



## **MANAGING RISKS AND OPPORTUNITIES NEWSLETTER**

**June 2008**

**To Watch:**

**Inflation related risks: Manage foreign exchange risks;  
Manage treasury and funding risks;**

**Manage regulatory risks; credit risks and customer  
insolvency**

In 2004 we published our White Paper about Managing Risks of Doing Business in Latin America. That paper had over 20.000 downloads when posted in our websites ([www.ftaaconsulting.com](http://www.ftaaconsulting.com) and [www.thealtagroup.com](http://www.thealtagroup.com)). Risk management is certainly a priority, especially for managers and business players in Latin America and other emerging markets. Risk management is our business, not because we sell insurance, but because our overall legal and consulting services provide mitigation solutions and general increase in profitability.

Risk management is a discipline in constant evolution. Risks are moving targets, and therefore, anticipation, assessment, mitigation and remediation change over the course of time. Therefore, we intend to initiate with this newsletter, a communication tool with all our clients and business partners to provide awareness and solutions. Not everything can be found here, but this is a good start. Further specific tools and solutions are available when you contact us.

In this Newsletter we will address some specific subjects of concern that are related to our day to day fields of practice. We hope that this will bring value to all of you.

**Latin America: Booming, isolated from the United States  
recession, or else?**

The news about a recession in the United States has created confusion worldwide. For starters, in the United States, there are still some voices denying the existence of a recession to stick to the actual academic definition, namely two successive quarterly decreases in the GDP. With or without the statistics, the



downturn in the United States economic activity is clearly felt: In empty restaurants, roads less congested and in our reduction of sales and timely collection of receivables.

Then, if the United States is in recession, what can we expect from the rest of the world? And for our subject matter, what can we expect from Latin America? Well, so far, so good, the recession is not yet driving a significant problem in Latin America. Is this true? Why?

Well, here it comes our first warning: Be careful with the exuberance. Brazil was recently upgraded as an investment grade country and suddenly, overnight, this country became a superpower. Everyone is turning its eyes into Brazil, these same eyes that some few months ago did not even pay attention to this South American country.

The following is our reading of the situation: The United States capital markets are efficient and developed because they have the legal structure, the information systems, the distribution channels, the players and the marketing that make them the ideal conduit for funneling savings into investment vehicles. At the core of the investment business there is always the challenge of finding the adequate investment vehicle to any excess liquidity looking for a yield. Investment and private bankers, brokers, etc. may not afford the luxury of waiting for a sound vehicle to be complete. They need to invest such funds in such investment vehicles that are ready in the marketplace. The United States mortgage market presented the best potential for making available the best investment vehicles: (a) A comprehensive information system about real property in the United States; (b) An efficient mortgage legal and information system that provided comfort about the ability to perfect security interests in someone's real property, (c) credit information systems, whereby credit bureaus can create credit scores for any individual owning real property, and (d) efficient legal systems that enable a fast turnaround time for enforcing the creditors rights and security interests. With all this, nothing should go wrong... Nothing? Think again: You forgot about the ability of such homeowners to generate cash!!

This is what we call exuberance: It is losing of sight the economic fundamentals of the business. In the case of the United States, dramatic changes were clearly happening: In the last 20 years (that is since the early 1980s), the United States education system has failed to prepare leaders with awareness about the fact that there is a world populated with 5.7 billion human beings who live out of the United States. This lack of education in globalization has been leading to the fact that the average American is not prepared to the same globalization that the United States itself has created. As a result, most average employees failed to get adapted to the global economy and when the manufacturing plant or service



office where such American worked, decided to shift manufacturing to China or outsourcing services in India, this person lost his/her job and its ability to generate cash. And this was concealed at the beginning when such individual received mortgage loans, and lived out of the cash flow generated by the same loans. At the time of repayment, when the cash went out, this was the time when the bubble started to explode. Was this predictable? Of course it was.

What is the parallel that this situation can have vis-à-vis Latin America? Well, the same: **Look at the fundamentals.**

The world has been changing in the same last 20 to 30 years. When China decided to abandon its isolationism and India improved its international presence, then more than 2 billion human beings started fueling a demand of all kind of goods, but specially commodities such as food and minerals. Of course that some other staples were demanded, including services, tourism, clothing, etc. And these countries, in particular China, amassed enormous fortunes and generate large amounts of savings. So most of these savings helped to finance the negative savings or exacerbated consumerism of the average American. But also, and this has direct connection with Latin America, the demand of commodities started creating a boom of exports and foreign reserves in all Latin American countries, in particular in those, such as Brazil, rich in natural resources. Is such demand of commodities going to last forever? Certainly not. This is another bubble that will explode sooner, rather than later. Therefore, before investing blindly in any of the countries whose boom and increase of foreign reserves is fueled by the increase of commodities prices, or if your company has already invested there, prepare yourself to a scenario where no such flow of hard currencies would go into the country and the foreign reserves may start to get drained. You need to assess right now how long this can take to happen and how to mitigate such risks. We can help you here.

Another factor of concern is inflation, and certainly inflation is a major risk to watch in Latin America. There are two main factors fueling inflation worldwide: Food prices and fuel costs, in particular, the price of oil. Exuberance again triggered speculation on the price of oil. Everyone recognizes that the ascending spiral of oil prices are mainly due to exogenous, rather than endogenous causes, such as, first, speculation, then the Iraq war and the corresponding geo-political tension with oil producing countries, and finally the low purchasing power of the United States dollar. This is another bubble that will blow-up. The question is: When?

But inflation is a real concern and it is causing damage to Latin American economies. The rise in inflation has forced the Central Banks and governments in Latin America to raise interest rates. The raise in domestic interest rates has created a general accumulation of hard currency foreign reserves in most of the



Latin American countries, Argentina being an exception where capitals are now flying away, and the country has lost more than US\$ 20 billion in the last few months. The overall outcome is that the exchange rates show a revaluation of the United States dollar vis-à-vis the domestic currency, either the Brazilian Real, the Mexican peso, the Colombian peso, the Peruvian Sol or the Chilean peso. And in general, the banks accumulate holdings in United States currency accelerating the revaluation process. Exporters start losing their competitiveness as they are unable to cover their domestic costs with the reduction in their nominal revenues. Some countries, such as Colombia and Argentina had reacted defensively creating mandatory deposits or reserves for importation of currencies, either via foreign borrowing or short term equity investment, and this has generated undesired effects, making the situation worse for companies operating in such countries. This is another risk factor, associated to the overall funding risk that needs to be assessed and mitigated. We also can help here.

In these risk scenarios, are there opportunities in Latin America? The short answer is yes. But, as mentioned, these opportunities go hand by hand with their corresponding risks. Here are the most attractive opportunities that we can see:

- √ Investment in Infrastructure: There is a lot of room for growth in fields of infrastructure investment, such as transportation projects, energy and power generation, telecommunications, water and sanitation. All the countries bring attractive opportunities. We have a project database available for our clients, but for the time being, we can highlight the following:
  - Power generation projects in Chile and Brazil. Both promise to be very profitable, but both require very tight risk management;
  - Transportation projects in Mexico, Peru and Colombia. These go from privatization of toll roads (under FARAC in Mexico), or massive transportation systems (such as the high speed train in Argentina, the Lima massive transportation system, and other), airports (such as recent privatizations in Colombia), etc. All investments in these projects require continuous risk management monitoring. We can help;
  - Telecommunications through the mobile telephony, the convergence of voice, data, images, video, all over the region. Investments in this area are coming without interruption. But the time for demanding returns is coming and this will need a lot of risk management, from the regulatory risk, to the competitive risk, to overall demand and market risks;
  - Water and sanitation, and in general, investments in the environment improvements, are being continuously emerging in



the last few years. There are a lot of potential, but there are also challenges.

- √ Financial sector: The emergence of the economies, the progress in credit information and easiness to do business would provide better conditions for the financial sector to develop sustainable profitability. There are some countries behaving better than other in such fields. Certainly, the key issues will need to do with credit risk management and all other related risks to the financial business. Each country has different performance and credit risk profiles. We have the best in class expertise in managing such risks. We can also help.
- √ Food production: Latin American countries are rich in agriculture. With different degrees of development, agriculture presents opportunities in countries such as Brazil, Mexico, Colombia, Central America and other.

## **Risks and opportunities by countries**

- √ Brazil: A lot of opportunities in agriculture, energy, manufacturing and financial services. But watch the risks: Inflation, exchange rate and interest rates; regulatory intervention, difficulties to do business, supply chain risks;
- √ Mexico: Also large opportunities, especially in government sales, energy projects, including Pemex and CFE opportunities, manufacturing. But watch the risks: government procurement risks, credit risks, potentially insolvency of large customers of manufacturers, inflation, interest rates and foreign exchange, mild but important political risk;
- √ Argentina: Large opportunities in infrastructure, rail transportation, energy (ENARSA is leading many important projects), and agriculture. However, watch the risks: Political, inflation, capital flights, another potential government default;
- √ Colombia: Large opportunities in infrastructure and the financial sector. The country has improved its economic conditions providing protection and security to its inhabitants. But watch the risks: Potential real estate bubble to exploit, inflation and high interest rates, potential bankruptcies in export related industries;
- √ Chile: Immense opportunities in the energy field and in financial services. The country is the best rated sovereign. Watch risks: Political,



labor conflicts, dependence on Codelco and the copper as main source of hard currency, supply chain risks.

- √ Peru: Large opportunities in infrastructure, M&A opportunities in manufacturing, and opportunities in financial services. Watch risks: Inflation and related risks, such as interest rates, exchange rates. Credit risks of exporters and supply chain risks;
- √ Panama: Immense opportunities in infrastructure with the expansion of the Panama Canal, tourism and real estate. Watch: Another real estate bubble and potential risks of inflation and supply chain risks;
- √ CAFTA-RD countries: Costa Rica, Guatemala, Honduras, El Salvador and the Dominican Republic present opportunities in infrastructure, especially in telecommunications and in the financial sector, as well as in light manufacturing. Watch: Inflation and related risks, regulatory risks in countries such as El Salvador.

If you need further information and/or you want to know how we can help with your risk management, feel free to contact us: [rc@ftaaconsulting.com](mailto:rc@ftaaconsulting.com) .

Further information at [www.ftaaconsulting.com](http://www.ftaaconsulting.com)