S&P Global Ratings

Latin American Corporate And Infrastructure Midyear Credit Outlook 2023

Market Ice Cracks, Yet A Chill Remains

July 6, 2023

This report does not constitute a rating action

Contacts

Diego Ocampo
Buenos Aires
diego.ocampo@spglobal.com

Luis Martinez
Mexico
luis.martinez@spglobal.com

Julyana Yokota
Sao Paulo
julyana.yokota@spglobal.com

Maria Soledad Mosquera
Bogota
maria.mosquera@spglobal.com

Overview

- We now expect U.S. policy rates to remain higher for longer, and while international bond issuances have picked up slightly since May for Latin American issuers, the scenario will remain challenging for speculative-grade issuers, with yields typically ranging from 7% to 12%.
- In contrast, domestic policy rates are dropping (or about to drop) across Latin America, which may revive activity in domestic markets. Still, Brazil's high policy rate is pressuring cash flows of low speculative-grade issuers. We forecast the Brazilian policy rate to drop by at least 100 basis points (bps) by the end of this year, which would be crucial to avoiding more distressed exchanges in the country.
- Our outlook bias is decisively positive at about 15%. We recently revised the global scale outlook on Brazil to positive from stable, triggering similar actions on many companies that we cap by the sovereign rating. Before that action, the region's outlook bias was slightly negative.
- We think various sectors are still fragile due to the high interest rates, including retail, homebuilding, airlines, fleet management and car rental, and telecom and cable. In addition, some other sectors are facing momentary headwinds, such as the protein and chemical businesses.

A bunch of corporate defaults in the first few months of the year made fears of a credit crunch grow. A combination of persistently high interest rates (especially in Brazil); lower demand in key sectors like retail, homebuilding, and consumer; some margin compression and a market freeze in international and in domestic markets, could lead to additional defaults this year for some Latin American speculative-grade issuers, in our view. However, we think that risks of an overall credit crunch have receded.

Corporations are handling the scenario relatively well so far, but we think the high interest rates are making debt service a major challenge, especially in Brazil. Rating outlooks are predominantly stable and corporate defaults at less than 1% of the portfolio. Corporate debt levels remain adequate and cash reserves are at reasonable levels to meet short-term debt. Economies are also fairly stable, while Latin American central banks have been successful so far at taming inflation while exhibiting mild growth prospects (with some exceptions). Although we think bond maturities look manageable for the rest of 2023 and 2024, more than half of the corporate sectors in Latin America are struggling to create value for shareholders because their pre-tax returns on capital are well below their borrowing costs. This is a major issue among Brazilian corporations that have debt structures more exposed to interest rate volatility and where Brazil's central bank still has a very tight grip on policy rates. We expect to see further credit deterioration in Brazil, especially at companies with already weaker credit quality.

We believe the U.S. Federal Reserve's policy rates will stay higher for longer. We expect the U.S. economy to continue its resilient pattern of the past few quarters. This is despite sharp rises in policy rates and standard recession indicators. We think that monetary policy rates will be higher for longer and financial conditions will also be tighter for longer, easing back to their longer-term levels as the economy lands (for more details on the topic, please read "Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer," published June 26, 2023).

Access to international markets has been improving, but remains well below historical averages. International bonds issued by Latin American corporations in the first five months of the year were roughly 10% above the same period in 2022, but remain 40% below the annual average for the 2017-2021 period. The main domestic markets also have stayed subdued.

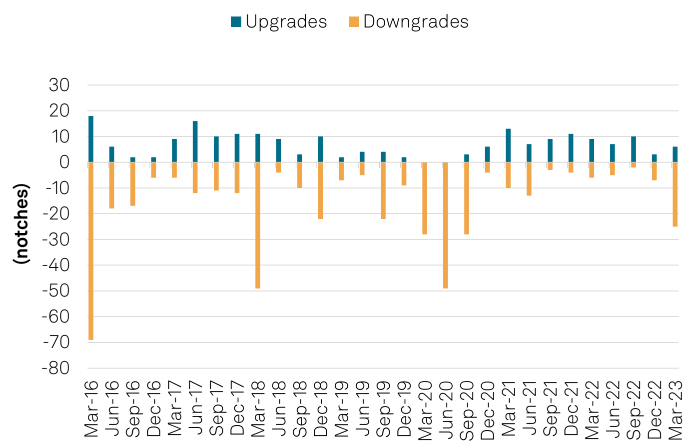
Corporate Rating Trends Are Relatively Stable And Defaults Are Contained

Downgrades multiplied in first-quarter 2023, while corporate defaults rose to 0.7% of the portfolio (see charts 1 and 2). We note that the Latin American corporate default rate highly correlates with that of the U.S. In our view, this correlation shows that domestic markets in Latin America are underdeveloped, so companies are more exposed to the U.S. market. It also indicates the large exposure to floating-rate debt that Latin American companies, especially Brazilian issuers, have compared to European counterparts that borrow more under fixed-rate schemes.

Chart 1

Corporate rating actions across selected LatAm countries

Downgrade activity has sped up since 4Q 2022

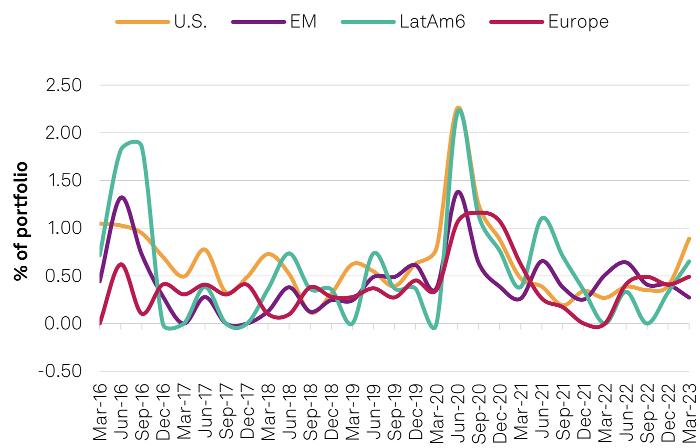


Source: S&P Global Ratings.

Chart 2

Corporate default rates of selected LatAm countries versus other regions

Defaults rose in early 2023



Latam6 includes Brazil, Argentina, Chile, Colombia, Mexico, and Peru.
Source: S&P Global Ratings.

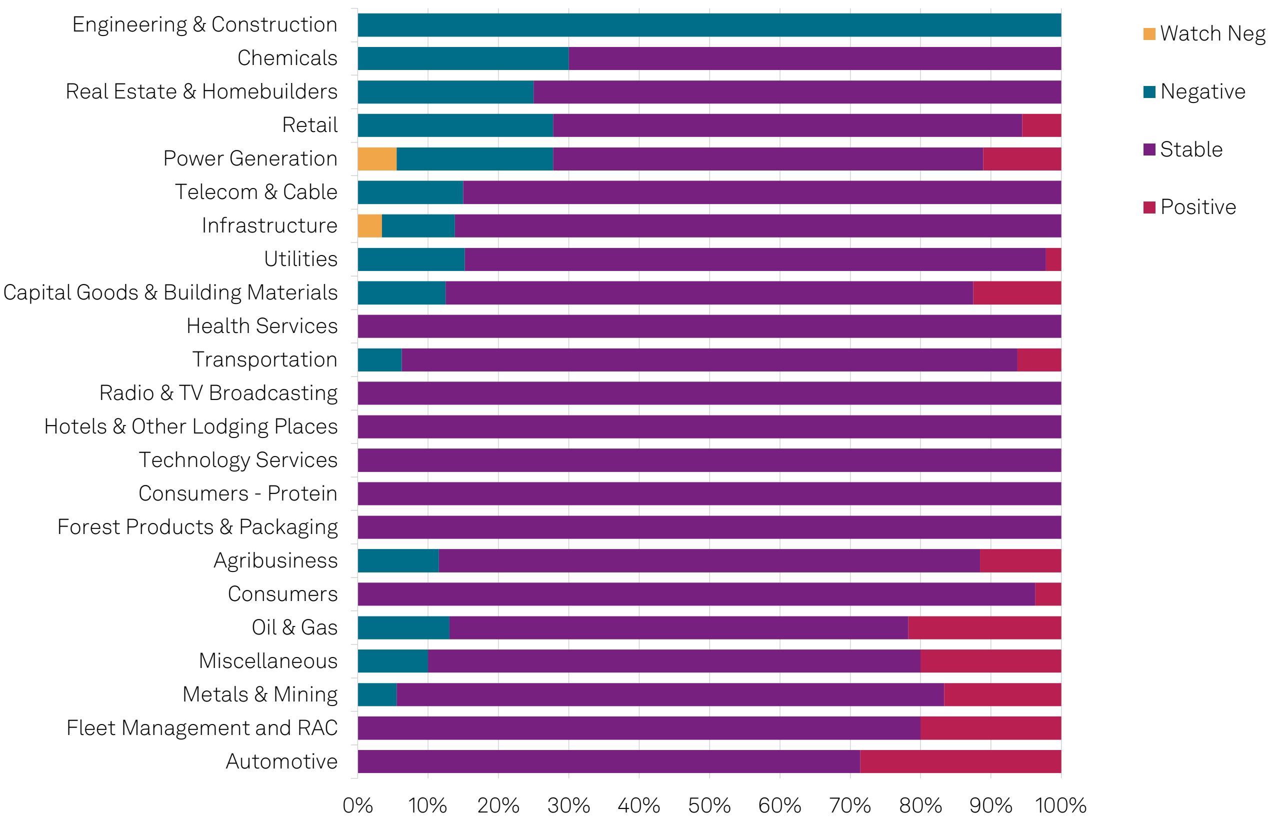
Our main assumptions behind our forecasts for these sectors are mild economic growth across most Latin American countries; a decline in inflation rates--which we expect to be more pronounced in the second half of 2023 and to extend well into 2024; and descending domestic policy rates, which we anticipate to be more pronounced in Brazil. In that country, we expect the interbank offered rate (CDI, its Portuguese acronym) to drop to 12.5% by the end of 2023 and 9.0% by 2024, from the current 13.75%. (For more details on our macroeconomic assumptions, please read "Credit Conditions EM Q3 2023: Inflation Peaked, Risks Remain," published June 27, 2023.)

We also factor in some degree of policy volatility. Political turmoil in some countries like Peru (foreign currency: BBB/Negative/A-2) and Colombia (foreign currency: BB+/Stable/B) may result in policy swings that differ from our base-case assumptions.

Chart 3

Outlook distribution by sector

Outlooks remain largely stable



Source: S&P Global Ratings.

Growth And Margins Are Stable, But There Are Some Warning Signs

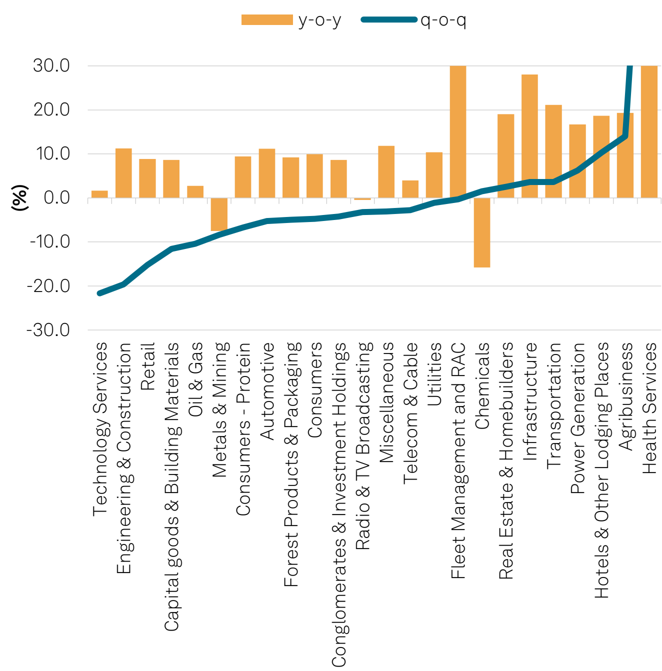
Year-over-year revenue growth rates look healthy, with most sectors growing around 10%, as chart 4 shows. However, miners and chemical producers have experienced revenue drops as metal prices have fallen from historic highs, while rated chemical producers are seeing weaker global demand for key chemicals.

Demand for chemical-related products such as plastic, polyester fibers, ethylene, acrylic, nitrogen, and fertilizers has weakened, lowering prices. That, combined with new supply entering the market, were the main drivers behind the chemical producing sector's margin compression so far in 2023, hurting the performance of investment-grade companies like **Braskem S.A.** (BBB-/Stable/--,brAAA/Stable/--), **Orbia Advance Corp. S.A.B. de C.V.** (BBB-Stable/A-3; mxAA/Stable/mxA-1+), and **Alpek S.A.B. de C.V.** (BBB-/Stable/--). Lower product prices have also led to negative rating actions among weaker-rated entities such as **Unigel Participacoes S.A.** (CCC+/Watch Neg/--, brBB-/Watch Neg/--) and **Braskem Idesa S.A.P.I.** (B+/Negative/--).

Chart 4

Corporates' revenue growth patterns

Most sectors' revenues are growing at 10% y-o-y

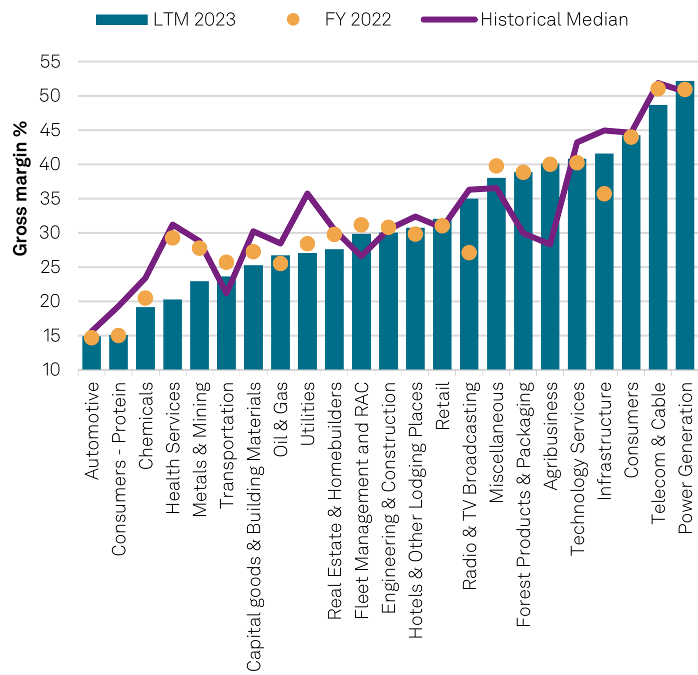


y-o-y--Year-over-year. q-o-q--Quarter-over-quarter. Source: S&P Global Ratings.

Chart 5

Corporate gross margins

Margin erosion isn't a widespread risk



LTM--Last 12 months. FY--Fiscal year. Source: S&P Global Ratings.

Margins of protein producers, transportation companies, and real estate and homebuilders have weakened in the past 12 months ended March 2023 compared to 2022. Protein giants such as **BRF S.A.** (BB-/Positive/--, brAA+/Stable/--), its parent company **Marfrig Global Foods S.A.** (BB+/Stable/--, brAAA/Stable/--), and **JBS S.A.** (BBB-/Stable/--, brAAA/Stable/--) were hit by a combination of excess supply, lower export prices, and substantial raw material costs (mainly grain prices and live animals) that eroded their margins severely, especially those of poultry in the U.S. We expect the trend to gradually revert in the second half of this year, although their annual performances will remain weak in 2023.

Brazilian real estate companies and homebuilders recovered their strong growth, but margins are still weak in the past 12 months ended March 2023. The year-over-year revenue growth rate of above 10% in first-quarter 2023 confirmed the pick-up in demand we saw at the start of the year in Brazil, although the fact that homebuilders' inventories were still high pushed prices down. Declining interest rates (which correlate negatively with home purchases) and better prospects for homebuilders to pass through inflation should propel better performances in this sector in the rest of 2023. Moreover, the recent increase in funding and subsidies to the "Minha Casa Minha Vida" program in Brazil should foster home demand in the country's low-income segment.

We think growing risks exist for Brazilian steel producers' margins because still high inflation and interest rates continue to undermine durable goods consumption. In addition, lower global steel prices will foster steel imports, pressuring margins further, while main raw material prices (iron ore, labor, and coal) also remain high.

Margins of Chilean power generation companies with power purchase agreements with regulated customers were hurt by abnormally high spot prices in 2022. This was due a combination of various factors, such as curtailment and high fuel prices, while Chile continues to transition its energy matrix to nonconventional renewables. These factors, combined with the enactment of the energy price stabilization law intended to stabilize electricity tariffs for regulated customers in August 2022, have pressured the financial metrics of rated entities, including some large players. In the short to medium term, we anticipate some alleviation of the high spot prices due to favorable hydrology from the climate event El Niño, lower fuel prices, and working capital relief from a $1.8 billion financial program to compensate generation companies under the energy stabilization law.

Leverage Imbalances Could Worsen If High Rates Persist

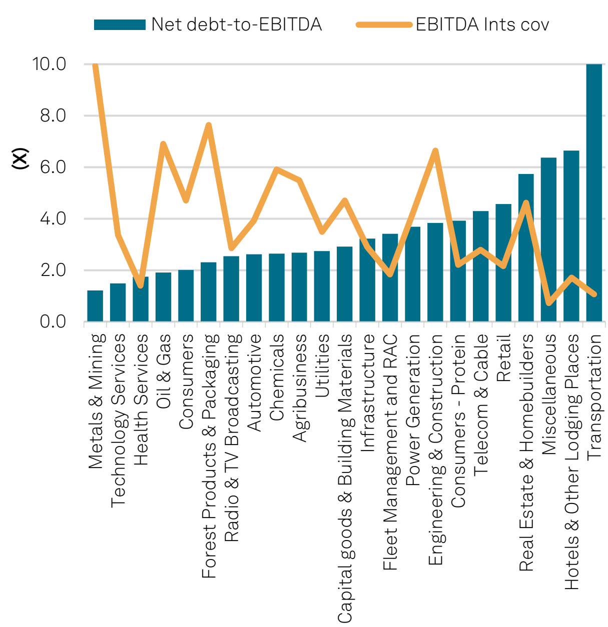
Coverage ratios remain the best compass to gauge debt sustainability, in our opinion. As interest rates rose, EBITDA interest coverage ratios weakened across our rated portfolio and signal leverage imbalances in various sectors.

We see clear signs of leverage imbalances among retailers, telecom and cable companies, protein producers, fleet management and rent-a-car companies, and transportation companies. Median EBITDA interest coverage ratios among those sectors look weak, as shown in chart 6. These sectors are dealing with effective interest rates much higher than their current and normalized returns (chart 7).

Chart 6

Corporate leverage

The cost of debt squeezes coverage ratios (last 12 months ended March 2023)

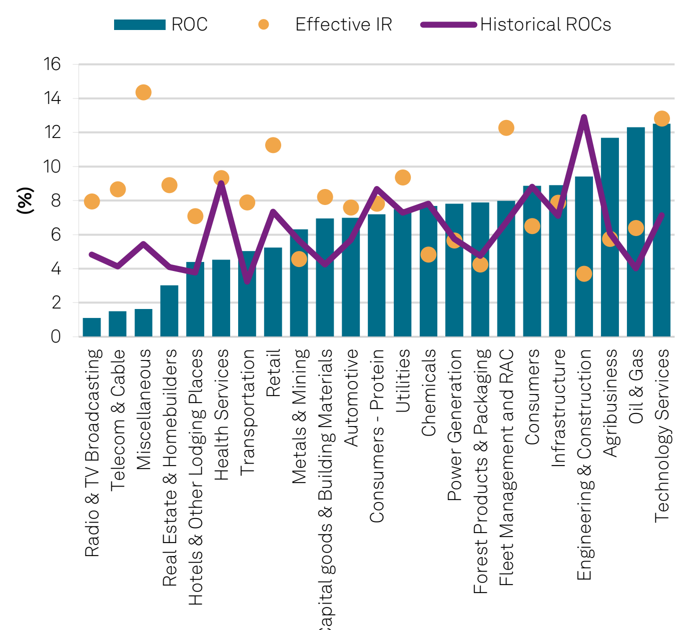


Ints cov--Interest coverage. Source: S&P Global Ratings.

Chart 7

Capital structure sustainability

Many sectors are dealing with interest rates higher than returns on capital (ROCs) (last 12 months ended March 2023)



Source: S&P Global Ratings.

Retailers' operating margins and growth are showing resilience, but their leverage is a challenge. Brazilian retailers such as **Magazine Luiza S.A.** (brAA+/Negative/--), **International Meal Co. Alimentação S.A.** (brBBB/Stable/--), **Atacad ao S.A.** (brAAA/Stable/--), **SBF Comercio de Produtos Esportivos S.A.** (brAA-/Negative/--), **and Via S.A.** (brAA-/Negative/--) are struggling to generate free operating cash flow under the heavy burden of policy rates, high debt levels, and still high inventories. But Brazilian speculative-grade retailers aren't the only ones under pressure. Chilean investment-grade **Fallabela S.A .** (BBB-/Stable/--) is also dealing with weaker margins and high interest rates that have pushed up its leverage. We expect the sector to remain under pressure through 2023, and gradually recover in 2024.

Telecom and cable operators are also struggling with the effects of high interest rates on cash flows, and their investment needs by nature are high. In Brazil, this is the case for speculative-grade network operators like **Ligga Telecomunicacoes S.A.** (brA+/Stable/--), **Triple Play Brazil Participaç ões S.A.** (brA+/Stable/--), and **America Net S.A.** (brA-/Negative/--). In addition, a very competitive market in Chile has been taking a toll on some Chilean operators' margins like **VTR Finance N .V.** (CCC/Developing/--) and **Telefonica Moviles Chile S.A.** (BBB-/Stable/--). At the same time, despite good operating performance, high investment needs and returns to shareholders have weakened Chilean telecom operator **Wom S.A.** 's (B/Stable/--) cash flow generation and leverage. The harsher market conditions are also impairing higher-rated entities such as **Telefonos de Mexico S .A.B. de C.V.** (A-/Stable/--), a Mexican telecom provider. We also expect to see further credit deterioration in this segment. In Colombia, sluggish economic growth and fierce competition are eroding the pricing power of **Colombia Telecomunicaciones S.A. E.S.P.** (BB/Negative/--).

Some Brazilian protein producers have underperformed, but we expect them to gradually recover in the next few quarters. As mentioned above, the sector was hit by unusually high raw material costs and soft poultry prices, on top of weak demand trends, which is the most influential of the three factors for future credit quality, in our view. We expect better business conditions, but avian flu trends in Brazil are a risk--although so far disease has been limited to noncommercial birds.

Virtually all rated fleet management and rent-a-car companies have weak EBITDA interest coverage ratios after their interest rates doubled since 2021, and given their inherent intensive use of capital. The companies with larger debt positions are suffering the most, such as **Simpar S.A.** (BB-/Positive/--, brAA+/Positive/--), Simpar's subsidiary **JSL S.A.** (BB-/Stable/--, brAA+/Stable/--), and **Localiza Rent a Car S .A.** (BB+/Positive/--, brAAA/Stable). We cap our ratings on Simpar and Localiza by the rating on Brazil, and could upgrade them if we upgrade the sovereign, despite their struggling EBITDA interest coverage ratios. The positive global scale outlook on Brazil drives the outlooks on these companies. In addition, Localiza and Simpar’s subsidiary, **Vamos Locação de Caminhões, Máquinas e Equipamentos S.A.** (BB-/Stable/--, brAA+/Stable), recently finalized follow-ons offering on their shares that would help them continue growing their fleets with more balanced capital structures.

Latin American airlines continue to struggle under the weight of high interest rates as they revamp their operations and capital structures. High interest rates are hampering companies like **Azul S.A.** (CC/Negative/--, brCC/Negative/--) and **Gol Linhas Aereas Inteligentes S.A.** (CCC+/Positive/--, brBB+/Positive/--) both of which have been working on restructuring their debts recently. Rates are also affecting **Grupo Aeromexico S .A.B. de C.V.** (B-/Stable/--) and **Avianca Group International Ltd .** (B-/Stable/--), which restructured debt earlier. We expect operations for all airlines to continue strengthening this year.

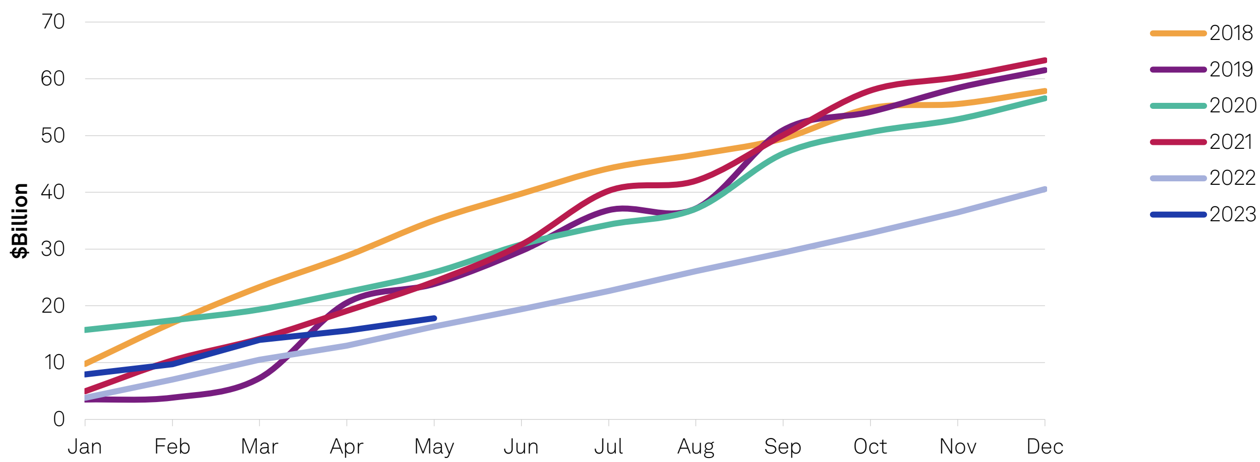
Capital Markets: The Ice Is Cracking

Access to international debt markets has improved mildly since May 2023, as chart 8 shows (June 2023 data isn't available, but preliminary estimates show an increase compared to the same month in previous years). Issuances are dominated by the investment-grade tranche, with coupons typically at about 6% for the 10-year tenors. Still, speculative-grade issuers' access to the market remains muted, with companies not willing to take on debts at yields typically ranging between 7% and 12%

Chart 8

Market access since 2018

International bonds issued by LatAm corporations since 2018 -all countries



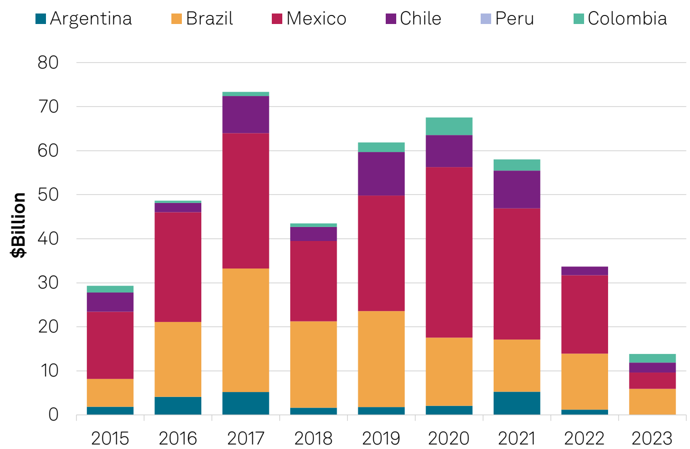
Source: S&P Global Ratings based on Thompson Reuters.

Domestic issuance also remained subpar until May 2023, especially in Brazil, which is by far the most active and diverse market in the region. Once again, the high CDI rates there and an exacerbated risk aversion among investors after Americanas' and Light S.A.'s defaults pushed spreads up. Activity has resumed since May as spreads started to drop in the wake of expectations for lower policy rates in the second half of the year. Although we expect market access to improve, spreads of weaker credits won't necessarily drop as fast as for issuers with better credit quality. In fact, we expect that more expensive borrowing will generally further differentiate the spreads of weaker credits from those of stronger ones.

Chart 9

International bonds issued by LatAm corporates

Mexican, Chilean, and Argentine corporates issuing less than in previous years

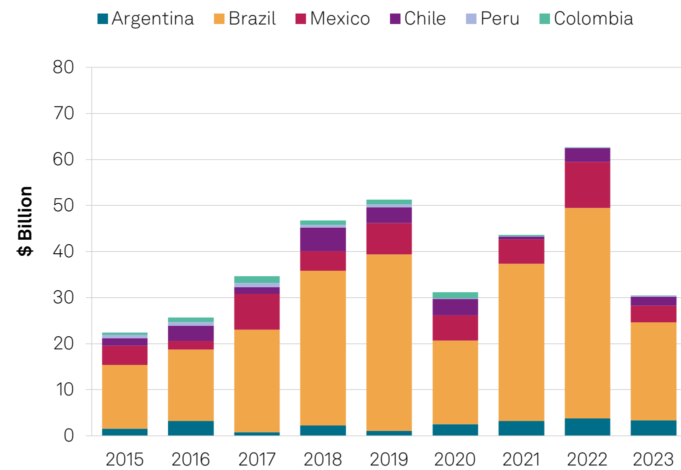


Source: S&P Global Ratings.

Chart 10

Domestic bonds issued by LatAm corporates

Brazilian domestic market is picking up steam



Source: S&P Global Ratings.

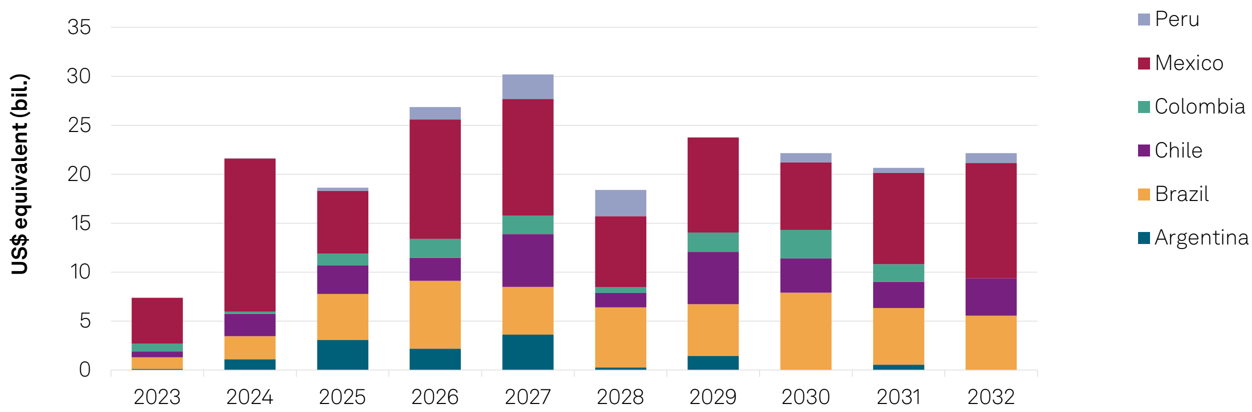
For Brazilian infrastructure, despite the standstill agreement granted to Light S.A. in April and the judicial recovery announced in May, we continue to see market appetite for the sector, with an aggregate R$29 billion rated debentures issuances to date this year, including recent R$10 billion for the sanitation segment, as well as the placement of a couple of hybrid instruments. We continue to expect utilities, power generation, and transportation infrastructure issuers to refinance the rest of their 2023 maturities and those due in 2024.

Lastly, international bond maturities remain manageable for the rest of 2023 and 2024, so we don't expect meaningful problems from those. This also fuels our expectation of a controlled default rate.

Chart 10

International bond maturities of LatAm corporations

Refinancing needs look manageable in 2023 and 2024



Source: S&P Global Ratings based on Thompson Reuters.

Related Research

- Credit Conditions Emerging Markets Q3 2023: Inflation Peaked, Risks Remain, June 27, 2023

- Global Economic Outlook Q3 2023: Higher For Longer Rates Is The New Baseline, June 26, 2023

- Economic Outlook Emerging Markets Q3 2023: A Slowdown Ahead After Beating Expectations, June 26, 2023

- A Sticky Slowdown Means Higher For Longer In Our U.S. Economic Outlook, June 26, 2023

- A Rise In Selective Defaults Presents A Slippery Slope, June 26, 2023

- Outlooks On Several Brazilian Corporate And Infrastructure Entities Revised To Positive On Similar Action On Sovereign, June 15, 2023