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PRESENTATION: An Overview of Latin America's Entrée to the Global Equity Markets

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AN OVERVIEW OF LATIN AMERICA'S ENTREE TO THE GLOBAL EQUITY MARKETS

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I. Introduction

Ladies and Gentlemen, good morning. I am Suzanne Nora Johnson, a Vice President at Goldman, Sachs. I have recently spent most of the past year working with a team at Goldman, Sachs to develop a Latin American strategic plan and in the past have worked with a number of Latin American governments developing foreign investment strategies, as well as with Latin American issuers seeking foreign capital. Roberta Karmel [Professor of Law, Brooklyn Law School and co-chair of the Brooklyn Law School Center for the Study of International Business Law] had asked that I prepare some remarks on Latin America's recent entree into the global equity markets.

Like much of Latin America's modern history, it is often difficult to sort out what is and to wager on what might be. As someone who is very respectful of Latin American business people's, and entrepreneurs' ability to survive in one of the most adverse and extreme economic environments in the world today, I thought it would first be useful to develop the context for today's discussion by briefly touching on the importance of Latin America and the factors responsible for Latin America's increased presence in the world equity markets. I will then discuss the actual market activity taking place and finally will speculate on the future growth of Latin American equity issuance in the world's leading equity markets.

II. The Relationship Between the Latin American Import Market and the United States

The significance of the Latin American import market to the United States cannot be overstated. It is this relationship which will critically affect Latin America's presence in the eq-

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uity markets as well as the United States' long-term economic health. Since the recent transformation of the Eastern Bloc and the reunification of Germany, a frequent lament one hears while working in Latin America is how such events are unjustifiably overshadowing the region's considerable progress since the outbreak of the debt crisis in 1982. The emergence of Eastern Europe as a new trading bloc underscores the need for the United States to cultivate and ensure the viability of the Latin American consumer markets in the same way in which the Europeans are courting Eastern Europe as a natural home market and the way in which the Japanese have aggressively invested in Southeast Asia and the Pacific Rim.

The Latin Americans' comments are well-founded. A recent study suggested that thirty percent of the United States trade deficit can be blamed on falling exports to Latin America. After adjustment for inflation, United States exports to Latin America remain forty percent below their 1980 peak. Consider that the United States had a 6.2 billion dollar trade surplus with Latin America in 1980 yet a trade deficit of in excess of 15 billion dollars in 1989.

United States firms still have a competitive advantage in Latin America based on proximity, familiarity, communication and financial links. The value of United States cultural penetration also should not be underestimated. Although Latin America's consumer base is depressed, by comparison United States exports to Eastern Europe are currently only two percent of exports to Latin America.

Although the United States and Latin America had approximately the same population in 1950, the number of Latin American inhabitants will be twice that of the United States by the turn of the century. In addition, the importance of Latin American culture will grow in the United States. Most commentators estimate massive and sustained migration from Mexico. It is also worth noting that ten percent of the Central American population fled that region in the 1980s.

Finally, if the United States Government is to continue its assault on the lucrative Latin American drug trade, industrial substitutes will have to be developed in Latin America to compensate for the injury to the many economies that derive substantial revenues from the drug trade.

III. Trends Favoring Investment in the Latin American Market

In addition to the preferred market status of Latin America, there are a number of other trends that are fueling interest in Latin America in the global equity markets. These trends fall into two broad categories: the macro-economic factors and the micro-market factors. On the economic plane, there are three major macro trends. First, the perceived democratization of the region: Chile has emerged as a democracy after seventeen years of Pinochet's rule; Argentina and Brazil have returned to democracy after military rule for seven and twenty-one years, respectively; and Mexico, despite its one-party-system, is considered the role model for Latin American capitalism. Second, significant structural economic reforms have begun. It is now politically acceptable to discuss downsizing the public sector, and privatization is the policy of choice. Import-export barriers are finally being dropped and significant debt reduction has occurred. Third, local capital markets are beginning to be developed.

On the micro market front, there are three major reasons investors are beginning to look seriously at Latin America. First, and most importantly, institutional investors need to replace a portion of their investment portfolio with a high growth asset class with double digit growth potential and low initial valuation. Illustrative of the growth potential is the fact that from June 1989 through June 1990 the Mexican, Chilean and Venezuelan stock markets' indices outperformed not only the United States, British and Japanese markets but also those of Korea and Taiwan. Second, many international investors, particularly international commercial banks, have significant stakes in Latin American companies by virtue of debt-for-equity conversions. One estimate is that 27 billion dollars have been converted into equity stakes in Latin American companies since 1984. Finally, access to country funds in Latin America has provided a market window into the potential opportunity available there. The relative success of country funds in Southeast Asia makes the opportunity that much more attractive.

VI. Actual Investment in the Latin American Market

Despite these trends — and all the attendant enthusiasm and favorable press — the actual market for Latin American equities in the United States has been thin at best. The only fully-registered Latin American ADR issue to date was an 89 million dollar issue for CTC — the Chilean telephone company. In addition, there are approximately ten unregistered ADR programs for Mexican companies and a 100 million dollar issue for a large Mexican conglomerate in the market which is being privately placed via Rule 144A. Most of the equity transactions to date have been strategic private placements — many used with debt/equity financing techniques — as opposed to investments by financial buyers.

The only other direct equity issues in the market have been transactions made in connection with the so-called country funds. There have been single country funds for Mexico, Brazil and Chile, as well as a number of integrated regional funds including investment options in Argentina, Brazil, Chile, Mexico, and Venezuela. However, even the most successful country funds, in terms of dollars raised, generally have been privately placed or sold in Europe. In addition, many of the investments in these funds were made in connection with debt for equity conversions instead of by including new money from investors unaffiliated with creditor banks.

V. The Decision to Invest in Latin America's Equity Markets

Although the list of Latin American issuers entering the world markets is modest, there has been growing participation by institutional investors directly in Latin America's equity markets. In a recent survey of international institutional investors, over sixty-five percent responded that they are now investing in emerging markets. Of that sixty-five percent, over sixty percent were allocating a portion of their portfolio to Latin America. It is instructive to note, however, that over ninety-five percent were investing in the Pacific Rim. After Thailand, however, Mexico is cited as the second most attractive emerging market.

Direct investment in the Latin American equity markets by institutional investors has been disproportionately from United States as opposed to British or Japanese investors. This belies a common market misconception that the Europeans have been the most active investors in Latin American equities. My own sense is that the confusion is generated by the fact that a large number of strategic as opposed to market investments are being made by Europeans. While many of the United States-based multinationals are in the final throes of divesting their Latin American operations, the Spaniards, French and Italians are actively making strategic alliances and securing lucrative management contracts.

Generally, investment decisions in emerging markets are more influenced by political and economic factors than by company-specific valuations. This is obviously the converse of investment decisions made in the developed world. The following factors are the most important to the decision to participate in the Latin American equity markets. First, the political and economic health and stability of the country must be assessed. Specifically, investors will analyze the relative success of structural reforms, control of hyper-inflation, and currency strength. The perceived move to democracy will also be considered carefully. For example, while most of Chile's economic success was achieved during the Pinochet regime, the installation of the Alwyn Government was key to many investors placing Chile on their approved lists. Second, the viability of the parallel equity market in the home country will be critical to investors' decision to invest. Whether investors are reviewing an ADR issue or a direct stock investment in the local market, the home market will provide the ultimate exit mechanism. Specifically, investors will also analyze the market capitalization and liquidity of the local market as well as restrictions on foreign participation, investment and tax structure. The irony now is that a number of attractive issuers, particularly in Brazil, are suggesting that the lack of a real home market should be a benefit because the risk of flow-back is mitigated. From an investor's view point, the home market for the shares is critical: (1) as a guide to the appropriate valuation for the ADR issue in the United States, and (2) as a potential exit mechanism. The fact that foreign investors may be able to arbitrage the underlying shares in the home market due to currency differentials is a problem that all world-class issuers face when they access foreign markets.

Third, the availability of credible and standardized financial information will be key to investment decisions. The problem of credible financial information is an endemic problem in Latin America. Financial statements are often not credible, disclosure standards are non-existent. Accounting standards are generally inconsistent with international accounting practices. Rarely are accurate adjustments made for hyper-inflation. This is one area where many Pacific Rim issuers are at a decisive advantage. Investors believe they must work harder and spend more money to achieve the same level of basic information when investing in the Latin American market. The lack of financial disclosure is also due in large part to the fact that many Latin American issuers remain closed companies with only preferred stock trading in the home market.

Fourth, foreign investment restrictions and tax-related issues will have to be resolved with a fair degree of precision to comfort investors. Finally, Latin American issuers still face the so-called "dirty business" issues which must be addressed. Investors will have to be convinced that they are not being set-up for a fall in view of the taint of past corrupt practices or different ways of doing business.

VI. CONCLUSION

In conclusion, there is substantial evidence to suggest that Latin American issuers will continue to prevail in the global equity markets. Their prospects, at least initially, will depend in large measure on their political and economic stamina to sustain crippling interest rates, low demand and the sudden withdrawal of government support. The loss of a reasonably priced oil base will also factor significantly in how quickly Latin America — excepting Mexico and Venezuela — will join the world equity markets. Second, the development of local markets as an alternative exit and valuation benchmark for international investors will be critical to the willingness of United States, European and Japanese investors to invest in Latin American companies. Third, many of Latin America's crown jewel companies are either state-owned companies in line for privatization and restructuring, or are currently closed, privately-held companies not represented on local exchanges. It will be important that these companies debut early in the process to instill investor confidence and set the precedent for smaller companies to follow.

Finally, Rule 144A is unlikely to be the most attractive way of accessing the global equity markets in the short-term given the concerns over the lack of available financial information, credible and uniform accounting standards and illiquidity. However, as Latin American disclosure, financial and accounting standards develop and investor confidence and experience grows, Rule 144A will be another important route for potential Latin American issuers to pursue.