Destination: South America

Evaluating Opportunities in a Period of Dynamic Change

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Research Report by
Ning Ma

On a recent trip to evaluate conditions in Argentina, we took the opportunity to revisit Colombia and Peru, smaller emerging market countries that present attributes similar to those of frontier market countries. The trip proved enlightening on a variety of fronts.

Argentina, ahead of its primary election, showed signs of uncertainty, doubt and the disenchantment that manifested into a primary election victory for the populist, Peronist slate of Alberto Fernández and Cristina Fernández de Kirchner. In contrast, Colombia and Peru displayed relative stability along with solid economic growth, low interest rates and benign inflation. However, both countries are relatively vulnerable to external shocks due to their heavy commodities exposures and Peru's relative stability has seemingly evaporated in recent weeks as a constitutional crisis has arisen.

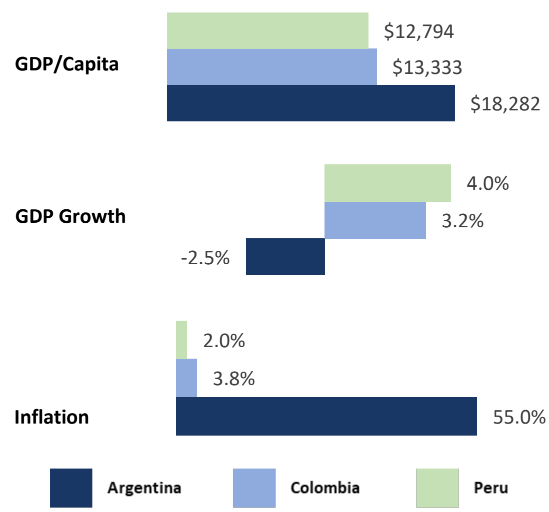
Along the length of the continent we saw companies run by competent managements and benefiting from economic growth and/or attractive demographics. While these publicly traded enterprises are navigating ably through their shifting home country environments, for a collection of reasons – valuation, political stability and geopolitical/financial conditions, among them – we are not rushing to add investment capital in any of the markets today.

Here is a sampling of what we saw:

**South American Equity Markets:
A Study in Contrasts**

Economic characteristics and conditions vary significantly along the length of the Andes. Photo: Rainbow Mountain, Peru

Shutterstock



	Argentina	Colombia	Peru
Population (mm)	44.7	48.2	31.3
Urbanization	92%	81%	78%
Literacy	99%	95%	94%
Unemployment	10.6%	10.8%	5.8%
Current account/GDP	-5.4%	-3.8%	-1.5%
Government debt/GDP	86.2%	50.5%	26.8%
Budget deficit/GDP	-5.5%	-3.1%	-3.5%

Source: Bloomberg

Argentina

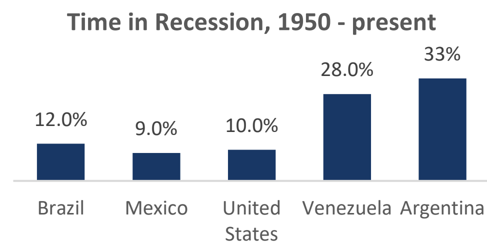
Buenos Aires skyline *iStock*

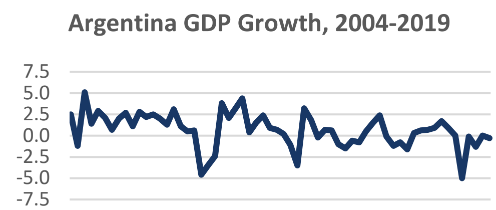
Simon Kuznets, a Nobel Laureate, once stated that there are "four kinds of countries in the world: developed countries, undeveloped countries, Japan and Argentina."

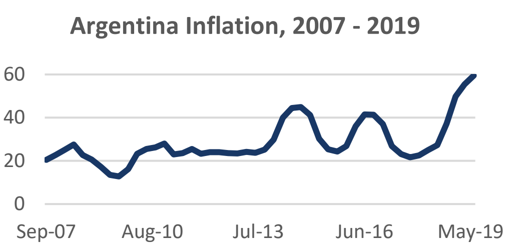
Once the seventh richest country in the world, Argentina, has suffered a long and steady decline with uneven economic performance and a recession about every three years. High inflation is considered normal, averaging 16% annually, excluding hyper-inflationary periods.

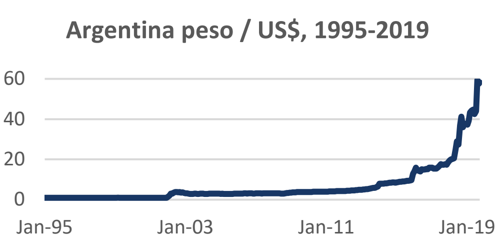
When Mauricio Macri won the presidential election four years ago, there were high hopes. His victory appeared to mark the end of the husband-and-wife presidential team era, the end of a populist regime and the beginning of a rationalized economic system. Macri promised to strengthen national institutions, introduce pro-business policies and negotiate solutions with the country's foreign creditors. However, it was neither an easy nor a painless task.

Fast-forward three years: The country is in recession with GDP down an estimated 2.5% in 2018 and further decline predicted for 2019. The Argentine peso (ARS) has depreciated some 344% against the US dollar and inflation has surged to over 50% annually. Not surprisingly, Macri's approval rating has fallen from 72% in 2016 to 34%, culminating in sharp rejection by Argentine voters in the August primary election, where Macri's ticket polled just 32%. The result was a shock to most people as consensus opinion was for a very close race with Macri winning after two rounds of voting. However, Fernández' large margin of victory (16 points) in the primary diminished Macri's hopes for reelection.









Source: Bloomberg

(In Argentina, primaries are used to ensure candidates have enough support to contend in the general election.) As a result, Argentine stocks fell roughly 50% in their first session after the vote – their largest one-day decline since WWII. Argentine bonds also fell sharply on the news.

Macri will face primary winner Alberto Fernández and his running mate, former President Cristina Fernández de Kirchner (not related) in the general election this month. Cristina Fernández, who served as president from 2007 to 2015 was half of the country's former husband-and-wife presidential team, along with her husband Nestor Fernández, who served as president from 2003 to 2007. Their "Peronist" rule took on a highly populist character with the nationalization of key businesses and other policies considered anathema to business competition and economic efficiency. Their tenures were also marked by widespread government corruption. Cristina Fernández is currently under indictment in 11 corruption cases from her time in office.

Pink House, Buenos Aires – fencing installed to protect against protestors

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Argentinians are indeed struggling. During our visit, unemployment was estimated at about 30%, although the official rate was quoted as roughly 10%. On a tour of Buenos Aires, our guide repeatedly instructed us to remove any valuable jewelry or watches. The capitol city's famous Pink House was fenced with metal bars to keep protestors away.

At an investment conference ahead of the primary election, the two leading political parties made presentations along with some 20 companies. Political dynamics dominated the discussion. At that moment, consensus opinion was predicting a runoff between the Macri and Fernández tickets with the outcome decided on the choices made by voters with distaste for both Macri and Cristina Fernández. At that point, consensus was that Macri would prevail. However, rumblings of "what if Cristina wins" were in evidence amid increasing uncertainty and nervousness.

In this environment, corporations' investment plans are largely on hold as managements await the election outcome for more clarity. Banks continue to report good numbers, at least on paper. The country's bank regulator relaxed rules to allow banks to invest up to 100% of their ARS deposits in the central bank's seven-day liquidity notes, or Leliq, which has risen to over 80% in recent weeks. Meanwhile, the interest rates for ARS deposits are kept high (45-50%) to keep depositors in ARS savings accounts. On the surface, this is a good margin, but managements at the conference agreed it was not a sustainable long-term strategy. Lending activity is contracting in real terms. While the utility industry is heavily regulated, we found comfort in Pampa Energia due to its good management, strong cash position, natural hedge in USD revenue and relatively cheap valuation.

Overall, Argentina equities don't inspire confidence. While we found managements to be competent, the operating environment is difficult and unpredictable. Stock market performance is ruled by the political situation, or even the daily poll results.

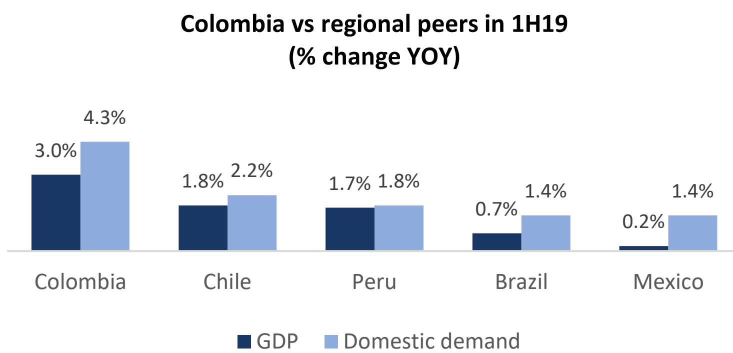
Colombia

Plaza de Bolívar, Bogota *Shutterstock*

Of the countries we visited, Colombia is probably best positioned for growth in the current environment. GDP growth has stayed on track with forecasts and the current government remains business-friendly and reform minded, working to improve its fiscal management. Corporate taxes are expected to be reduced although tax policies can be vexing: Tax collection is challenging and the last attempt to increase VAT on some basic food items was unpopular.

The Colombian economy has enjoyed a gradual recovery driven by higher oil prices and a better political environment. So naturally, oil prices remain a key factor to watch.

We met with nine companies on the trip: three banks, two consumer names, two cement companies, a financial services company, and the stock exchange.



Source: DANE, BCCh, BCRP, Banixco, BDB, Credicorp Capital

Banco Davivienda, the country's third largest bank, offers significant exposure in mortgage lending (25% of total loan book) and consumer lending (25% of total loan book). It is a leading player in social housing. We expect decent loan growth with improvement in credit quality and some benefit from a tax rate cut. At 10.5x PE 2020e and 1.4xPB 2020e, Davivenda trades in line with other Colombian banks

Exito, Colombia's largest retailer, faces intensive competition from the hard discounters who are gaining market share and expanding aggressively. Exito management believes these competitors are not operating at profitable levels but haven't relented as they seek to take market share. There is also a potential corporate governance issue as Exito acquired an operation in Brazil (owned by its parent) and at a 30% premium to the market price. While management claims compliance with the law and justifies the premium based on efficiency gains, the self-dealing aspect of the acquisition remains troubling.

The two cement companies we met reported having survived challenging years recently due to reduced demand, weak overseas markets and the emergence of Turkish and Chinese imports that pushed in-country market prices from $200/ton to $100/ton.

Peru

Plaza de Armas, Cusco *Shutterstock*

Peru's situation has worsened with GDP growth falling behind forecasts and the government facing a constitutional crisis.

Analysts have revised growth forecasts downward reflecting a reduction in public investment, a trend we confirmed in meetings with company managements. Private investment had advanced 4% in the first half of the year on the strength of a 26% increase in mining investment. However, concerns are growing over weakening global demand for copper due to the US-China trade war.

Also influencing capital markets is a worsening domestic political situation. In a standoff President Vizcarra moved to dissolve Congress, an action met by Congress' move to suspend the president. This type of dysfunction along with rampant corruption has long characterized Peru's national government. The last four presidents all face corruption investigations.

Against this backdrop, there is an infrastructure deficit in Lima and probably the whole country. It is unfortunate that the government has not addressed these needs, which could have a constructive effect on the national economy. But construction activity has been limited and company managements expect few public works projects. Instead, growth will come mostly from the private sector, primarily mining.

As shown in the table at right, there are a number of big mining projects ongoing.

Peru Main Mining Investment Projects

Project	Mineral	Investment (mm)	Start	Status
Quellaveco	Copper	$5,300	3Q18	
Mina Justa	Copper	$1,600	3Q18	
Toromocho expansion	Copper	$1,355	4Q18	
Pukaqaqa	Copper	$700	2H20	
Corani	Silver	$585	2H20	
Pampa de Pongo	Iron	$2,500	2021	
Yanacocha Sulfuros	Copper	$2,100	2021	
Zafranal	Copper	$1,160	2021	
Haquira	Copper	$2,824	2022	
Los Chancas	Copper	$2,800	2022	
Rio Blanco	Copper	$2,500	2022	
Michiquillay	Copper	$2,500	2023	
Tia Maria	Copper	$1,400	n.d.	
Galeno	Copper	$3,500	n.d.	
Conga	Copper	$4,800	n.d.	
Total		**$35,624**		

Under execution / close to start

Slow advance / delays in start

Paralyzed / extremely slow advance / not adjudicated

Source: Credicorp Capital

We met with managements of eight companies in Peru: two consumer names, two banks, two cement companies, one industrial company and one mining company.

InRetail stands as Peru's market leader in grocery stores, drug stores and shopping malls. The well-managed company targets consumers in the country's emerging middle class. The company holds a 41.5% share in grocery, owns and operates 21 shopping malls and stands as the country's leading pharmaceuticals retailer with 2000 stores nationally. It is well positioned for growth through consolidation in the retail and pharmacy segments where mom & pop stores remain dominant and a big part of the economy is still informal.

InRetail's drug store chain Mifarma is ubiquitous in Peru

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Peru's Caterpillar equipment dealer Ferreycorp presents attractive long-term real growth prospects. While primarily a mining sector play, the company would likely benefit from public infrastructure investments should the government address that pressing need.

Cement companies in Peru are interesting and distinct from those in other national markets. The three main producers hold dominant positions in their own regions. We met with companies in the north and center regions. While they are not in expansionary mode, running at only a 50-60% utilization rate, amid low prices, they receive steady demand, mainly from retail customers. This means imports are not much of a threat which serves to preserve their attractive dividend yields. In this way, their investment fundamentals resemble utilities companies more than materials companies.

Conclusion

The South American markets of Argentina, Peru and Colombia show long term promise for frontier market investors. Although they are technically categorized as emerging market countries, they have much more in common in terms of scale and development with frontier countries like Morocco, Egypt, and Ukraine than with emerging markets like China, India or Mexico.

Argentina, unfortunately, is overshadowed by political uncertainties in the near and medium term. Who will win the general election? What will be the economic/social policies going forward? As a matter of fact, there are lots of disagreements between Cristina and Alberto. At this point, no one seems to have any good insights. Managements are very conservative and preparing for the worst.

In Peru, despite concerns we have over the slowdown of global growth and the domestic political uncertainties, we are optimistic over the long run. Peru is a country that is rich in resources, has relatively low labor costs, and has economic policies that are relatively business friendly. It offers strong GDP growth compared to many of its regional peers. On our visit, we identified ample investment opportunities and added a handful of names to our watch list.

Colombia has been the best performing economy in the region in 2019. Unlike Peru, the domestic political environment seems to be stable. The economy is expected to continue to grow nicely with stable oil price, fiscal reform, and strong private investments. We also identified a few interesting ideas and put them in our watch list.

While we are not rushing to invest new capital in South America, we are actively monitoring these markets and several attractive target companies.

About Frontier Global Partners

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Frontier Global Partners, LLC
7817 Ivanhoe Avenue, Suite 200
La Jolla, California 92037
Telephone: (858) 456-1440
Fax: (858) 456-2040
http://www.frontierglobalpartners.com