Allianz Global Investors

Attractive yields and historically low defaults: The Latin American infrastructure debt opportunity

Most investors have historically considered fixed-income investments in Latin America to be riskier than developed markets and, as a result, should reside outside of their core allocation to the asset class. That's understandable, especially given Argentina's B and Brazil's BB– credit ratings. However, we believe that some investments in the region can fit within a core fixed-income allocation, helping to boost returns at comparable levels of risk to similarly rated U.S. credits and comparable levels of default. In our view, that can be achieved by taking steps to manage market, currency and political risks.

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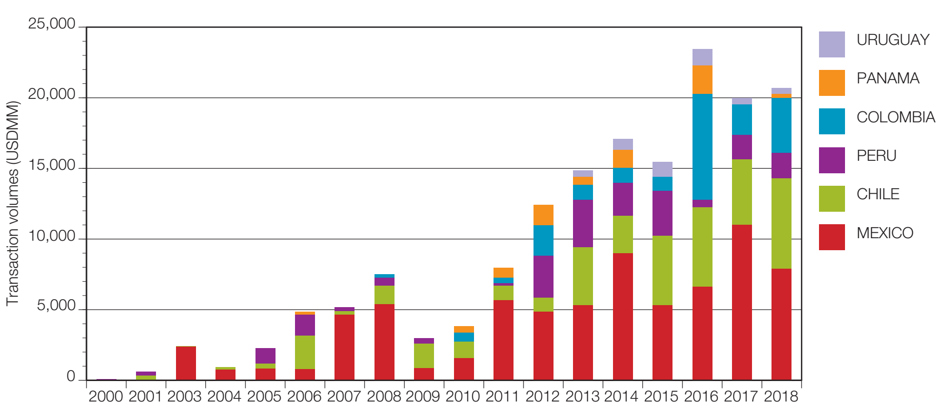
Considering LatAm infrastructure as a core allocation starts by managing market risk through focusing exclusively on the six countries in the region that have investment-grade credit ratings, namely Chile, Peru, Mexico, Colombia, Uruguay and Panama (Exhibit 1). These countries have all demonstrated a strong track record for developing their infrastructure with foreign capital. And, crucially, they all also will require significant inflows of foreign investment in the coming years.

Exhibit 1: Latin America's investment-grade countries have a BBB+ weighted-average credit rating

	Chile	Peru	Mexico	Colombia	Uruguay	Panama	Weighted average[4] / Total
Credit Rating[1]	A+	BBB+	BBB+	BBB	BBB	BBB	BBB+
2018 GDP growth[2]	4.0%	4.0%	2.0%	2.7%	2.0%	3.7%	2.9%
Population	18	31.9	127	48.2	3.4	4	232
Infrastructure Index[3]	4.8	3.8	4.3	3.8	4.7	4.9	4.2

As of March 18, 2019
Notes: [1]Credit ratings based on average long-term foreign currency ratings by S&P, Moody's or Fitch, where available; [2]Bloomberg Economic Forecast Function; [3]Infrastructure Index: Scale 1 to 7 (best), World Economic Forum's Global Competitiveness Index 2017–2018; [4]Weighted average based on infrastructure debt activity over the past five years to Dec. 31, 2018.
Sources: Allianz Global Investors, Bloomberg, World Economic Forum

Exhibit 2: The infrastructure market in Latin America's investment-grade nations is mature



As of March 18, 2019
Source: INFRAnews database

Risk can be further managed through choosing a mix of investments within these countries, across various sectors. Investors can also mitigate risk by focusing on the large economies of Chile, Peru and Mexico, with smaller allocations to Colombia, Uruguay and Panama. Current market conditions, we believe, favor investments tilted toward debt that supports critical infrastructure assets: electricity distribution and transmission; water pipelines and desalination systems; renewable energy; and transportation projects, such as airports and toll roads.

Recent data suggests that lenders are indeed becoming more comfortable with investing in Latin American infrastructure, as evidenced by the rising transaction volume of deals throughout the past decade, especially in Mexico, Chile, Peru and Colombia (Exhibit 2).

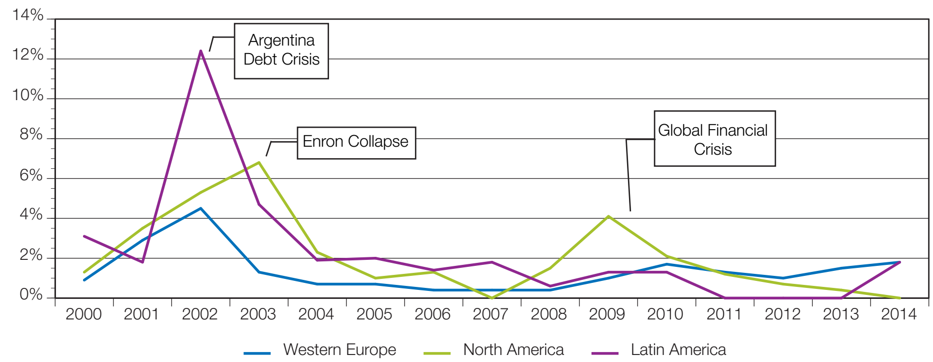
While the vast majority of infrastructure financing is facilitated via bank loans, borrowers that seek out infrastructure bonds gain one natural benefit: Bonds can offer long-term debt without refinancing risk, something that is difficult to procure from a bank loan.

Higher yields than comparable U.S. deals

How can Latin American infrastructure deals achieve comparable quality to deals made in countries with superior sovereign ratings, such as the United States and Western European nations? That's achieved through having stronger underlying transactions, typically achieved through more conservative terms and greater government support. While every deal is unique, we believe investors can typically achieve a gain of between 75 basis points and 100 basis points of additional yield compared with similarly rated U.S. public corporate debt.

Exhibit 3: Infrastructure defaults in Latin America were comparable to North America

Annual default rates in project finance loans by region[1]



Default and recovery rates for project finance loans by region

Region	Avg. Default rate[1] 2000–2014 (excl. 2002)		Average years to default[2]	Average ultimate recovery rate[2]	Average years to emergence[2]
Western Europe	1.37%	(1.14%)	4.7	79.50%	1.8
North America	2.10%	(1.87%)	3.9	77.40%	2.1
Latin America	2.27%	(1.55%)	3.2	83.10%	2.6

As of March 18, 2019
Note: [1]S&P Global Market Intelligence, "Annual Global Project Finance Default and Recovery Study, 1980–2014"; [2]Moody's Investors Service, "Default and Recovery Rates for Project Finance Bank Loans, 1983–2015," based on the Basel II definition of default
Source: Allianz Global Investors, S&P Global Market Intelligence, Moody's Investors Service

That yield pickup is not the only reason institutional investors are drawn to the Latin American infrastructure opportunity. These deals also have historically exhibited relatively low default rates, helped by the fact that these bonds tend to be senior-secured obligations in the capital structure, and the underlying businesses are typically regulated, monopolistic assets with contracted revenue streams.

The low default rate and high recovery rate on Latin American infrastructure deals are consistent with the risk profile investors expect from core infrastructure. That's illustrated in Exhibit 3, which shows that default and recovery rates on Latin American project finance loans were comparable to North America and Western Europe.

A strategic approach to diminishing currency and political risk

Whenever U.S. investors make allocations abroad, currency risk is a concern. However, that's not always the case with Latin American essential infrastructure projects, as several industries have U.S.-dollar cash flows and, therefore, prefer to borrow in dollars. That's especially true in the energy/power sectors, where the economics are tied to the marginal cost of electricity, which, in turn, is linked to the global price of fuel. However, in the transportation sector, there can be some currency risk: While some projects, such as airports, have U.S.-dollar cash flows, others, such as toll roads, do not. That underscores the need for careful asset selection.

Finally, concerns about political risk — something many investors feel is relatively high in Latin America — can be managed by only investing in the highest profile infrastructure projects (such as regulated companies and projects), where the winning bids are chosen through an open procurement process.

Additionally, a significant proportion of the investment opportunities in LatAm infrastructure fixed income is in renewable-energy projects, such as wind and solar power, or lower-carbon natural gas, making them good candidates from an environmental, social and governance (ESG) perspective.

Conclusion

Latin American infrastructure debt can produce a stable investment-grade portfolio with a risk profile similar to U.S. deals that would sit within a traditional core allocation, but designed to have significantly enhanced returns and relatively low defaults. And, by focusing on essential infrastructure projects in strategic countries in Latin America, investors can also minimize the typical concerns that are associated with investments in the region — market, currency and political risks — adding diversification to core fixed-income allocations, while also adding an ESG benefit to portfolios.

CORPORATE OVERVIEW

Allianz Global Investors, or AllianzGI, is one of the world's leading active investment managers. Employing more than 2,700 people across 25 locations, AllianzGI manages $577 billion in assets for individuals, families and institutions around the world, as of Dec. 31, 2018. AllianzGI offers its clients a wide range of actively managed strategies and solutions across the risk/return spectrum. With more than 700 investment professionals, the firm has established expertise in equities, fixed-income, multi-asset and alternative investments. Alongside an active approach to investment and active engagement with clients, the firm is an active steward of the assets it owns. It aims to incorporate environmental, social and governance (ESG) criteria throughout its entire investment value chain, providing tailored ESG and SRI processes with a broad range of approaches, adaptable to different levels of ESG incorporation and client preferences, enhancing clients' investment decisions while helping create benefits for society as a whole. AllianzGI has been a signatory to the United Nations Principles for Responsible Investment (UN PRI) since 2007.

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