IFR

INTERNATIONAL FINANCING REVIEW ROUNDTABLE

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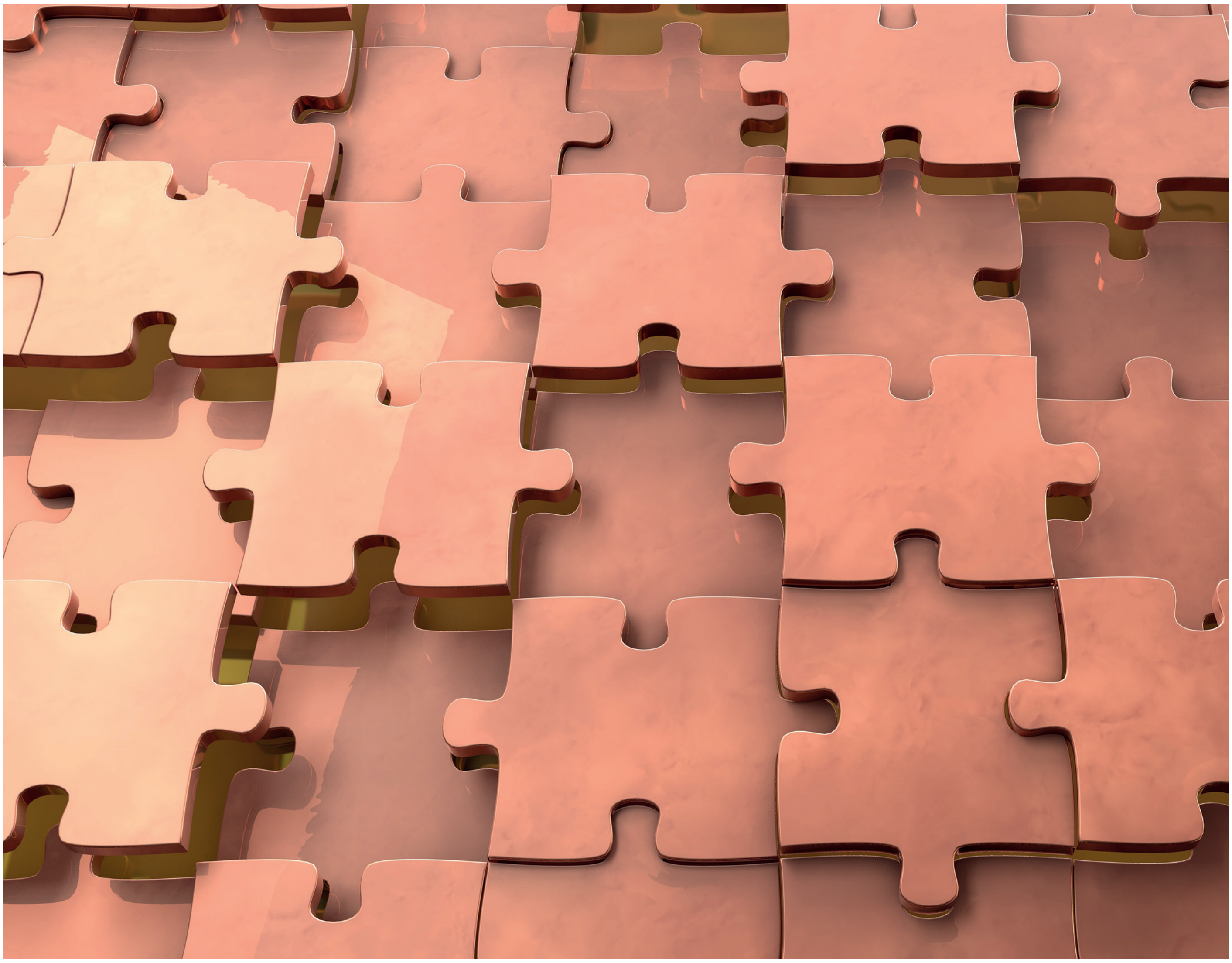

LATAM INVESTOR SERIES: CHILE

FOREWORD

The IFR Chile Capital Markets Roundtable took place on May 16, a month after the latest wave of Covid took hold in the younger community and the week following the weekend election of members to a constituent assembly charged with writing a new constitution. The results of the election were surprising to financial markets and to the panel themselves. Support for the ruling coalition collapsed, while voters returned a significant proportion of independents sitting on the left of the political spectrum. In the last two years, Chile has also come through the riots of 2019 and the first wave of the pandemic in 2020. The panel met to discuss how Chile fared through the turmoil of recent years and look at what's in store for the country as it, and the rest of the globe, begins to emerge from a Covid-induced slump into a newer economic, financial and social environment while keeping a wary eye on its own domestic political vagaries.

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Chair: Keith Mullin **Participants:** Stephen Guthrie, Carolina Mery, Eduardo Milligan, Andrés Pérez, Gianfranco Truffello, Robert Williams,
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Roundtable participants

CAROLINA MERY

AFP Habitat Chile

Carolina Mery is the chief investment officer of AFP Habitat, the largest private pension fund in Chile, with assets under management of more than US$55bn. She has worked at the company for the last 15 years and has more than 20 years of experience in the Chilean pension fund system. Prior to becoming CIO in 2018, Mery was head of international equity and developed a US$700m private equity programme for the firm.

GIANFRANCO TRUFFELLO

Celulosa Arauco y Constitución

Gianfranco Truffello has been chief financial officer of Celulosa Arauco y Constitución since 2005. The company is the biggest forestry, pulp and wood products company in Latin America and the second-largest global producer of market wood pulp and wood panels in terms of production capacity. Truffello is responsible for finance, treasury, accounting, taxes, procurement, IT, risk, and strategic planning for all the countries where the company operates. He has worked for Arauco for 27 years, which included three years at CFO of Alto Paraná, Arauco's subsidiary in Argentina from 1999 to 2002.

EDUARDO MILLIGAN

Engie Energía Chile

Eduardo Milligan has been chief financial officer and investor relations officer for Engie Chile since 2017. He is responsible for facilities management, procurement, digital and innovation. Milligan also sits on the boards of GNL Mejillones, a regasification terminal in the north of Chile; and electricity transmission company TEN. Before joining Engie Chile, he was CFO and head of human resources of Engie Peru, having joined the Engie group in 2008 in the M&A department for Latin America. He has more than 10 years of experience in the banking industry, working in Citigroup's corporate and investment banking division in Peru and Ecuador.

ANDRÉS PÉREZ

Republic of Chile

Andrés Pérez has been international finance coordinator at Chile's Ministry of Finance since 2018. He supervises the Public Debt Office and the Sovereign Funds Unit, develops sustainable finance, and is responsible for managing the relationship with international financial institutions. He has represented Chile at the G20 as finance track deputy. Pérez previously worked at the Central Bank of Chile, the World Bank, the New York Federal Reserve, and in the private sector, and has been a professor at the Institute of Economics of the Pontificia Universidad Católica de Chile and at the Faculty of Economics and Business of the University of Chile.

STEPHEN GUTHRIE

Scotiabank

Stephen Guthrie is SVP for international corporate and commercial banking at Scotiabank, responsible for defining and implementing the strategic direction and execution of key initiatives. Previously, he was SVP and head of wholesale bankiing in Chile, leading the growth strategy in corporate, commercial and real estate banking, global transaction banking, corporate finance, capital markets and brokerage. He has more than 27 years of banking experience, the last 20 with Scotiabank in senior roles in several geographies, including responsibility for corporate and commercial banking in Central America.

KEITH MULLIN

KM Capital Markets (moderator)

Keith Mullin is founder and director of KM Capital Markets, a media and thought leadership consultancy, and adviser for banking, investment banking, global capital markets, social and sustainable finance, financial regulation, and related topics. Before setting up KM Capital Markets in 2018, Mullin spent more than 30 years in specialist banking media and media-related fields, latterly in thought leadership in the capital markets insights group of Thomson Reuters, now Refinitiv. He was previously editor-in-chief of the company's capital markets publishing group, which includes IFR.

ROBERT WILLIAMS

Scotiabank

Robert Williams is CEO of Scotiabank Costa Rica and senior vice president for Central America, with oversight for operations in the region and the implementation of key initiatives in support of the growth strategy. Before his appointment, Williams was SVP for international corporate and commercial banking for Latin America and the Caribbean, a position he had held since 2018. He joined Scotiabank in El Salvador in 1999 and has held senior positions in risk management and corporate and commercial banking. In 2011, he was appointed country head of Scotiabank Panama and was promoted in 2015 to SVP and country head of Scotiabank Dominican Republic.

"The authorities did a very good job with the different plans that were implemented"

ECONOMIC REVIEW

Even before the first case of Covid was recorded, at the beginning of March 2020, Chile's economy had been disrupted by an idiosyncratic shock: Chile's worst political unrest in decades. The violent protests, which began during the last quarter of 2019, provided the context against which discussions about the economy were set.

"Chile's response to the pandemic was proactive and multi-faceted," said Andrés Pérez, international finance coordinator at Chile's Ministry of Finance.

The government moved to defend the country's physical, economic and financial well-being with a stimulus package that saw the healthcare system's budget increase, measures implemented to protect workers against loss of income, and the introduction of tax measures to support small and medium-sized enterprises (SMEs). The Ministry of Finance, the central bank, and financial regulators, combined to ensure the flow of credit to companies and consumers. The central bank reduced interest rates and increased its bond purchase programme, while structural changes were initiated to foster greater growth, mainly by enhancing competition.

Those measures have made a positive impact, with Scotiabank projecting a strong recovery for the economy in 2021 of 7.5%.

"We see a strong rebound in consumption and investment, fuelled by a benign interest rate environment, the strong price of copper, and a continued accommodative monetary policy and stimulus in terms of fiscal policy," said Stephen Guthrie, senior vice president and head of wholesale banking at Scotiabank Chile.

That said, unemployment is running at relatively high levels of more than 10%, so there is still quite a way to go before employment returns to pre-crisis levels. "And demand for commercial credit is very weak, especially in the corporate and higher-end segments of the market," said Guthrie. Where there is growth, it is in the sector falling under the government's guarantee programme.

Demand for consumer credit is also weak, which is put down to the amount of liquidity in the market. Consumer liquidity is a function, once again, of government support programmes, as well as the controversial government-sanctioned three rounds of withdrawals from pension funds.

Mortgages are recovering but, overall, demand for loan assets remains relatively subdued.

The experience of the corporate world can be split into two periods: 2020 and 2021. Electricity demand from regulated clients – residential customers and small businesses – declined. This drop in demand was tempered by stable consumption levels from large industrial and mining companies, something that was not only positive for revenues in the energy industry but an indication of better times for the overall economy.

"The authorities did a very good job with the different plans that were implemented," said Eduardo Milligan, CFO of Engie Energia Chile, the power utility and locally listed unit of Engie Group. "Not all countries in our region were able to mitigate the impact on economic activity due to the crisis in this way."

Weaker levels of energy consumption in the first half of the year reflected the slowdown in the domestic economy, but sectors reliant on international trade also had to contend with a global economic slump. They experienced huge swings in demand for their products.

Celulosa Arauco y Constitución, Latin America's largest forestry, pulp and wood products company and the second largest global producer of all pulp, wood pulp, and wood panels, is a good example of the volatility faced by companies reliant on the global economy. It sells 85% of its output on the international market.

"The trend last year was very difficult," said the company's CFO, Gianfranco Truffello. "Demand for our wood products collapsed at the start of the pandemic and we had around two months where we were operating at 50% capacity in the wood product division."

That situation turned around once the world began to emerge from the first wave of Covid.

"Very quickly, starting in July, demand rebounded very aggressively. We are now selling at record levels, full production, record prices," he said.

The recovery points to some key changes in the construction sector, where a sudden rush to affect home improvements has led to strains in the supply chain for timber. In addition, the success of the vaccination programme and the rise of e-commerce – and its need for packaging, has resulted in record prices for pulp.

"Right now, we are in very good shape in terms of prices and demand," said Truffello.

The international focus of other parts of Chile's economy also benefited from the post-first-wave global rally, with industrial mining output rising in response to a surge in demand (and prices) for copper.

Electricity consumption increased as mining output grew and that trend is likely to continue. In May, even with several regions under quarantine, Engie Energia Chile realised a 7% growth in electricity generation compared with 2020, while in 2020 production decreased, but only by 3%.

THE FINANCIAL MARKET

Chile is a very open economy, given its reliance on international trade and revenues, so the path taken by its financial markets is largely determined by global events. The local political situation and implementation of policy issues, such as the pension draw-downs, has created an overlay of domestic volatility, however. It will continue to do so.

The panel is keeping a close eye on the direction of interest rates in the US for an indication of what to expect in Chile. US rates have been trending higher in tandem with a stronger economy and a jump in inflation although long-term yields remain at historically low levels.

Despite recent statistics, inflation is not yet seen as an issue. Carolina Mery, CIO of AFP Habitat, the country's largest private pension fund, said the uptick in interest rates indicated improved economic activity rather than being a harbinger of rampant price rises. Truffello agreed with Mery, pointing to short-term supply constraints as being partly responsible for current price pressures.

"We see a strong rebound in consumption and investment"

He outlined the scene: the international economic outlook has become more positive, masks are starting to come off in the US, people are returning to restaurants and demand for consumer goods is increasing – good news for the paper industry.

"We look at the rest of the world and it looks like summer is coming. Everything is more positive," said Truffello.

The picture is not so rosy on the domestic front. "When we look at Chile, then it's more like winter is coming," he said. "We are more negative because of the election at the weekend."

The market spiked immediately after the election results but, notwithstanding the short-term election-related volatility, term interest rates remain low from a historical perspective. Guthrie said that US rates began to move higher in mid-December, with emerging markets – including Chile – following suit after a lag. "Rates in Chile, both inflation-adjusted as well as normal rates, began rising mid-February by 1% to 1.25% across the curve, reached a period of stability around mid-April and then started to come down again."

DEBT CAPITAL MARKETS

Guthrie highlighted very healthy local, as well as international, debt capital market activity in 2020, despite Covid.

"Supply in the local market is typically around US$5bn per year," he said. "That is what we saw last year and this year it is running about US$1.5bn year-to-date. The international market is around US$15bn, and we are seeing reasonable year-to-date levels as well."

The message is that Chilean issuers, in general, remain very attractive to national investors and its largest issuers remain attractive to a broad range of investors. They can tap the local market, the international market, even the bank market, which is open to corporate credit.

The positive borrowing environment of the last few years has been good news for Milligan, since Engie has committed to investing US$2bn in renewable power plants between 2020 and 2025.

"Fortunately for us, we concluded a liability management exercise in January 2020, just before the crisis started, which gave us enough liquidity to get through the year," he said. Engie also sold accounts receivables to an SPV, with the SPV issuing a corporate bond in the international markets, and it also found a way to mechanism to monetise the reduction of CO_2 emissions (the US$125m financial package from IDB Invest was a world first).

"We have been busy," said Milligan. "The capital market and the bank market has been there to support us, and we see several possibilities to continue financing our capex programme for the next years."

At a governmental level, Chile found itself requiring significantly larger-than-expected funding to get it through the Covid shock. But Chile had additional pressure on its financing activities due to the social unrest of 2019.

To compensate for the anticipated reduction in revenues associated with a contraction in economic activity and the tax measures taken to enhance household and corporate liquidity, the government turned to a combination of debt and the use of pension fund assets.

Chile's financing strategy was determined by a checklist, said Perez: ensuring competitive terms for the sovereign while generating market benchmarks; further diversifying the investor base through the issuance of thematic bonds, such as green, social and sustainable; and issuing dollar-denominated bonds.

There has also been greater emphasis on flexibility and transparency on the debt management strategy, he said, such as adjusting the issuance calendar, for example, to accommodate unexpected changes in financial conditions, at home and abroad.

The government's financing needs for this year are expected to be somewhere in the order of US$24bn, of which a little under 50% has already been raised. That may change, of course, depending on the evolution of the pandemic.

BANKING

The panel's bond market experiences may have been relatively benign, but the debt market has not been open to all firms. They have relied on the banking sector.

"Within international corporate and commercial banking, we were managing a book of somewhere in the range of about US$78bn entering the pandemic," said Robert Williams, senior vice president, international corporate and commercial banking, Latin America and Caribbean, at Scotiabank. "During the first two quarters of the pandemic, the book went from US$78bn to about US$88bn; it jumped up very quickly with corporate and commercial customers seeking liquidity as they had very little visibility as to what was coming up during the pandemic."

> "We will be watching the issue of pension reform very carefully"

The book has now gone back down to somewhere in the range of about US$79bn–$80bn. "Companies are getting back to normal operating conditions, in some cases generating more revenue, reducing debt, and also accessing capital markets," said Williams.

In Chile it has been a similar story: Scotiabank's book went from around US$18.7bn to about US$20.6bn, and now it is back to US$19.6bn.

Within that dynamic, prices behaved as expected; margins went up significantly in Q2 and Q3, but then returned to levels seen prior to the pandemic.

"We are back to relative normality," said Williams. "In the case of Chile, good policies, better copper prices, and just a better overall economic dynamic suggest this level of normality will prevail."

"We have now had three draw-downs of the pension fund"

PENSION FUNDS

For those living in and dealing with Chile, the government's actions around pension fund draw-downs, releasing savers' money to facilitate household liquidity, has been a major topic of discussion and some controversy.

"We have now had three draw-downs of the pension fund," said Mery. "The third was a surprise."

Draw-downs come with implications for the operation of pension funds and for the market, although the central bank moved to reduce the impact on the market by permitting the use of repos as a measure to facilitate demand for liquidity. But the simple act of fulfilling the draw-down obligations has implications for the portfolio mix, since it is easier to realise cash from more liquid international investments.

The draw-downs and the need for liquidity comes with long-term problems for pensions in terms of asset allocation, returns and management. There is wider significance for the capital markets and the economy in general.

"We can't underestimate the importance of the pension funds, not only to the long-term savings for the populace but, also, in terms of providing the backbone support for the capital markets," said Guthrie.

Pension funds provide long-term investment for infrastructure projects, they fund mortgage portfolios at commercial banks with fixed-rate funding, provide liquidity in the derivatives market, and together with insurance companies and mutual funds, they are major players in the capital markets, particularly at the long end of the market. If the depth of domestic demand deteriorates then it will affect companies that are unable to access international capital flows.

"We will be watching the issue of pension reform very carefully," said Guthrie. "We are supportive of today's private system, but even if we have to move towards a mixed system, as long as it provides stability for individuals and stability for the capital markets, then we will support that as well."

CONSTITUTIONAL CONVENTION ELECTIONS

The other major domestic talking point was the constitutional convention election of early May and how the assembly's confirmation would translate into the drafting of the constitution.

Uncertainty stems from the emergence of a large independent group, forming 48 of the seats or 31% of the constituents, and how that group will work with the other constituents from the left and the centre of the traditional parties in forming the constitution. The stakes are high.

On the agenda are issues like control of natural resources, healthcare, education, pension reform, basic salaries and minority issues. What is not likely to be on the table, according to the panel, is the independence of the central bank and free trade agreements.

The panel said a significant proportion of independents are moderate and hopes were high that they can work together to reach a deal that is beneficial for all Chileans.

And then there is a presidential election in November. It is safe to say that that capital markets are going to be affected.

THE ESG AGENDA

ESG is an increasingly important topic for the government and every sector of industry.

There has been important progress on the ESG front in the public sector, according to Perez. The government and the Ministry of Finance has led the way with sovereign issuance, with green bonds since 2019, social bonds since 2020, and sustainable bonds this year.

"We have added credibility to these products," said Perez. "Raising a total of US$16.2bn in thematic bonds, roughly 16.6% of our total bond issuance, places us among the highest ESG issuers in the world."

Other institutions are also driving the financial transition. The Financial Market Commission and the pension fund regulator are working on several initiatives that incorporate climate action as part of their regulatory and supervisory approach.

"We also embarked on an important strategy in terms of developing the potential for green hydrogen, which will further bolster our progress in terms of the decarbonisation of our energy mix," said Perez.

In the power sector, Engie has been working closely with the government to accelerate the energy transition and reduce emissions. In 2019, it signed a voluntary agreement with the government to stop the development of coal power plants and committed to start a gradual decarbonisation of the energy matrix.

Two years later the power industry has committed to the closure of almost half of the coal power plants in the country by 2025. That is hugely significant for a country that relies on around 35%–40% of its electricity production from coal.

"We are very optimistic for the future of this country"

"Our CEO announced, together with the ministries of energy and the environment, that Engie will fully exit coal in Chile by 2025," said Milligan. "We will be converting our three remaining coal units to biomass and natural gas, and at the same time we will build an additional 1GW of renewable power plants for a total investment of US$1bn."

"We have been committed to the sustainability of our operations for years," said Truffello. "We are essentially a sustainable industry, and we are very proud of being the first forestry company in the world to be certified as carbon-neutral."

The panel said that the environment will be higher up the agenda after the pandemic as people feel more vulnerable, and they care about the long-term sustainability of the planet.

OUTLOOK

On the whole, the panel were positive about the future.

Williams said Chile had been very successful in managing the Covid crisis, not only from a government perspective but also from the

"Chile has strong institutions built on several decades of growth and high-level policymaking"

prudent way corporations managed their capital structures.

He also said that vaccinations are going well, so all those things are very positive.

The key determinant for Chile's financial future, however, is likely to stem from the negotiations on reform.

Most were optimistic that there are enough moderates within the assembly to ensure stability in Chile, and that will ensure it remains the reference point for its Latin American peers.

Mery expects a strong recovery following Covid but said that political issues will lead to volatility. She was more guarded in her enthusiasm for the reform process, hoping that the pension fund reform is not too aggressive, for the sake of savers, the population and for the market.

Truffello recognised the significance of a process that determines the future prospects of the country over the next 30 years.

"We have more than 80% of our assets in Chile, we have good grounds for the future for investment in Chile, and I hope that these guys can talk sense," he said.

Milligan said that the past 15 months had been challenging but he was positive for the immediate outlook. "We believe that the economic recovery will have a positive impact on electricity consumption while the current copper price can further bolster the recovery and is a positive factor for overall economic activity."

He stressed the importance of a strong and stable regulatory framework to promote the long-term investment needed to reach climate targets.

"Transition is under way and will require important investments in renewables, in storage and also in electricity and transmission lines," he said.

Perez was more cautious, reminding everyone that the country is still in the middle of a pandemic, and that there is still uncertainty regarding the effectiveness of vaccines to variants but noted that the government will continue to support households and firms with flexibility and within the realm of fiscal responsibility.

Even within the context of global uncertainty and concerns over reforms, Perez said Chile is well placed to benefit from a return to normality after the pandemic.

"Chile has strong institutions built on several decades of growth and high-level policymaking. Regardless of the unexpected outcome of the elections last weekend, the constitutional process takes place within an institutional framework that was set out to allow for this process to take place," he said. "And Chile is a small, open, financially integrated economy that will continue to be supported by the rapid turnaround in global growth lying ahead."

Guthrie agreed. "We continue to be very optimistic for the future. Chile has dealt admirably with the pandemic, is well positioned from a fiscal perspective to weather the remainder of the storm, and our confidence is exemplified by Scotia's recent additional 7% investment in the bank. We are very optimistic for the future of this country, and we are here for the long haul," he said. ●