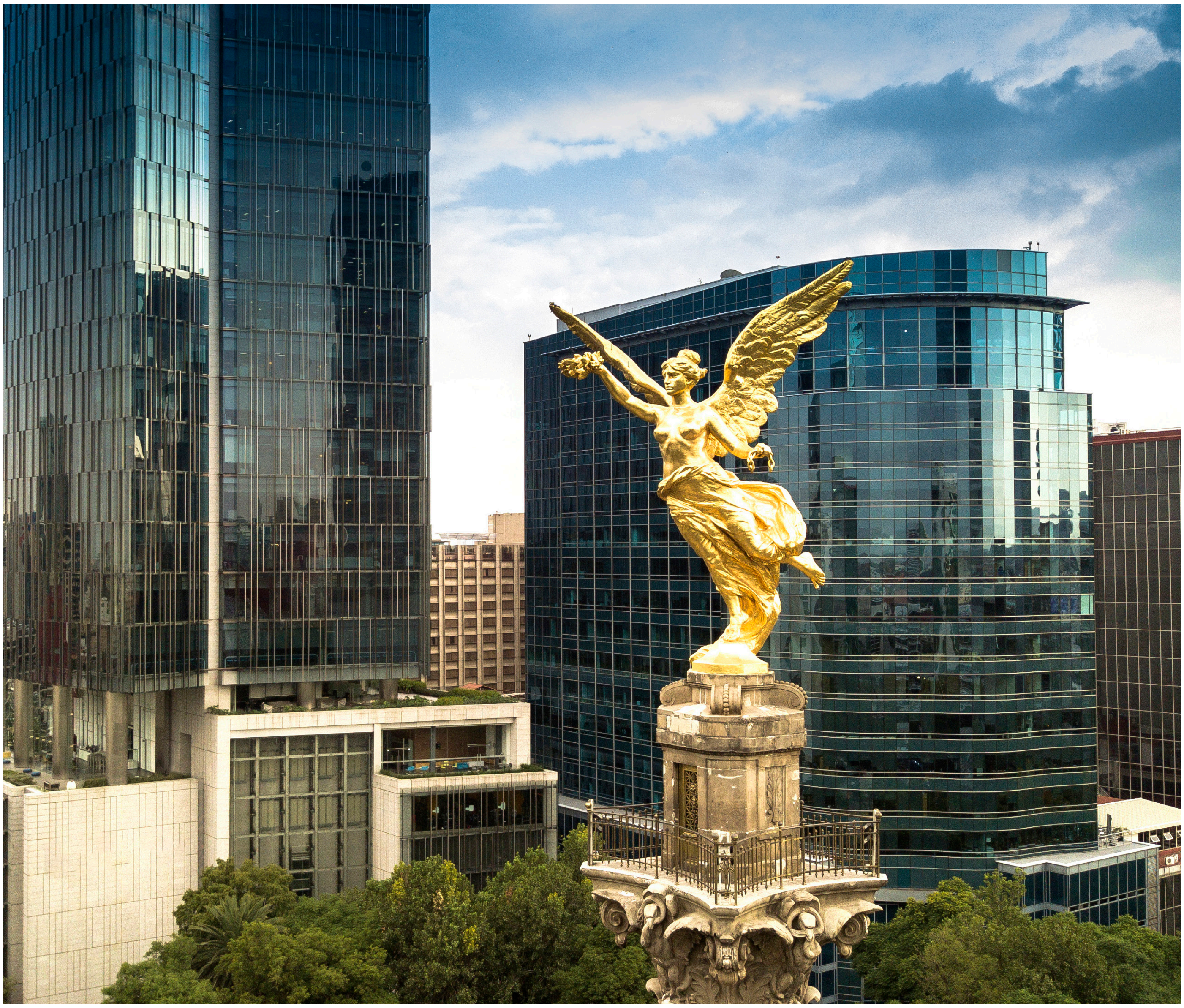
IFR

INTERNATIONAL FINANCING REVIEW

MARCH 2023

www.ifre.com

In partnership with: Scotiabank GLOBAL BANKING AND MARKETS



IFR LATAM INVESTOR SERIES: MEXICO

Chair:
Keith Mullin

Participants:
María del Carmen Bonilla
Juan Fullaondo
Héctor Pérez

Head of production:
Clive George

IFR production manager:
Carole Styles

Senior production executive:
Gavin White

Global head – advertising & sponsorship sales:
Shahid Hamid
shahid.hamid@lseg.com

Advertising & sponsorship sales director:
Leonie Welss
leonie.welss@lseg.com

Client Services:
IFR.Clientsupport@lseg.com

Cover image:
Aerial view of Mexico City, Reforma Avenue © istockphoto.com

ISSN 0953 0223

Printed by Stephens and George Print Group

www.ifre.com

FOREWORD

Mexico is the latest topic of conversation in a series of LatAm investor webinars, hosted by IFR in association with Scotiabank. The webinar brought together a panel of capital market practitioners to discuss the challenges faced by investors in Mexico's sovereign and corporate sector, and the potential opportunities it may present in 2023, in the context of an uncertain global economic landscape.

The session reviewed the sector's performance over 2022 and touched on the emergence and growing importance of green and sustainable finance in the country. Joining the chair of the webinar, Keith Mullin of KM Capital Markets, were María del Carmen Bonilla, head of public debt and international affairs at the Mexican Ministry of Finance; Juan Fullaondo, head of Latin American DCM at Scotiabank; and Héctor Pérez, Scotiabank's Managing Director and Head, Global Banking and Markets.

The United Mexican States, the second largest economy in Latin America and one of the top 15 in the world, sits on the doorstep of the world's largest economy – the United States. Yet, despite its proximity to the global economic powerhouse to the north, Mexico's economy has been a relative underperformer over the past 30 years.

World Bank figures point to an economy that has grown, on average, by just 2% per year between 1980 and 2018, and one that fell by 8.2% in 2020 during the Covid-19 pandemic.

An economic recovery is underway, driven by its openness to trade and stability in its macroeconomic infrastructure.

Mexico's global trading position was enhanced in July 2020 when the United States-Mexico-Canada Agreement came into force. The country's importance to the North American supply chain has been reinforced by the breakdown in manufacturing and distribution channels in Ukraine, following the Russian invasion, and China, as a result of that country's zero-Covid policy and deteriorating political relations.

The clamour for outsourcing and offshoring has been replaced by onshoring and nearshoring as security of supply has risen in importance. Companies in Mexico's northern states are adapting to the new paradigm and responding to demand from customers across the border and into Canada.

Growth remains uneven between the north and south, however, and Mexico's 2022 budget looked to respond to the inequalities by instigating a series of major infrastructure projects. They stretch across the country and across different sectors, but increasing the standard of living and economic contribution of the population in the south is seen as one of the key drivers of sustainable economic expansion.

Investment requires capital and investors need stable financial markets. Despite the turmoil in international markets, rising inflation, and higher interest rates, Mexico's domestic capital markets continue to provide ample liquidity – either through bank lending or via bond markets. Buoyant foreign direct investment has also ensured the peso has outperformed Latin American rivals over the last year.

ESG considerations in Mexico, as elsewhere in the world, are becoming increasingly important and the government is investing in its green infrastructure to help meet its commitments to nationally determined contributions under the Paris Agreement on climate change. The government is also contributing to the country's sustainable finance sector by developing green curves and benchmarks against which corporates can better price their own funding exercises.

ROUNDTABLE PARTICIPANTS

María del Carmen Bonilla

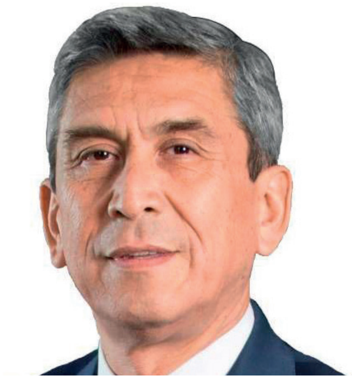
Head of public credit and international affairs
Ministry of Finance and Public Credit, Mexico

María del Carmen Bonilla is head of public credit and international affairs at Mexico's Ministry of Finance and Public Credit, in charge of managing the federal government's public debt portfolio and executing the annual borrowing plan for domestic and foreign markets. Bonilla has more than 16 years' experience in the financial sector. Between April 2019 and July 2020, she was investment manager at the Mexican Social Security Institute, which has Ps280bn in managed assets. She was previously a cash and derivatives trader at banks including HSBC and Santander.

Juan Fullaondo

Head of Latin America and Caribbean DCM
Scotiabank

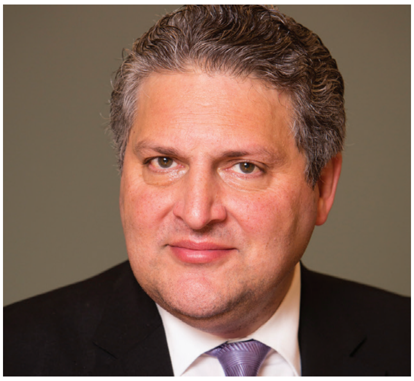
Juan Fullaondo is head of Latin American debt capital markets at Scotiabank, joining the firm in 2018. Before that, Fullaondo spent almost 14 years at HSBC, where he was latterly co-head of Latin American DCM, overseeing local and cross-border bond operations for Mexican and other Latin American issuers. He was also head of investment banking at Mexican broker IXE and started his career in Operadora de Bolsa Serfin's debt capital markets division.



Héctor Pérez

Managing Director and Head, Global Banking and Markets, Mexico, Scotiabank

Héctor Pérez is head of global banking and markets, Mexico, a position he has held since April 2015. Before that, he was vice president, wholesale banking at Scotiabank Chile, which he joined in 2001, managing a team of 190 professionals in corporate, commercial and real estate banking as well as product teams across global transaction banking, leasing and factoring. Before joining Scotiabank Chile, Pérez was the head of corporate and investment banking at a global financial sector organisation in Chile. He also spent four years at one of the major local banks.



Keith Mullin

Director and founder
KM Capital Markets (moderator)

Keith Mullin is founder and director of KM Capital Markets, a media and thought-leadership consultancy and adviser for banking, capital markets, 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 related fields, latterly in the thought-leadership group of 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.

IFR LATAM WEBINARS - MEXICO

Mexico has not been isolated from the macroeconomic and geopolitical shocks that have afflicted the global economy in 2022: war in Ukraine; tensions between the US and China; supply chain issues; higher energy prices; rising inflation; and the corresponding central bank response of increasing interest rates.

The IMF estimates that GDP in Mexico rose by 3.1% in 2022 but predicts that economic activity will only increase by 1.7% in 2023 and by 1.6% in 2024. Core inflation remained on an upward trend, reaching 8.51% in November and, in December 2022, Banco de Mexico's governing board raised the target for the overnight interbank interest rate by another by 50bp to 10.50%, the 13th increase in overnight rates from the 4% target in May 2021.

While global growth forecasts for 2023 continue to deteriorate, due in part to higher interest rates and the uncertain geopolitical environment, there are signs that energy prices are starting to fall and global inflationary pressures may be easing. Fears of a global recession persist but the conversation has changed as to whether any economic contraction is likely to be mild and short-lived or significant and long-term.

"We could be faced with a period of high interest rates around the world if the current inflation trajectory is slower than expected," said María del Carmen Bonilla, head of public debt and international affairs at the Mexican Ministry of Finance. "This could potentially push the global economy into a harsh recession. On the other hand, markets are currently pricing in a soft landing, and this would be really helpful in terms of growth and job creation."

In the case of Mexico, she pointed to a good end to the year for the economy and a sense that international investor confidence in the country is growing.

"Growth was better than expected," she said. "This is partly due to the new trends in 'nearshoring', but also some other initiatives undertaken by the federal government in terms of expenditure and, more specifically, investment in infrastructure projects that are helping to make the economy more resilient."

At the same time, foreign direct investment held up well and there were no significant outflows from local capital markets, with the results that: "All through 2022, we had a relatively stable FX rate," Bonilla said. In February 2022, it took Ps20.53 to buy one US dollar and in February 2023, the rate was Ps18.64 to the dollar.

Bonilla painted a largely optimistic picture for the Mexican economy's outlook and her view was supported by Scotiabank's Héctor Pérez. He sees a country that operates with investment-grade ratings from S&P and Moody's, has well-managed levels of foreign government debt, and respectable internal deficits.

Strength in Mexico's manufacturing sector, where a booming nearshoring phenomenon is the driving force behind the overall economy, is buoying his optimism.

"Supply chain issues faced by US and Canadian companies during Covid, and the US-China issues have resulted in many of them shifting their supply chains to Mexico. Under the trade agreement with the US and Canada, Mexican companies are just a few hours away by truck," said Pérez.

Tourists have also returned en masse to the country's Pacific and Caribbean shores, with hotels "registering record high occupancy rates", he said, and remittances from the US are at record levels.

SHARED OPTIMISM

With one of the most stable FX rates in the region and a relatively benign political calendar, Scotia's outlook for the Mexican economy in 2023 remains positive.

But is that optimism shared by bond investors and, if so, how is that reflected in the spreads they demand in return for taking exposure to Mexico at the sovereign level, its corporates and other issuers?

According to Scotia's Juan Fullaondo, investors see Mexico as a relative safe haven, with many of them said to be substantially overweight in their exposure to the country.

That has been good news for the international borrowing programme of the United Mexican States.

"There has been good appetite for hard currency Mexican assets over the last year," said Bonilla. She referenced the extent of demand that surfaced for Mexico's traditional visit to the international markets during the first week of the year.

"The response was really amazing," she said. "We had around US$18bn in demand for a proposed US$2.5bn–$3bn issue. At the end, we were able to place US$4bn in the market, accounting for around 75% of the foreign currency requirement of our annual borrowing plan."

In recent years, Mexico has been rebalancing the proportion of external debt to internal markets and strong international investor appetite for sovereign exposure in the domestic market has resulted in significant inflows. It has created conditions for a virtuous circle of investment and growth.

"We closed last year end with a positive balance in terms of inflows, and we also saw a bit of a rally in the exchange rate," said Bonilla. "As long as this scenario continues then it's potentially a soft landing for the economy. With growth and inflation under control, it will be good news for Mexico as an asset class."

Changes in the interactions with primary dealers have helped improve liquidity.

"We increased the size of the greenshoe at auctions, which allowed us to tap periods of liquidity between our regular weekly operations," she said. With the greenshoe option, market-makers have the option to buy up to 25% of every issue offered in the primary auction a day in advance at the same allocation price.

Liquidity is also enhanced by reducing the selection criteria for new participants, while the introduction of a switch tender mechanism whereby the ministry acquires outstanding debt in return for new issues, supplements its benchmark offerings.

The corporate sector has also been offering more bonds in local markets. Firms have been visiting the dollar market less frequently due to the rise in US interest rates and have been turning their attention to the domestic sector where pension funds, mutual funds and investment funds have exhibited strong demand. Corporates now have the option to refinance locally.

"Mexican corporates are very well positioned because of the strength of the local capital markets," said Fullaondo. "The total amount of debt issued offshore during 2022 was only US$54bn versus US$136bn we saw in 2021. That's a substantial decrease over the year – almost 60%. In fact, I think local capital markets saved the day for some countries in LatAm, especially Chile, Brazil, and Mexico." (Source: *Bond Radar EMD Pricing Archive research, 2021/2022*).

He pointed to the America Movil deal from December as evidence of the ability for Mexico's domestic markets to digest big deals.

"You wouldn't believe that on a single trade, you can pull almost a billion dollars in local currency. Not only that, the America Movil issue managed to price inside its dollar curve – and by a substantial amount," said Fullaondo.

Mexico's favourable capital markets position is credited to the success achieved by UMS in its debt market operations through the years.

"Banks are liquid and local markets are functioning to the point where you can print in size along the curve," said Fullaondo. "You also have access to international capital markets where the basis swap still works in favour of Mexican issuers and where it can still accommodate bigger sizes and longer tenors."

BOND BOOM

Bond market issuance is likely to increase through 2023 and 2024, the panel said, given expectations that market volatility is set to subside. Corporates will take that as a cue to term out debt from the short-dated bank loan market into longer maturities available with bonds.

It will make up for the paucity of issuance during 2022 when gyrations in the debt market resulted in corporates favouring the safety of the less-volatile bank lending sector rather than risk selling bonds.

"There was a huge amount of banking activity during 2022," said Fullaondo. "There are a lot of bridge loans taken out that will eventually convert into bonds, either on the international or on the local side."

Nevertheless, the bond market is still likely to face stiff competition for business from the banking sector, where lenders are willing to go longer out the curve on expectations that interest rates will start to fall.

"Most corporates are looking at two-year, three-year, or maybe even longer-term bridge loans," said Pérez. "Bridge loans are usually 12–18 months, but we are extending the tenors because interest rates are due to shift lower later this year or at the beginning of next year. So yes, bank financing has increased and there is a relatively strong corporate liability management pipeline."

It's almost the perfect scenario for many corporates, where balance sheets are described as "healthy". It explains why Scotia is positive about the sector.

"In general, we see a strong corporate sector in Mexico," said Pérez. "Companies are taking advantage of the opportunities in nearshoring and are even making strategic acquisitions in the US. We're very comfortable with the corporate sector, very comfortable."

RESILIENT INFRASTRUCTURE

Reference had been made earlier as to the importance of infrastructure spending to the Mexican growth story and in creating a resilient domestic economy. The panel took this theme up once again.

"Over the last 10 years or so, Mexico made some adjustments on the expenditure side to meet its fiscal objectives resulting in some significant reductions in infrastructure spending," Bonilla said. That trend has been reversed over the last couple of years, however, with a floor having been established for infrastructure spending at 3% of GDP. For 2023, that target is rising to around 3.7%, according to Bonilla.

"If you combine this strategy of greater investing in infrastructure with an increase in FDI and other sources, then this can create a positive multiplier effect on the economy," she said. "It strengthens the local economy, promotes local consumption, and helps build resilience in the face of some growing headwinds."

Infrastructure spending is not limited to one sector of the economy or one region, with major projects in development in the transport, sports and energy sectors. At COP27 in Egypt, Mexico made new green energy commitments that included plans for 30GW of new renewable capacity by 2030. The country intends to deploy wind, solar, geothermal, and hydro to meet its goals.

Power from the massive solar park, Plan Sonora, in Sonora state will soon come online. "This will help provide energy to the northern border states that are taking advantage of the nearshoring cycle we discussed earlier," said Bonilla.

While the majority of these major projects are carried out by the federal government and funded by the country's budget, the private sector is also playing its part, in some cases alongside state-owned companies such as Comision Federal de Electricidad, the country's dominant electricity company.

"We're seeing some key infrastructure projects being undertaken on the energy/gas pipeline side by the government and the private sector," said Pérez. "There are also some foreign private equity funds acquiring electricity generating assets in Mexico that, in the current environment, will likely be financed in the bank market, probably through mid-term bridge loans, before going to the bond market in the future."

GREEN FINANCE

Whenever the topic of infrastructure is raised, it is inevitably followed by a discussion on developments in sustainable finance and the importance of ESG in the domestic and global economy. Given net-zero ambitions and the need to build resilient and sustainable economies, ESG is a critical and vital topic. Its growing importance, however, needs to be set in the context of the current geopolitical climate, cost of living crisis and a government's imperative to raise living standards.

Bonilla said sustainable finance plays an important part in the country realising its nationally determined contributions as part of the Paris Agreement on climate change. At COP27, Mexico announced an increase in NDC ambitions to reach a 30% reduction in greenhouse gases by 2030. Developing a vibrant sustainable financial sector will be essential in funding those ambitions.

"We think it's important for the federal government to start building curves and in creating reference bond benchmarks for the private sector," said Bonilla. "We know that reaching greenhouse gas targets will need a lot of capex. The government cannot do it by itself – not even by using multilateral funding. Successfully greening the economy is an exercise that must be undertaken with the participation of all sectors of the economy."

As well as building out green government bond curves and establishing benchmarks from which the private sector can reference their own bond issues, Mexico also has plans to introduce a sustainable finance taxonomy to help with the transition to a lower-carbon economy. The taxonomy gives clear guidance on what is and what is not a sustainable investment, and that covers more than just energy.

"We have also been very focused on the social aspect of sustainable finance because we need to reduce income gaps between the north and south of the country," said Bonilla. "When you examine the use of proceeds of our latest issuances that focus on health and education, the filters in our framework help us to channel resources to places or municipalities that will make the greatest impact."

Reskilling/upskilling the workforce reinvigorates its contribution to the economy at the local level, leading to higher incomes, improved services and greater opportunities.

"Of course this is going to take time," she said. "And there will also be a focus on biodiversity, water projects, waste projects and other areas that will help in decreasing emissions. It's a huge task."

Realising all these objectives will see the sovereign increase the share of sustainable finance in its borrowing programme and promote its development in local markets. "That's why we issued bonds domestically last year. It gives the corporate sector, commercial banks, and national development banks a reference point for their fixed-rate sustainable finance issuance," said Bonilla.

Mexican corporates assign the same importance to ESG considerations as the UMS, and this is reflected in the share of ESG bonds issued as a percentage of the whole.

"What is very interesting is that almost 50% of the total amount of corporate issuance in 2022 was ESG-related," said Fullaondo. "That's a huge proportion."

Many corporates are building sustainable frameworks as a necessity. "Investors, ratings agencies – everyone in Mexico is demanding it," he said. "In general terms, corporates and the sovereign are willing and able to work through the process because, at the end of the day, it's in all our interests to do so."

To what extent all corporates can incorporate ESG and sustainability into their business models and corporate DNA is questionable. There is no doubt that it's a difficult process for smaller firms, but the journey must begin somewhere. In Mexico, as in the rest of the world, that process starts with the big multinationals and makes its way down to the larger mid-caps and then becomes more widespread.

"It's true to say that ESG is a priority in the large corporates, but it's becoming an increasingly important topic for local firms as well," said Pérez. Scotia has a specific director that works with local corporate clients to provide counselling and advice on the banking and DCM side to determine how to approach the subject of sustainability and ESG.

Adhering to sustainability frameworks may not result in a great saving in the cost of debt for corporates, but it does act as a signal to investors of a company's level of commitment and engagement to transition.

"Investors – and ourselves as a bank – would look more favourably on a company that has completely engaged on the topic," said Pérez.

FUTURE VIEWS

While there have clearly been some positive developments in the financial markets and global economy during 2022, as discussed by the panel, many of the issues that resulted in market volatility and uncertainty – geopolitics and inflation – remain in place. The session ended with an outlook for 2023.

"We might face less volatility this year and, consequently, a rebalancing of risk appetite," said Bonilla. "As an issuer, you will have to remain flexible and ready to react quickly to access any windows of liquidity that may appear. In that scenario, further development of local markets will be key, not only for the sovereign but also for the private corporate sector."

Fullaondo agreed with Bonilla's assessment of overall future trends in 2023 and was bullish about Mexico's borrowing potential.

"Mexico is extremely well positioned in respect of the banking industry, the local capital markets and internationally," he said. "Almost any of the frequent issuers of Mexico can tap into the market without a problem. It's just a question of if they're willing to do it or not."

Having the flexibility to pick and choose between the banking sector, and local and international capital markets, puts the UMS and Mexican corporates in an enviable position.