Expanding Our View of Latin America

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Latin America holds valuable natural resources, young growing populations and enterprising companies but investors often overlook smaller markets in the region. Only Argentina features in frontier markets indexes. The bulk of the region's countries tend to be among the smaller constituent markets in emerging indexes. As these conditions suggest that market inefficiencies and value opportunities might be present, we decided to take a closer look. I revisited Argentina where we have several holdings and put boots on the ground in Peru and Colombia for a firsthand look.

Shale play

Oil company YPF is progressing with production from 550 wells in the Vaca Meurta formation, Argentina's sizeable shale reserve

Argentina: Riding the Reform Wave

Argentina is back. No longer caught in the economic void created by the Kirchner-Fernandez administrations, it has become a favorite among frontier market investors. Possibly too much of a fast favorite as evidenced in recent volatility, but still it holds sway thanks to President Macri's economic reforms and reengagement with the international investment community. Although it is an ambitious agenda, he has made admirable progress, particularly in international trade and finance.

Reopening Argentina to foreign markets meant eliminating currency controls thereby allowing the peso to devalue against the US dollar. Along with subsidy reforms, this caused a sharp increase in inflation and the peso remains vulnerable. Just how vulnerable is evident in the Central Bank's 1200 basis point hike in interest rates to 40% in an effort to stem FX weakness. The government is also engaging with the IMF to secure a credit line. Thus far Argentines have accepted that near-term inflation is the price to pay for broader economic growth in the future. Inflation should ease in 2018, allowing the central banks to reduce interest rates – another positive for economic expansion

Political undertones will likely always be part of the Argentina story, but on the ground, optimism is high. The economy is beginning to recover, companies are investing, and additional listings are expected this year. Though recent new listings have been lukewarm at best and some have actually been postponed – a deeper local market (70% of trading takes place on the NYSE via ADRs) is a welcome development and one that further capital market reforms should expedite.

Our company meetings in Argentina covered a wide range of industries including consumer staples, banking, utilities, and real estate. San Miguel is a leading citrus producer with commanding market share in lemons. The company operates an integrated business model from fresh fruit to processed citrus used for flavoring. It is the leading fresh lemon exporter in South America with agricultural operations in Argentina, Peru, Uruguay and also South Africa. This is an interesting, cash flow generative company with hard currency revenue, but liquidity remains low. We also met with the small cap company Havanna, a maker of Argentina's famous alfajores cookies and operator of small coffee shops. The company is expanding Havanna cafes and working on a "healthier" version of the cookie.

The Grupo Galicia meeting confirmed our thesis on normalization of the banking industry. With credit penetration levels at 15% of GDP (well below the regional average), expectations are for steady loan growth over the next 10 years and return on equity should average in the low 20s (on a higher equity base). We also met with locally listed Bolsas y Mercados Argentinos (BYMA), the country's main capital market exchange and central depository. It is a direct play on the migration of trading for US listed ADRs to the local market. Pampa Energia is benefitting from tariff reform and is now working

Alfajores

Argentina's Havanna is expanding its cafes and working on a "healthier" version of its famous cookie.

to further integrate vertically via its acquisition of Petrobras Argentina. Oil company YPF is progressing with production from 550 wells in the Vaca Meurta formation, Argentina's sizeable shale reserve. The government has also deregulated oil prices to align with international prices and is working toward a new gas price mechanism that will support shale development. The company is targeting 5% annual production growth, >1x reserve replacement and 10% annual EBITDA growth. This is one to watch as the energy sector normalizes.

On the surface the market is not inexpensive, but earnings momentum has been supportive of higher multiples. The market is also on track to be elevated to the MSCI EM Index, providing further support via expected GEM flows. Consistent with our strategy in other markets, we will "grandfather" Argentina in our investment universe post the expected upgrade. The ever-expanding list of frontier markets slated for elevation (will Vietnam be next?) has us thinking about some of the smaller emerging markets that are often overlooked by emerging market managers that have a massive universe to evaluate in China alone. That is what took me to Peru and Colombia.

Looking beyond Frontier Latin America

Peru: Top Regional Growth Prospects

Peru was the most compelling stop on my trip, and not only because of the amazing quinoa burgers and ceviche. The country's solid economic growth outlook is backed by a strong copper price that local producers believe is appropriately valued at current prices around $3.00/lb., additional mining opportunities in gold and zinc, tourism, and infrastructure development -particularly reconstruction of the El Niño impacted north. However, political turmoil – some say the worst in recent memory – has stalled progress across several infrastructure projects. The opposition dominated Congress worked diligently to impeach President Kuczynski over his alleged involvement with Odebrecht, the Brazilian construction conglomerate ensnared in a major corruption scandal across the continent. Although not successful, he finally resigned when videos surfaced showing his allies "buying" votes against impeachment. Even before impeachment proceedings, the former President battled with a Congress dominated by supporters of his rival candidate (Keiko Fujimori – daughter of former president Alberto Fujimori), making it nearly impossible to implement policy or expedite government investment. Vice

King Copper

Mining pit in the Peruvian Andes, at 3600 meters above sea level

President Vizcarra is expected to fare better than his predecessor, at least according to the market's benign reaction to President Kuczunksi's resignation. His government background is limited to a governorship in a small province, but he is known for working with the opposition and avoiding corruption.

With GDP expected to expand 4% (5-6% potential with effective government policy) in 2018 vs 2.7% in 2017, Peru is the fastest growing of the larger South American countries. Not surprisingly, the market has done well and appears fairly valued with the MSCI Peru Index trading at 14x earnings for the next 12 months. Still there are several high quality companies across banking, mining, and the consumer space that could be interesting portfolio candidates at the right price.

Peru's grocer

InRetail commands 38% of Peru's supermarket sales

Credicorp is Peru's leading financial services company, with dominant share in a market that was never well penetrated by multinational banks. Credit penetration is higher in Peru than Argentina - 40% loans/GDP - but Credicorp management believes there is ample room for further expansion.

Peru's informal sector accounts for 70% of the country's employment and its off-the-grid companies and workers remain outside the banking system. In the near term, loans are expected grow modestly in the high single digits, while net interest margins will remain low with inflation stable at 1.3%. The company is working to increase digital banking in anticipation of fintech competition. Credicorp is a bellwether for Peru given its size, US listing and trading liquidity.

On the mining side, Southern Copper is a standout due to its 60-year reserve life, ore grade, ease of extraction, and generally low cash costs per ounce. Its execution skill should help offset expansion delays caused by local social conflicts. The company has the largest copper reserve base in the mining industry at 71.4MMT with operations in Peru and Mexico. The stock is above it pre-global financial crisis peak; however, it is one to watch on any pullback. Ferreycorp is an interesting way to play both mining and construction growth in Peru. As the country's exclusive Caterpillar dealer and service operator, the company stands to benefit from increased mining cap ex and the El Nino rebuilding effort. Service margins are 30% vs equipment sales at 10%, but the stock looks fairly valued after rallying 43% from its 52-week low.

On the consumer side, InRetail commands 38% of supermarket market share in Peru and also operates pharmacies.

The company has posted high single digit sales but is struggling with a saturated pharmacy sector. Alicorp is the country's largest consumer staples company, with products in home care, edible oils and pasta. The company also operates across the Andean region and is working to increase operating margins by restructuring operations in Argentina and potentially increasing its reach in Brazil.

Peru's equity market has clearly advanced over the past two years, but there could be opportunities to participate in Latin America's fastest growing region, particularly if there is sufficient political will to push the country to its natural potential.

Colombia: Advancing with Peace and Stability

A visit to Colombia belies its troubled past, marked by the illicit drug trade and violent conflict with antigovernment rebel groups, particularly FARC (Revolutionary Armed Forces of Colombia). The 2016 peace accord, orchestrated by outgoing President Santos, is fragile at best, but by all appearances the country is moving forward and is well supported by strong democratic institutions. The current presidential election is a testament to the country's transparency, with several candidates campaigning for the office. Former FARC members were also allowed to participate in recent elections as part of the accord. Though they performed poorly, their involvement in the political process might signal the official end of paramilitary activity in Colombia.

Colombia is a major oil producer (the fourth largest in the world) and a key producer of gold, copper and emeralds.

Pent up demand

Colombia's house ownership is among the lowest in Latin America and Daviveneda is the leader in mortgage lending with 22% market share

Commodity prices are a key driver of economic activity. From a pure valuation standpoint, Colombian stocks look interesting, but the economy has struggled to gain traction following the oil price collapse in 2014. The currency came under pressure, causing an inflationary bite to the economy. Admittedly, the oil industry, which has traditionally accounted for roughly half of the country's total exports, was in trouble long before the industry was shocked into efficiency by the precipitous price drop. It has been late to employ new technologies to increase oil recovery rates and boost reserve life. According to Bancolombia, the country's largest lender, the economy has potential to expand 4.0-4.5%, but only expanded 1.8% in 2017. The upside is compelling, but probably won't happen during an election year, with most corporations taking a wait-and-see approach to capital investment.

That is not the case at Colombia's largest oil company, however. Management at Ecopetrol indicated that change is underway under a new management team that has focused on efficiency and improving reserve recovery. They have eliminated the use of traders, which took a cut of crude oil sales, improved midstream efficiency and employed new drilling technology in mature fields. The company supplies 100% of Colombia's refined product needs and 80% of its crude oil.

There are several conglomerates operating in Colombia. Grupo Aval Acciones y Valores is Colombia's largest financial conglomerate. The company owns majority stakes in four major banks, each under a different banner; the country's largest pension fund; and an investment vehicle involved in toll roads, hotels, and energy. Grupo de Inversiones Suramericana is another financial conglomerate with holdings in property and casualty insurance, asset management and a 46% stake of Bancolombia. Both could be interesting ways to gain exposure to the country's financial sector, but pure plays such as Bancolombia and Banco Davivienda offer more direct exposure and potentially more earnings power. Colombia's home ownership is among the lowest in Latin America and Daviveneda is the leader in mortgage lending with 22% market share. Currently mortgages are growing in the high teens, but corporate lending growth is slow. Bancolombia is primarily a corporate lender, but it also has an important mortgage book and consumer lending division. Both banks are working to improve efficiency while investing in technology platforms.

Grupo Nutresa generates 40% of sales outside of Colombia and operates a B-to-B as well as a consumer food business. The company specializes in cold cuts, biscuits, and chocolate, but at 25x 2018 earnings it's probably fairly valued. Almacenes Exito operates grocery retail in Colombia, Brazil, Uruguay, and Argentina, with Brazil being its largest market by far. Exito, the Latin American partner of France's Casino (the French retailer owns 53% of Exito), is dealing with heavy competition and weak consumption in its home market, but Brazil appears to be improving steadily. This is a challenging business with typically low operating margins, but the company is working to improve efficiency and its largest market is posting decent same store sales growth. Exito could be interesting at the right valuation.

It is clear that Argentina, Peru and Colombia are experiencing growth at below their potential for a wide range of reasons: politics, regulatory restrictions, commodity price volatility, and recent weather events. However, I sense long-term opportunity in Argentina's political transformation, Peru's mining investments and possible political truce, and Colombia's slow emergence from the oil crisis. As in most of our markets these days, it is more about selecting the right stocks across the region. The addition of Peru and Colombia to our universe give us more opportunity to deliver strong returns for our clients. Both markets are similar to our main frontier markets: low penetration in several industries, low liquidity relative to emerging markets, and high growth potential.

Passive indexes can create investment structures that often don't reflect the reality of investing in less developed economies, be it emerging or frontier.

The constant chatter about EM elevation creates a run up in frontier stock prices that often veers in the opposite direction after the decision is made – witness Pakistan, Qatar and the United Arab Emirates. We will continue to look beyond index allocation and take advantage of smaller markets that have moved up to EM status, but remain small constituents and are often overlooked by EM managers.

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