and is a CFA charterholder.

STACY STEIMEL

Managing Director, Head of Latin America Equities Santiago

Ms. Steimel joined the firm in 1998 and is responsible for managing the investment activities of Latin American equity portfolios. She is also the lead Portfolio Manager of the Global Emerging Markets strategy. Her previous experience includes business development in a local investment bank, IM Trust, and three years as assistant to the US Executive Director of the Inter-American Development Bank, in addition to nine years experience in international finance for the US Treasury Department. Her postings included key positions in the Group of Seven in Washington, DC and in the Embassy in London. She also served as a legislative assistant in the US Senate and House of Representatives. Ms. Steimel received a BA from the College of William and Mary, an MA in Latin American Economics from the University of Texas at Austin, and an MBA from the Catholic University of Chile.

GUIDO PADOVANO

Managing Director, Head of Latin America Alternative Investments São Paulo

Mr. Padovano is Head of Latin America Alternative Investments for PineBridge Investments. Based in São Paulo, he has overall responsibility for the firm's private equity activity in the Latin America region. Between January 1998 and April 2009, Mr. Padovano was responsible for the Merrill Lynch Private Equity (MLGPE) business in Latin America, and concurrently for Europe from 2003 to the end of 2007. During that period he was a member of MLGPE's worldwide Investment Committee and the Operating Committee. Among other companies, he served on the Board of Directors of Rexel SA (France), Debenhams PLC (UK), and was Chairman of Cremer SA (Brazil) and Convermex SA (Mexico). Mr. Padovano was a founding partner of Pad Investimento SA, a VC company which he managed between 1985 and 1992. He holds a BS in Industrial Engineering from USP in São Paulo and an MBA from Stanford University.

ANDRESSA TEZINE

Managing Director, Head of Research, EM Fixed Income London

Ms. Tezine joined the firm in 2005 as a Senior Analyst for Latin America. She is responsible for the coverage of Latin American sovereign credits and market analysis. In 2008 she became Head of Research for the Emerging Markets team. Prior to joining PineBridge Investments, she was a Senior Analyst at ABN Amro Bank Brazil and also Dresdner Bank Lateinamerika. Ms Tezine began her investment career in 1993 at Unibanco. She received a degree in Economics from the University of Sao Paulo and an MSc in Economics from the Universitat Pompeu Fabra, Barcelona.

ALEJANDRO RODRIGUEZ

Senior Associate, Latin America Private Equity New York

Mr. Rodriguez joined the firm in 2008 and is responsible for sourcing, performing due diligence, analyzing and monitoring private equity fund investments primarily in the U.S. and Latin America. Prior to joining the firm, Mr. Rodriguez interned with Citi's Latin America Strategic Planning Group, and at Aleutian Capital Partners in New York, performing due diligence and analysis of middle-market private equity investment opportunities. Prior to earning his MBA, Mr. Rodriguez led third-party fund raising efforts for Seguros Banamex (Citi's insurance subsidiary in Mexico). Mr. Rodriguez earned an MBA in Finance and Business and Law from NYU Stern School of Business, and a BS in Business from the Instituto Tecnologico Autonomo de Mexico (ITAM) in Mexico City.

The full audio replay is available upon request from your PineBridge representative, or email us at **info@pinebridge.com** or visit **www.pinebridge.com**.