

**Corporate Finance
Latin America
Special Report****Latin America: Local Capital
Markets Still Open for Business****Analysts**

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Executive Summary

The impact of the global economic and financial crisis on Latin American capital markets has triggered a severe liquidity crisis for many Latin American companies with otherwise intact long-term fundamentals. While local capital markets have provided some relief in the form of liquidity to meet short-term debt rollovers and current maturities, the success with which local capital markets have been able to fill the void has varied substantially throughout the region.

Corporates in Chile and Colombia have been able to obtain their financing needs in the local capital markets as borrower and investor confidence has been supported by the government's adequate response to the crisis. Investors in Mexico and Brazil have experienced a more significant loss in confidence, given the bankruptcy or near collapse of some of their largest and most respected companies. As a result, many corporates in these countries have required significant government intervention to stay afloat, with Mexico being hit the hardest. Finally, Argentina continues to stand apart due to the government's highly questionable response to the crisis, which, instead of injecting liquidity into the system, has reduced local capital markets' depth by nationalizing private pension funds in late 2008.

While international investors have remained cautious this year, the U.S. government's proactive approach has been successful in calming global financial markets, slowly restoring capital flows towards the developing world. International financing for Latin American corporates is generally limited to defensive sectors (notably energy), as well as large investment grade and upper-tier 'BB'-rated names. With default rates for Latin American corporate bonds jumping to 5% in 2008 and expected to slightly increase in 2009, investors are still demanding a significant premium to compensate for the additional risk. Not willing to pay the extra cost for external funding, Latin American companies have used this option only when local funding has not been feasible — generally for larger-sized issues of USD500 million or more.

Although some local capital markets, such as those in Chile and Colombia, have been able to respond adequately to corporates funding needs thus far, there is a risk that growing fiscal deficits might lead to a crowding out by the public sector as governments tap the markets to fund these deficits and refinance debt amortizations. The risk is higher in countries with low domestic savings rates (such as Brazil's 19.1%), large government debt relative to GDP (such as Argentina's and Brazil's 66% ratio and Colombia's 44% ratio) and/or significant state intervention in the pension system (Argentina).

The risk is lowest in Chile where domestic savings are the highest (28.8%) and government debt is the lowest (5.2% of GDP). While Chile is expected to finance its anticipated fiscal deficit for 2009 primarily through a stabilization fund accumulated during years of fiscal surplus, increasing fiscal deficits in Colombia, Mexico and Brazil may have to be funded primarily through additional government debt. In order to reduce the risk of crowding out in those countries, fiscal authorities are trying to minimize their reliance on local markets by borrowing from multilaterals and using funds from development banks to provide financing for the private sector.

Chile and Colombia: Strong Local Corporate Debt Markets

With funds evaporating from abroad, reduced bank lending at home and plummeting stock markets worldwide, Chilean and Colombian corporates have sought the local bond market as their primary source of funding, encouraged by investors' overwhelming appetite for fixed income securities. With monetary easing leading to a marked decline in interest rates and volatile stock markets increasing investors' risk aversion, corporate bonds became the most attractive investment alternative for institutional investors by far. In Colombia, greater demand for corporate bonds also reflected the banks' stricter loan approval processes, which led banks to shift assets from riskier loan portfolios towards relatively safer and more profitable investment portfolios (see the table below).

Colombian Banks' Asset Breakdown

(COP)

	April 2007	April 2008	April 2009	% Change at 09/08
Loan Portfolio	88,393,452	105,383,497	119,830,096	13.7
Investment Portfolio	30,963,959	31,344,465	40,301,358	28.6
Cash	10,500,288	11,386,385	13,260,290	16.5
Total Assets	145,220,252	165,363,029	193,092,785	16.8
% of Total Assets				
Loan Portfolio	60.87	63.73	62.06	(2.6)
Investment Portfolio	21.32	18.95	20.87	10.1
Cash	7.23	6.89	6.87	(0.3)

Source: Superintendencia Financiera de Colombia.

With demand for corporate bonds greatly exceeding the amount offered, corporate debt markets in these two countries are currently experiencing their most significant expansion in years. In Colombia, total debt issuance between January and April nearly reached 77% of the COP5.6 trillion (USD2.8 billion) issued throughout the entire previous year, reflecting the market's great appetite for this instrument. During the first four months of this year, a total of 17 companies (10 financial institutions, one food and beverage company, three utilities, two construction firms and one conglomerate) placed COP4.3 trillion (USD1.8 billion) in bonds through the local market. This compares with only eight placements totaling COP1.2 trillion (USD681.9 million) a year ago. About 49% of the total amount issued so far this year corresponds to the corporate sector, while the financial sector and multilaterals received a respective 39% and 12% of all proceeds raised. This represents a significant change from 2008 when over 84% of all debt placements were floated by the financial sector.

In Chile, local corporate bond issuance has soared as well, with the USD4.4 billion placed during the first five months of the year almost tripling the amount issued during the same period last year. It should be noted that 88% of the issuance (USD3.87 billion) was long term in nature. Between January and May, a total of 20 long-term bond issues (versus 10 issues in the first five months of 2008) were registered in the Chilean market, with most of these placements being carried out by the pulp and paper (Masisa, Celulosa Arauco and CMPC) and retail (Sodimac, Cencosud and Falabella) sectors. The largest local bond placement (USD340 million) took place in January and was carried out by state-owned oil company ENAP with a 10-year tenor. It should be noted that during the same month, Codelco placed an even larger USD600 million 10-year bond issue internationally. In addition, electric utilities CGE and AES Gener, food and beverage companies CCU and Carozzi, as well as Telefónica Chile, Esval (water

treatment), SQM (chemicals), Cementos, Mall Plaza (real estate), and Sigdo Koppers and Indura (diversified manufacturing), among others, participated in the market through local bond offerings.

The tremendous dynamism displayed by Chilean and Colombian capital markets has led an increasing number of foreign issuers to consider these two countries as an attractive source of funding. Multilaterals such as Corporación Andina de Fomento (CAF) and Banco Centroamericano de Integración Económica have tapped the Colombian capital market with great success. CAF, who issued USD100 million in Colombia's market in April, also considered a USD100 million–USD200 million “huasobond” (UF or inflation index-denominated bond issued by a foreign company in Chile) placement in Chile. The first “huasobond” was successfully placed by Mexico's telecom giant América Móvil, for a total amount of UF4 million (USD145 million). Grupo Romero, which controls Banco de Crédito del Perú (BCP), is expected to follow after recently announcing a debt placement of up to USD300 million in Chile. Other names that have been mentioned are the Australian Pacific Hydro, as well as Cemex and Petrobras, although none of these have been confirmed yet.

With Chilean investment bankers and brokerage firms actively promoting local capital markets abroad and demand significantly exceeding América Móvil's offer in April, “huasobond” placements are expected to become increasingly popular. The growing interest from businesses abroad can be attributed to the numerous advantages Chilean capital markets exhibit when compared with other Latin American markets, including i) greater market depth in terms of both number of institutional investors and total amount of debt outstanding (which is ten times larger than only a decade ago); ii) significant liquidity, with the USD137 billion in resources available through local pension funds, insurance companies and, to a lesser extent, mutual funds, being almost the size of Chile's GDP; and iii) long tenors, of 20 years or more. In addition, foreign issuers benefit from both a more developed derivatives market, which allows for better protection against exchange rate fluctuations, and investors' growing appetite for “huasobonds” as a way to increase portfolio diversification.

As of May 2009, total corporate debt outstanding in the Chilean capital markets reached USD27 billion, with long-term debt representing the bulk (96%). The vast majority (90%) of this debt belonged to the private sector (93, versus four issuers from the public sector). Market liquidity is primarily provided by local pension funds, followed by insurance companies, with these two groups of institutional investors holding nearly 80% of all publicly traded corporate debt. Whereas pension funds generally demand bonds with relatively shorter maturities (five to seven years), insurance companies are interested in the longest-term instruments (+20 years) available on the market. Including the financial sector, total private sector debt outstanding amounted to USD42 billion as of May.

Total Chilean Corporate Debt Outstanding
(USD Mil.)

	May 2009	May 2008	% Change
Long-Term Bonds	25,698	20,827	23
Commercial Paper	1,067	745	43
Total	26,765	21,573	24

Source: Superintendencia Valores y Seguros (SVS).

Total Assets and % Invested in Corporate Bonds by Type of Institutional Investor
(USD Bil., As of March 2009)

	Total Assets	% Invested in Corporate Bonds
AFPs (Pension Funds)	86	12
Insurance Companies	31	33
Mutual Funds	29	16
Total Assets in Chile	145	—

Source: SVS, Superintendencia de Pensiones (SAFP).

While Colombia's capital markets are still much smaller than Chile's, their growth has been impressive over the past 12 years. Consequently, stock market capitalization has more than doubled in size since 1997. The much smaller corporate debt market expanded at an even more remarkable pace, growing by over eight times since 2001. With total managed assets now being more than 10 times larger than in 1997, private pension funds have positioned themselves as the most important group of institutional investors, representing over two-thirds of all managed assets. Reflecting the growing interest of the pension system in private sector instruments, the share of government instruments (TES) dropped at a time when general government funding needs diminished and private sector financing needs rose. However, it should be noted that, contrary to what has been observed in Chile, government debt still represents about half of all pension fund assets and over 60% of all insurance company assets.

As in Chile, institutional investors in Colombia are mostly long-term oriented, allowing companies to issue long-term debt even during the current economic downturn. In fact, most of the bond issues this year have been long-term in nature (seven- and 15-year tenors). Liquidity has not been an issue either, as pension funds (total assets: USD32 billion) have been receiving large inflows of cash each month (between COP5 trillion and COP7 trillion) for principal and interest payments on government debt. Favorable market conditions for local corporate bond placements have also been reflected in the downward trend in spreads experienced since December 2008, with spreads for 'AA'(col)-rated issues declining from 238 basis points (bp) to well below 200 bp in June, which is similar to the range exhibited by 'AA'(cl)-rated bonds in Chile.

However, a growing number of Colombian companies are concerned that local liquidity may not last forever, particularly if the economic deceleration turns out to be worse than expected. In this case, a higher-than-initially-expected fiscal deficit may lead to a rebound in TES placements — the fastest and easiest way for the government to obtain funding. To protect themselves from such a scenario, several companies have started to look into diversifying their investor base through bond placements overseas. Nonetheless, most corporations do not have immediate plans to go international as pricing is still less attractive than at home and local markets have been able to offer sufficiently long tenors. Only companies that require financing for over USD500 million, a scale that is difficult to achieve domestically, are willing to pay the extra cost associated with external funding. Consequently, companies seeking to expand regionally, such as electric utilities Empresas Públicas de Medellín (EPM) and Interconexión Eléctrica (ISA), as well as oil-producer Ecopetrol, are seeking to obtain financing through large-scale international debt placements. Finally, corporations, most notably within the electricity sector, have been keen on obtaining funds from development banks due to the better terms associated with these funds (premiums can be as low as 20 bp over Libor for long-term issues).

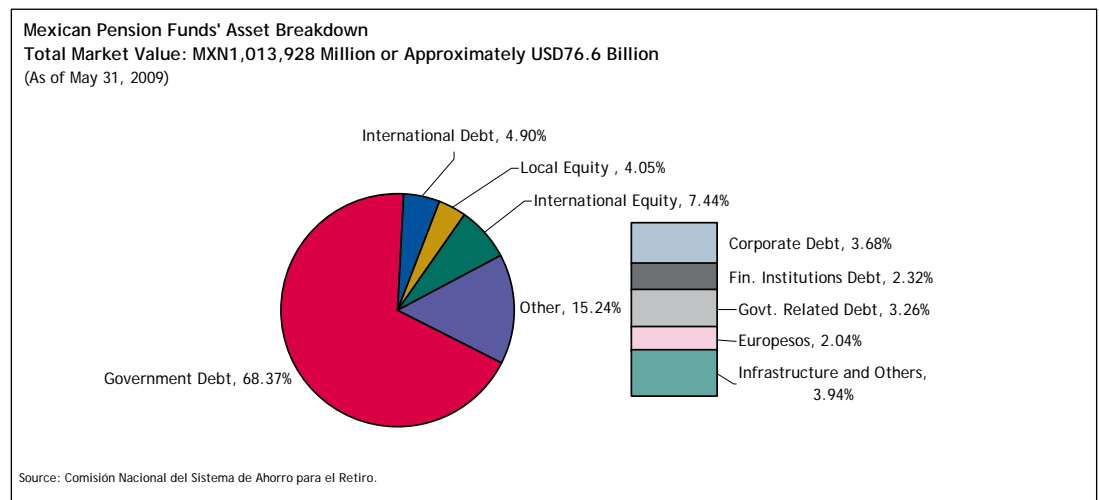
Mexico and Brazil: Government Intervention Has Been Crucial

The downturn in Latin America's corporate credit cycle became evident in October when two major Mexican companies, papermaker Corporación Durango and food retailer Comercial Mexicana (CCM), defaulted on their debt. While Durango was forced to file for bankruptcy mainly due to high energy and corrugated paper prices, CCM succumbed primarily to skyrocketing foreign currency derivatives losses and its inability to roll over its short-term debt. CCM's failure to pay commercial paper obligations in the amount of MXN400 million (USD30.1 million) caused panic among investors, paralyzing Mexico's *certificados bursátiles* market (one of the most important sources of funding in that country) and threatening the survival of many companies that had counted on meeting their (mostly short-term) financial needs through the issuance of this type of instrument.

As a result, the global financial crisis exposed the vulnerabilities of some of the largest and most respected companies in the region. Particularly affected were those companies with a large proportion of short-term debt on their balance sheets and those that exhibited significant currency mismatches. However, while derivatives losses affected companies in both Mexico and Brazil, Brazilian corporates (including Aracruz and Votorantin) generally went into the crisis with adequate liquidity and relatively low exposure to short-term debt. Consequently, defaults in Brazil were largely confined to the beef and ethanol sectors, which, in addition to weak fundamentals, exhibited poor credit metrics, relying on large export credit lines to finance their working capital needs. With default rates jumping to 5% in 2008, more than a third of Latin American companies rated 'B+' and below became at risk of defaulting on their debt in the near-to-medium term.

The fact that the crisis is far from over (at least in Mexico) became evident in February when glassmaker Vitro defaulted on more than USD1.2 billion of debt and then again in March when cement giant Cemex was unable to carry out a debt placement of USD500 million, forcing the company to sell some of its assets and to renegotiate USD14.5 billion of loans with its bankers. Other companies too, in an effort to adjust debt maturities to new cash flow projections, have been trying to restructure their debt. Corporación Durango reached an agreement in April, and Comercial Mexicana is expected to follow within the next few months. Gruma's announcement in March that it was able to convert a USD668 million derivatives liability (or 87% of the company's open currency position) into a seven-year loan has shown that a solution is possible for the derivatives problems affecting many corporates.

Unlike their Colombian counterparts who took advantage of favorable exchange rates prior to the crisis to lower their foreign debt and substitute it for local debt or Argentine companies who reduced debt levels in the aggregate, Mexican companies maintained their leverage at levels similar to those observed in previous years, a fact that was aggravated by Mexico's economic slowdown and currency depreciation, as well as some companies' significant derivatives exposure. Another factor distinguishing Mexico (as well as other countries in the region) from Colombia, Chile and even Peru are the latter's large, private pension fund systems, which are capable of providing significant capital market activity. While Mexico does have a large pension fund system as well, most of the system's funds have been allocated to Mexican sovereign issues, with the pension funds' policy to invest in only highly-rated issues leaving little room for lower-rated private sector companies to obtain financing through this source (see the chart below).

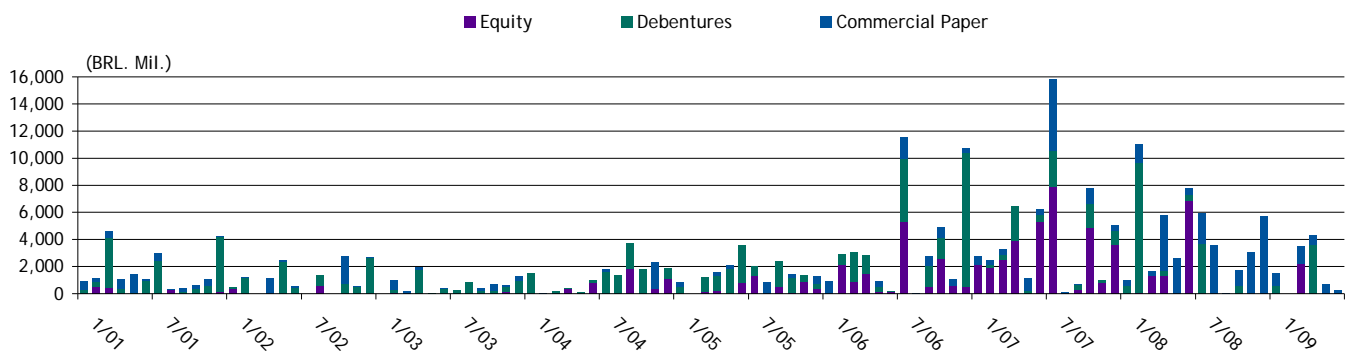


With the lack of appetite for corporate bonds affecting all local companies, both Mexican and Brazilian authorities had little choice but to step in to fill the void. Support to the private sector has largely been provided through the following development banks: Bancomext, Nafinsa and SHF in Mexico and BNDES in Brazil. In addition, both governments have actively participated in negotiations to find a solution for the companies' problems. While in Mexico, the government has reportedly been involved in negotiations to convert derivatives liabilities into long-term debt, in Brazil, the government has aggressively pushed for mergers and other deals, sometimes investing directly in companies to ensure that the deal would go through (e.g. Aracruz's acquisition by Votoraim).

In order to re-establish investor confidence in the local debt market, the Mexican government implemented an emergency program providing partial guarantees to help refinance short-term debt. While the emergency plan has been somewhat successful in reviving capital markets, its effectiveness has been limited due to the high costs and guarantees in assets required to access the program. As a result, total corporate debt placements continued to decline for the second quarter in a row, reaching MXN182 billion (USD13.6 billion) in the first quarter of 2009, a 2% drop in total debt placements versus the third quarter of 2008. However, it should be noted that the amount placed in the first quarter of 2009 was still 18% higher than the MXN154 billion (USD11.5 billion) recorded in the fourth quarter of 2007, at least in nominal peso terms. Taking into consideration exchange rate fluctuations (i.e. using the respective end-of-period exchange rate), total debt placements in USD terms declined by 10.6% between the fourth quarter of 2007 and the first quarter of 2009. Most of the issuance during the first quarter of 2009 has been short term in nature, as investors have shown a strong preference for one- to two-month tenors, demanding a significant premium over the reference rate. Long-term bond issuance during that period barely amounted to MXN7.9 billion (USD591 million), with all four corporate debt placements (Kimberly Clark, América Móvil, Arca and Coca-Cola Femsa) being 'AAA' (mex)-rated.

While demand for local debt issuance has been more solid in Brazil, providing adequate support for medium-term placements, volumes have dropped substantially (see the table below). With the onset of the global financial crisis, longer-term debt placements became more difficult as investors showed a strong preference for shorter maturities of two to three years (versus an average five to seven years for debentures prior to the crisis). In fact, between October 2008 and May 2009, most of the issuance has been short term in nature, with commercial paper issuance doubling to a total of 40 and debenture placements dropping by 83% to only five.

Issuance in Brazilian Capital Markets



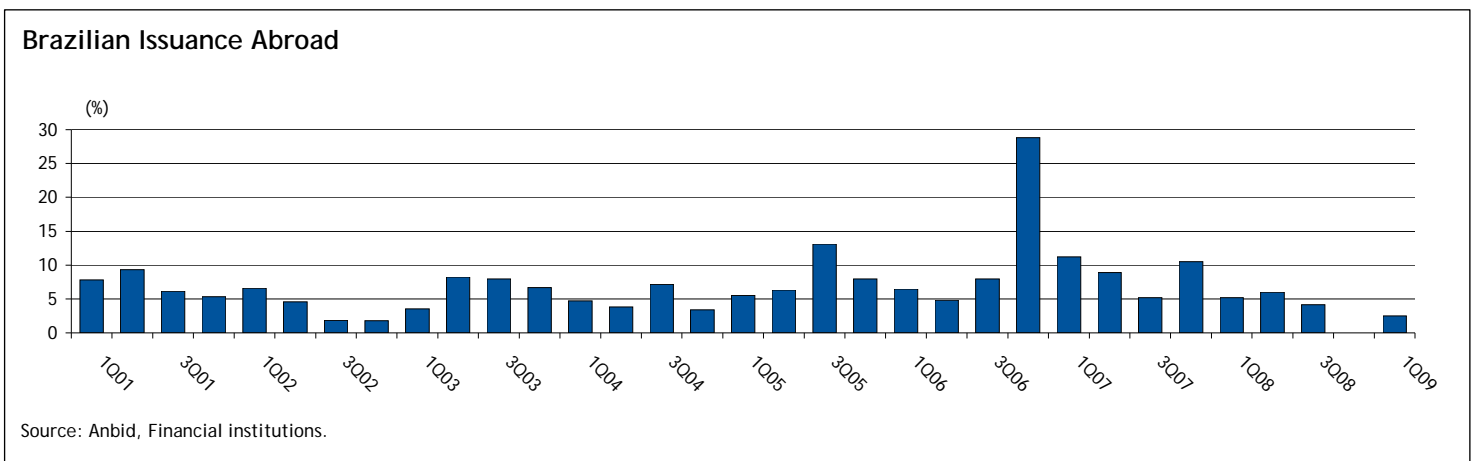
Source: Comissão de Valores Mobiliários (CVM).

Immediately after the crisis, the strong devaluation of the real combined with a shortage of international funding led larger companies to turn to the local debt market as their primary source of funding, making it more difficult for small- and medium-sized companies to obtain financing. Moreover, financial institutions became more cautious in their loan approval processes, giving preference to larger, higher quality companies, which had previously relied on external funding. Therefore, government support through special credit lines became crucial in softening the impact of the global financial crisis on the local economy. Policymakers' swift and transparent response to the crisis (e.g. addressing liquidity issues in small- and medium-sized banks in a timely manner), combined with Brazil's greater insulation from the global economic crisis (Mexico has been burdened by its strong exposure to the U.S. market), has helped restore confidence relatively faster in this market than in Mexico. In addition, the drop of the basic interest rate (Selic) to historic lows has made corporate debt a more attractive investment alternative relative to government bonds.

Brazil's strong fundamentals and relatively stable macroeconomic and financial environment have sparked renewed interest, not only among local investors, but also among foreign investors in Brazilian corporate debt this year. In February, Petrobras was the first Brazilian company to place debt abroad since the crisis, although at less favorable terms than a year ago (the coupon for the 10-year bond was 7.875% compared with 5.875% in early 2008). Since then, Construtora Norberto Odebrecht (BB+), Telemar (BBB-) and beef producer JBS (B+) have all been successful in accessing international markets, albeit at much higher rates than prior to the crisis (JBS, for example, paid a record 1,114 bp above U.S. Treasuries for a USD700 million five-year bond, more than double the premium it paid in 2006). Importantly, Odebrecht's and JBS's debt placements have proven that international financing is even available for high yield bonds as long as the pricing is right.

Argentina: Pension Fund Nationalization Heightens Liquidity Concerns

After repeated intervention through questionable tax and price control mechanisms, the nationalization of private pension funds (AFJP) carried out in October 2008 provides another example of a policy that may have unintended consequences. While the government is expected to benefit from social security contributions and pension fund assets in the short term, the disappearance of a major group of institutional investors is expected to reduce the depth of the local capital market, eliminating an important source of long-term financing for Argentine corporates.



Consequently, the reversal of the pension system's privatization 14 years ago has caused major concern within the international investment community. With less favorable terms of trade having a negative impact on both Argentina's fiscal surplus and Venezuela's public finances (Venezuela's government has been a primary source of funding in recent years), and increased risk-aversion/less liquid domestic capital markets making local issuance a less viable option, Argentina's government is likely to rely increasingly on intra-public sector financing. This may lead the government to invest a larger proportion of the former AFJP's portfolio, estimated at 9.3% of GDP (USD26 billion), in government securities to meet its growing financing needs (prior to nationalization, government securities already represented 60% of the pension funds' portfolios). Although the public social security agency (Administración Nacional de Seguridad Social, ANSES) has so far continued to provide financing to the private sector with a 30% average participation in this year's seven corporate debt placements, and issuance during the first six months of fiscal 2009 surpassed that of 2008 (during the same period last year, there had only been two placements, with one of them taking place in the international markets), concern over the government's ability to navigate the crisis has led economic actors to be skeptical over the longer term. In addition, larger companies will continue to rely on global capital markets to refinance the bulk of their debt obligations, a task that will be more difficult to achieve going forward as Argentine corporates will find it harder to differentiate themselves from the sovereign sector.

The government's lack of transparency (primarily perceived in the form of inflation underreporting) and inadequate response to the crisis combined with the farmers' strike in early 2008 have had a detrimental impact on investor sentiment, resulting in repeated deposit loss and flight to the USD. In order to prevent further losses in the depository base, interest rates increased sharply towards the end of 2008 to an average 19.3% in December (versus 11.6% earlier in the year). Given the economic and financial uncertainty, the banking system has shown an increased preference for liquid assets, which combined with stricter loan approval processes, has made it harder for companies to obtain funding through the private banking system. Consequently, most of the loans extended to the corporate sector since October 2008 have been in the form of credit lines from state-owned banks. The bulk of these credit lines have been peso-denominated with a three-year tenor and an adjustable interest rate based on the Badlar (average deposit) rate. It should be noted that after reaching its peak in November (26.1%), the Badlar rate has gradually declined to 12%.

On the positive side, Argentine corporates generally came into the crisis with sound credit metrics and healthy financial positions, as most companies had taken advantage of the favorable market conditions in 2007 to pursue a conservative financial strategy. However, as companies continue to use cash to pay down their debt and the economy further deteriorates, liquidity may eventually become an issue.

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