

Larrain keeps driving Chile forward

Finance minister Felipe Larrain is the architect of Chile's economic success story. He wants to capitalize on it by making the country a financial centre for Latin America. But are the problems the government faces at home simply the growing pains of success or a threat to Larrain's ambitions? Rob Dwyer reports from Santiago

CHILE IS NOT just the darling of Latin America's financial markets. It is an emerging markets template of rules-based, disciplined economic management. International investors certainly think so: the yield on its 10-year \$1 billion bond issued in September this year is, at 3.35%, the lowest ever for a Latin American issuer.

Other numbers stack up equally impressively. In the first half of the year GDP grew by 8.4%. Growth for the full year is expected to be 6.5% and, after a conservative revision, next year's expected level is now 5%.

Half a million jobs were created last year – job creation of more than 7%. Real wages rose by 3%. Productivity is rising. The central bank's reserves are just shy of \$30 billion. A current account surplus is swelling the size of two sovereign wealth funds – one created to fund the country's pension arrangements, the other a counter-cyclical source of liquidity. Exports – calibrated towards the world's still-growing emerging markets – are, well, growing. Gross debt as a proportion of GDP is 9%, interest rates are 5%; that gives plenty of fiscal and monetary room to respond to any global crisis.

And yet, a more pressing constituency for Chile's government – the voters – is not feeling the warmth radiating from the international markets. President Pinera's opinion poll ratings vary between 20% and 30%. Not much political capital is being generated to match the economic variety being amassed.

The prolonged campaign of demonstrations by the country's students for better state-provided education seems to resonate with the country as a whole. The growing pains of success is one banker's interpretation of the social unrest; membership of the OECD (Chile became South America's first member in 2010) has led to domestic demand for greater state expenditure and better social provision.

Finance minister Felipe Larrain is late for our meeting, delayed by discussions with the president. The finishing touches are being put to next year's budget. Larrain is the architect of the recent Chilean economic performance – rules, transparent, orthodox and effective. The clamour for greater spending, for the relaxation of his financial rules, seems to simply wash over him. But some of his ministerial colleagues are perhaps becoming nervous, and certainly less rigid.

Pablo Longueira, the economy minister, recently suggested

that perhaps higher corporation tax could be used to fund greater spending on education. Larrain, an academic by profession and, one suspects, by nature, won't be drawn into commenting on his colleague's public pontifications, but agrees that, compared with politics, economics and finance are easy. "I love solving models, estimating complex equations – solving systems that simulate the world," he says. "I loved [the academic] world – I still do. I love the possibility of writing a paper, a book, of concentrating and spending an afternoon on solving a problem. This is the most exciting job I have ever had but it is the most demanding." He then adds, perhaps a little caustically: "Sometimes you don't have complete explanations in politics."

Increase integration

Larrain is more interested in talking about his plans for building on his country's growing strength. He aims to make Santiago the financial hub for the Andean region and perhaps beyond. Market-friendly reforms have been enacted and more are planned. Financial modernization and globalization are priorities. "Many of the things we are doing are to increase our integration into the financial markets," he says, pointing to the promotion of *huaso* bonds as an example.

Huaso bonds are issued in the Chilean domestic capital markets by international issuers, named after the Chilean word for cowboy. The regulations allowing these transactions were introduced six years ago but were relaxed earlier this year to lower the qualification requirements for issuers.

"Previously, the regulation said that to come and issue bonds in Chile you had to be rated in a triple-A country but we only saw two issuers in the last six years," says Larrain. "It's a good idea but the problem is that the restrictions were so high it was only available to US companies and why would a US company come to Chile? We need to be competitive with [other] emerging markets, so we lowered the hurdles. Now emerging market companies and multilaterals can come here."

The rules were changed before the US was downgraded, so, in theory, those companies have had continual access to the Chilean domestic market but only *América Móvil* and *Banco de Crédito del Perú* (both listed on the NYSE) have issued. *América Móvil* opened the *huaso* market in April 2009 and has also done the most recent transaction in May 2010. The first transaction was

for UF4 million (\$225 million) in five-year paper at government bonds plus 141 basis points, and its latest was for UF5 million of 25-year notes at government bonds plus 70bp (yielding 4%). In between these deals, Banco de Crédito del Peru sold UF2.7 million in five-year bonds at government bonds plus 140bp.

Bladex, the Mexican trade financier, and multilaterals IDB and CAF have been strongly rumoured to be interested in conducting a huaso bond since the relaxation. Bladex mandated BBVA for the transaction but the volatility in the global debt markets has been blamed on the lack of deals to date. Larrain, though, is sanguine. "This will take time to develop," he says. "We have seen a lot of interest expressed and we will see some emissions. This is a way to provide more alternatives to local institutional investors, most prominently the pension funds, but also as a way to create and to improve Chile and Santiago as a regional financial centre. This is part of the strategy. We have a very ambitious agenda to improve the attractiveness of the capital markets. We are doing a lot of things."

Local pension funds now have assets under management of more than \$140 billion and are increasingly looking to diversify their portfolios into non-Chilean assets. The growth of huaso transactions would provide an easy source of such diversification of credit for these pension funds. In return, Chile's mature, liquid and deep markets will likely offer an attractive source – and cost – of funds for companies and multilaterals throughout Latin America. And the pension funds have demonstrated their appetite for buying longer-term than the 10-year deals usually sold in the US.

Also, in May, Chile's Depósito Central de Valores (DSV) and Euroclear Bank announced an agreement to enable the latter to launch settlement, custody and related services for cross-border Chilean domestic debt transactions (a move Larrain "celebrated"). The DSV also began offering similar services involving securities transactions for its clients through Euroclear Bank. The deal should further encourage the issuance of Chilean peso-denominated securities by foreign issuers and lower the cost of financing.

The agreement with Euroclear is also part of Larrain's objective to internationalize the Chilean peso. In the republic's dual-tranche debt transaction in 2010, Chile issued a peso-denominated 10-year tranche worth \$520 million. This year, at the time of its new \$1 billion bond, Larrain decided to re-tap the 2020s for another \$350 million-equivalent, taking the total liquidity to close to \$900 million. The focus of the re-tap was to minimize yield rather than achieve size, and Chile priced the new notes at a yield of 4.4%.

"On that day, the already issued bonds were trading at 4.95%, so we reduced the borrowing costs by 55bp, which results in [net-present-value] savings of about \$20 million on just the [newly issued] \$350 million [equivalent]," says Larrain.

Pricing reduction

The pricing difference between the local and offshore bond curves shows the potential that the government has to lower its borrowing costs, says Vicente Monge, senior country officer for Chile at JPMorgan. The bank expects further relaxation in

regulation and Euroclear to facilitate foreign investors to more easily buy CLP-denominated debt, and believes the result will be a narrowing of the offshore and onshore yield curves, to the advantage of the government, quasi-sovereigns and private companies. "The pricing reduction for domestic Chilean peso debt could be significant and we expect to see interest in foreign investors buying domestic securities, as well as a steady growth in the issuances of huaso bonds."

Chile is also one of the main planks of Mila, a market created to trade stocks from Colombia, Chile and Peru. Larrain is optimistic about its impact on Andean equities, despite a recent Bloomberg report that showed that in the first four months Mila trade totalled just 183 transactions worth \$2.9 million, or the equivalent to about 20 seconds of average volume of the BM&FBovespa. However, should it be a precursor to integration, Chilean, Colombian and Peruvian stocks have a combined value of \$578 billion, more than Mexico's \$387 billion. Brazil's BM&FBovespa has a market value of \$1.2 trillion.

"Mila is a way of integrating financial markets," says Larrain. "It goes back to Chile developing their companies. I love seeing that – Chilean champions in the public and private sector developing their competitive advantages."

Bankers in Santiago say intra-Andean equities are less active than M&A and DCM, but the potential is there. JPMorgan is looking to use Mila as a means to develop a Chilean hub to oversee its equities operations in Peru and Colombia, although to operate in the latter two countries will require agreements with local brokerage houses. Juan Andrés Camus Camus, president of Chilean company Celfin Capital, believes the Mila experiment needs more time but thinks the pan-Andean focus reflects shifting institutional investor behaviour.

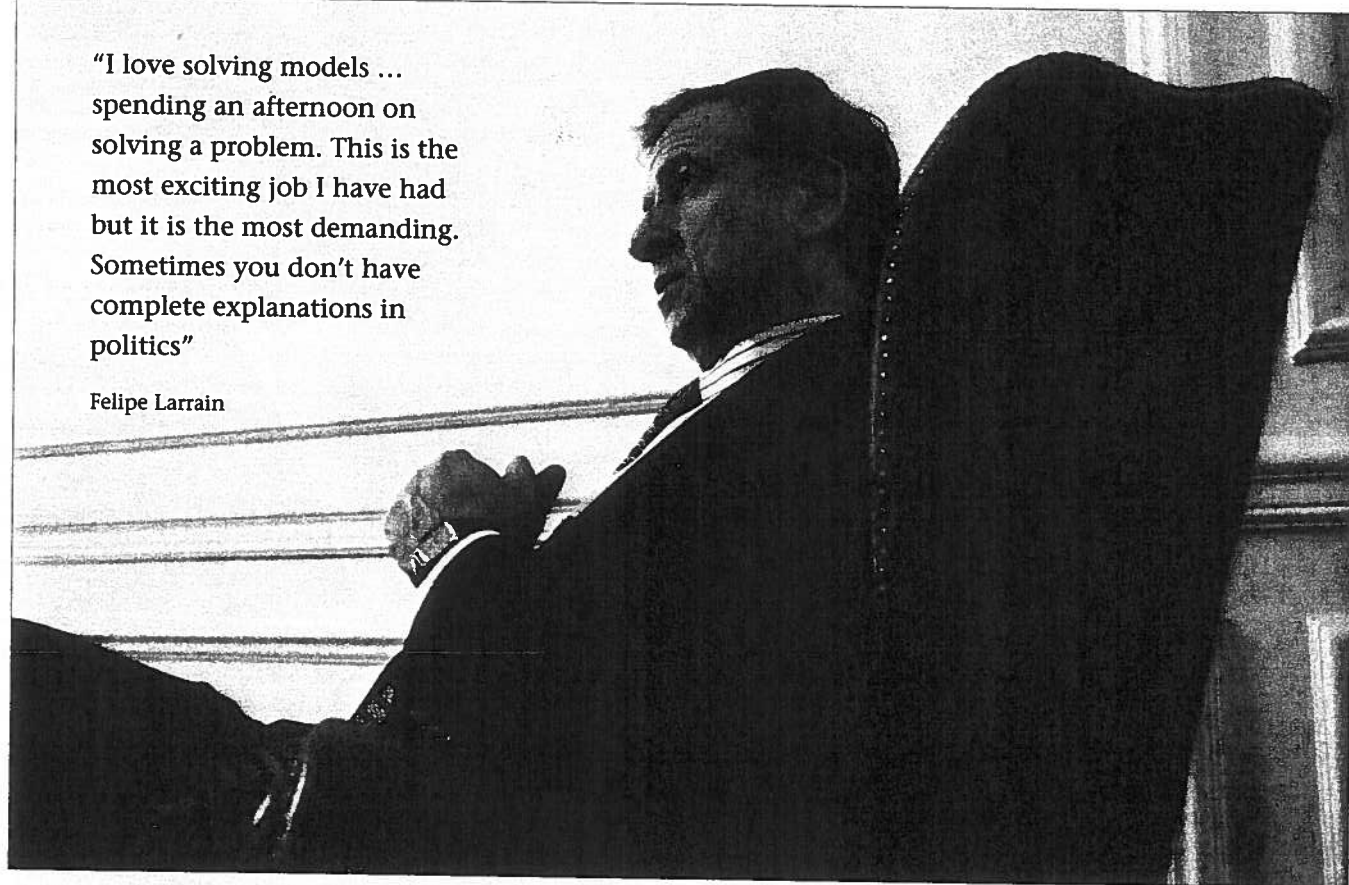
Up to now, Camus says Chilean investors have stock-picked Chilean equities and used mutual funds managers in Colombia and Peru as subcontractors for the management of their equity portfolios in these other Andean markets. Celfin now has offices in Colombia and Peru. "Mila goes beyond the concept of only trading equities. It's the whole concept of this region in Latin America having a pool of savings that we didn't have 10 or 15 years ago," says Camus. "Previously, for any large transaction you needed to have Wall Street involved, but today you don't because there is sufficient liquidity in your home domestic market. Mila is just an extension of that, driving depth among Colombia and Peru investors as well."

Larrain's efforts to position Santiago as a regional financial power should only further enhance the strength of what are already very mature and deep domestic capital markets. This, in turn, will further strengthen the competitive advantage that Chilean companies enjoy with regard to cross-border M&A. Bankers in Chile expect the recent volatility in international markets to heighten this advantage, and a wave of outbound M&A is expected.

Alfonso Eyzaguirre, co-head of investment banking Chile, Argentina and Peru for JPMorgan in Santiago, says: "Chilean companies will expand with certain competitive advantage. They are already big, they have strong domestic capital markets and they have a low cost of capital compared with the rest of

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Latin America. The advantage isn't as strong as it was in the 1990s, when Chile was the only investment-grade country, but in periods such as this, the more stable countries regain that competitive advantage, so we do foresee Chilean companies going abroad."

Juan Ignacio Langlois, co-head alongside Eyzaguirre, also notes that in recent years, as Chile's leading companies have become large for their relatively small domestic market, anti-trust has become another driver of cross-border acquisitions by Chilean companies. "Anti-trust has become very complex in Chile," says Langlois. "We went from having no anti-trust to now, when nearly every transaction needs to go through the consultation process, which of course adds lots of uncertainty."

David Jana, head of BAML's southern cone countries (including Chile, Uruguay and Argentina) agrees. "In the last six months, I have had many discussions with clients who are looking a lot more aggressively at targets in the region and the US, and even into Latin Europe," he says. "Acquirers will fund themselves here in Chile, or refinance the debt of the acquired company at much lower costs with Chilean vehicles."

International confidence

Larrain points to the March acquisition of US wine producer Brown-Forman's Fetzer Vineyards by Chilean Concha y Toro as proof that Chilean companies are increasingly confident on the international stage. "I would love to see the Chilean companies expanding and developing their competitive advantages and

using them locally, not only in Chile but also regionally and abroad," he says. "The Chilean company that bought the US winery is a good example of what comes from having a solid macro-economic management and this company having a unique fiscal position." The government's support goes beyond creating a fertile economic environment. In October, Codelco, which is 100% publicly owned, announced it had received the government's support to exercise the option to buy 49% of Anglo American Sur.

"We worked with Codelco to analyse the deal," says Larrain. "It is going to obtain up to \$6.75 billion of financing to exercise the option, which includes important mines with huge reserves of copper." He adds that it was critical the decision did not impact Codelco's previously announced \$17 billion capex programme. The decision has reportedly frustrated Anglo American, which has tried to buy the option from Codelco at least twice in recent years and now faces a write-down in the reserves of one of its most prized mines.

Investment bankers are hoping for large M&A volumes to bolster thin fees from DCM, and even thinner fees on equity transactions. M&A still pays well, according to most Santiago-based bankers who talked to *Euromoney*, although most of the serial acquisitive companies, such as Codelco and Cencosud, have internal M&A expertise and have either completed cross-border acquisitions without investment bank advisers, or brought them in near the end of the deal to minimize fee levels.

But compared with equity transactions, at least, M&A can still

France's former finance
and economy minister
Christine Lagarde and
Chile's finance minister
Felipe Larraín in Paris



be lucrative for international firms. Local investment banks such as Bice, IM Trust and even Banchile have dominated the equity capital market in Chile in recent years, and investment banking fees are very low, typically less than 1% for IPOs. With the typical deal being sold entirely to local institutions, and dominated by the relatively few pension funds, distribution has hardly been onerous. Local domestic equity transactions require no traditional underwriting service; no capital and no stabilization expertise are required. Also, little detail is required in disclosure and so international bankers imply that at least the low fees can arguably be said to be linked to effort required.

There are hopes, however, among the international banks that things could be changing. The growing size in the average deal is in line with the growth in Chilean companies. More deals are breaking the \$300 million to \$350 million barrier at which international bankers argue they can demonstrate their value-add. By introducing international demand, they argue, they introduce competition into a pricing process that can otherwise be dictated by the large pension funds.

JPMorgan was involved in two transactions in the past year, E-CL and Recalcine. The former's size of \$1 billion clearly provided a role for an international bank marketing the transaction to offshore investors. With the latter, Monge says JPMorgan managed to show the issuer that "they would gain price advantage by having more pools of liquidity competing for the same offering".

JPMorgan is also close to launching a local brokerage. The idea isn't to compete on purely domestic transactions but to offer key clients or strategic targets the ability to execute locally if that provides either business directly (such as equity and FX derivatives trades) or for client relationship management purposes.

BAML bought a local equity brokerage in 2008 (Ureta y Bianchi) to round out its ability to offer clients fixed income, currency and commodities trading capability. "We have positioned the firm as full service for our clients on the international side by having this local capability," says BAML's Jana.

BAML, Deutsche and JPMorgan – and Citi through Banchile – are the only international banks with operations in Chile. Others reported to *Euromoney* that entry would be difficult given the market practice of a very low level of fees. One said he had hopes that BTG Pactual's acquisition of local firm Celfin Capital would lead to increased pressure on the locals to charge higher margins for local business but this might be optimistic.

Execution strengthened

Since January 2010, there have been 25 equity capital market transactions worth approximately \$6.5 billion. None had an ADR portion and the majority weren't 144a transactions. Only nine of these deals broke through the \$300 million floor for international bank relevance and of these, three were for the Chilean development bank, including the recent sale of state shares in water companies Essbio and Esvial.

One banker, who works for an international bank that has offshore coverage for Chile, says he received the RFP with a fixed maximum spread at which the bank could quote, and he believes that many banks didn't bother to respond. *Euromoney* was told the final fee was between 20 and 30bp. Lead manager BAML declined to comment on the fee, just saying the sale was a success, with international interest from dividend yield funds attracting demand that strengthened both execution and post-deal performance.

Fees for DCM are reportedly more in line with international

norms ("at least Latin American norms," says one banker) but total fees for investment banking services proves a dilemma – there is a lot of interest in Chile as a growing and strong market, but its very strength and maturity mean that charging profitable margins is difficult.

The fierce competition for the investment banking and corporate business of the top 1,000 Chilean companies has led Santander to change its strategy. It sees no future in pursuing this elite sector and so is instead targeting the next tier. Raimundo Monge, director of corporate strategy for Santander in Chile, explains: "Our vision is to take our focus away from the larger companies and go into the second tier with more or less the same product."

Santander is also seeking to broaden its non-credit services, such as cash management and treasury services, where margins are wider. "Today, credit spreads are even lower than in the beginning of the downturn, so that's why we have moved more into the non-lending products," says Santander's Monge. "We have been selling simple derivatives or forward products for companies with currency mismatches. We have very strong links with these companies through our corporate bankers and we can offer them more sophisticated products."

Larrain's desire to promote Chile as a financial markets centre is

Record-breaking Chile

Larrain takes pride in overseeing the sovereign's latest international bond. The timing was particularly impressive, coming as it did in early September amid choppy global markets, volatile on the back of bad news from the US and, worse, uncertainty from Europe.

Larrain says Chile had made commitments to investors during the roadshows for the previous year's transaction that the country would return this year to support that transaction by adding extra liquidity. The SEC filing from the earlier deal had been for \$3 billion, and with \$1.52 billion issued in 2010, Chile could assess the development on the bond markets without attracting attention with a new filing.

"We didn't need to issue but we had made a commitment to issuers last time who had been critical that Chile had been a one-shot-deal," says Larrain. "We could place at any time, and the work we needed to do was much smaller [than the previous year]. So we did this in complete confidentiality. We didn't want it to be known [that we were coming to the market] because we wanted to decide the right moment. We took the decision on a Monday [September 5] and we placed on the Wednesday [September 7]."

Being an academic, Larrain was aware of the history of the country's international bond transactions, which date back to 1822 when the newly independent republic (Chile won independence from the King of Spain in 1818) placed a deal with a yield of 10%. "We broke our own record," he says. "We got 3.35% all-in financing compared with 3.89% last year and we were told by our advisers [the deal was managed by Deutsche

also permeating this second tier of companies. "We just approved a new tax rule in congress which encourages smaller companies to take derivatives coverage for hedging," he says. In future, companies can offset the cost of options against tax. In the last month, Larrain says 600 new companies began to trade derivatives, with more banks entering, and there are now six banks trading in options. Larrain says: "We try to make it more popular. We have made it less expensive to manage identified risks."

But what about risks to Chile? In the 2008 crisis, the central bank cut interest rates to 0.5% and it was the only Latin American country to conduct quantitative easing. Does Larrain think such measures could be possible again?

"We don't foresee the same kind of shock as in 2008/09," he says. "We believe this will be significantly milder. The recent estimates by the World Bank and the IMF say deceleration but not recession. Our budget is not being done for recession, but we have the contingency plan. We gave room for monetary and fiscal stimulus. There are countries that cannot do either – they are running deficits in the area of 10% of GDP and have public debt to GDP ratios of 90% to 100% or more, and then interest rates are rock bottom." But he adds, without discernible pleasure: "Then you have very little room to expand. And we have room on both fronts." **EM**

Bank and HSBC] that it is the lowest rate that any Latin America issuer has ever achieved. We were very pleased that we could place \$1 billion in a transaction which was more than two times oversubscribed in a very complicated market, a market that was looking at possible recession in Europe and was shying away from risk. Our bet was that the markets would differentiate – that we had a very strong position."

Despite the overall yield being lower than the 2010, the spread over treasuries increased from 90 basis points to 130bp, while at the same time Chile's credit strength arguably increased and the US suffered its rating downgrade. Does Larrain feel this increase in spread is justified? "There has been an increase in the sovereign spreads for many countries," he says. "Of course, you would like to push the premium down but ultimately the all-in is what matters. If I place when treasuries are at 3% and I get 3.9% like last year, and then this year I place when the treasuries are slightly over 2% but the premium has increased and we place at 3.35%, what do I prefer? The 3.35% rather than the 3.89%."

As well as following through on the commitment it made during the 2010 roadshows to return to the market this year, Chile returned to establish a new benchmark for other Chilean issuers. The sovereign also earmarked the proceeds as insurance against the possibility that the global slowdown turns into renewed recession. "It is part of the contingency plan we have been working on for the past four months in case we face a more complicated international scenario," says Larrain.

He has not made any further commitment to return to the international debt markets next year but says he is considering another transaction in 2012, and while another 10-year bond is most likely, he hasn't ruled out five- or even 25-year transactions to establish new benchmarks for other Chilean issuers.