Extra hot

Foreign investors' appetite for Latin bonds is putting pressure on spreads. But any market indigestion should be only temporary.

BY ALYSSA A. LAPPEN

It's early June at New York's Marriott Financial Center. An audience of 200 or so portfolio managers listens raptly as Scudder, Stevens & Clark's Lincoln Rathnam spins a beguiling story of the bonanza awaiting them south of the border. The head of his firm's Latin America and high-yield-bond group, Rathnam is no Latin fabulist, no Gabriel García Márquez of the markets. He's perfectly sincere when he tells the portfolio managers that the opportunities across the Rio Grande are of that rare kind that built the reputation, and the fortune, of Warren Buffett.

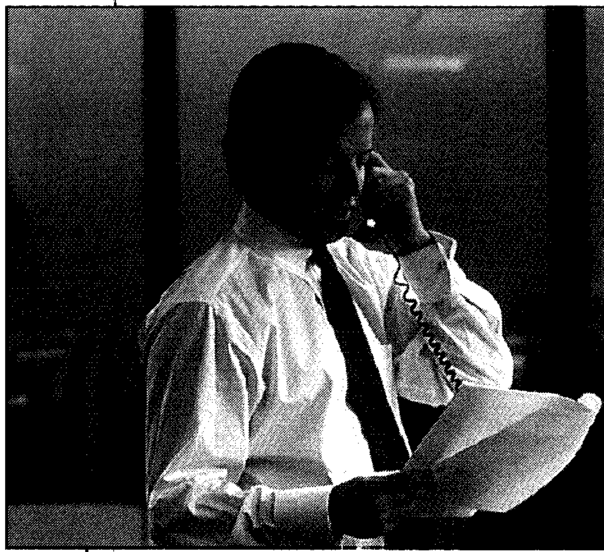
"The ten-year interest rate swaps of Venezuelan debt-conversion bonds paid 19 percent [earlier this year]," Rathnam says, his voice rising, "and in Brazil and Argentina, long-term rates of return can be locked in as well. You get a double whoopee, with high yields and narrowing credit spreads."

Assuming the status quo, adds Rathnam, yields in Argentina might stay at their current 10.8 percent for the next five years. Not bad. But, he excitedly continues, if Standard & Poor's Corp. goes ahead and upgrades Argentina's sovereign debt to BBB, and if rates on 30-year U.S. Treasuries decline to 5 percent, the effect could be to push total returns to Buffett-like levels of 30 percent.

Such a scenario is not terribly far-fetched, Rathnam insists. "We are already at a point where Mexico and Venezuela are better off than some investment-grade countries like Greece," he concludes. The applause is hearty.

Rathnam has not spent too much time in the equatorial sun. The savvy André Roberto Jakurski, who runs money for George Soros from Banco Pactual in Rio de Janeiro, is also an unbridled Latin debt enthusiast. "The debt market is benefiting from the realization that the paper was extremely underpriced and that the supply is more or less in strong hands," he says. "Mexico has not had a huge rally this year. Its debt trades at a very low premium over U.S. Treasuries,

Jook Leung



Chris Jones

Trust Co. of the West's Bergan: Buying the defaulted credits of countries for which she once arranged loans

Buck Ennis

Shawn Henry/SABA

J.P. Morgan's Rohatyn: Prices may break before year-end, but long-term prospects are bright

Scudder's Rathnam: As long as borrowers need capital, current obligations will be met

but that has been the case for a long time. And in countries like Venezuela and Argentina, even after [the latest] big rally, we are still trading below the peaks of last year. So we are not moving into [dangerous] uncharted territory."

Perhaps not. Nevertheless, investors venturing into the lush wilds of Latin American fixed income (see table, page 42) would be wise to bring along a good map and a strong stomach for adventure. Circumstances vary from country to country, but with the onset of summer, the Latin debt market overall was showing signs of overheating.

Spreads have been narrowing ominously. In June Petróleos Mexicanos issued three-, five- and seven-year notes at spreads of only 165 to 175 basis points over U.S. Treasuries of the same duration. Similarly, Cemex and Banco Mexico made huge offers of debt at spreads lower than those of debt on the existing market. Nicolas Rohatyn, head of J.P. Morgan Securities' Latin American research effort, warns that prices may break in the second half as investors take profits, underwriters scramble for new deals to clamber up the league-table rankings and issuers take advantage of record-low spreads.

"I have to be bullish," jokes Susan Bergan, a onetime Latin America debt trader for Drexel Burnham Lambert who now co-manages a $650 million Latin stock and bond portfolio (started at Drexel) with Penelope Foley and Gerard Finneran for Trust Co. of the West. "My livelihood depends on Latin America. But I'm a dinosaur. I started at Citibank, putting together loans for a lot of these countries. Now I'm buying the defaulted credits." She, for one, is "more than prepared" to trade at these prices and reestablish positions at lower levels. Noting that at Drexel the Latin bond desk was known as "the toxic-waste department," she says that others have forgotten history too quickly.

Yet the tenor of the warning noises being sounded by Rohatyn, Bergan and other veterans of Latin markets is "Proceed with caution," not "Prepare for a calamity." In the near term the going could be rugged. But long-term they say the region's prospects are bright.

The excitement over Latin American markets should come as no surprise. After all, the intense craving for capital in Mexico and South America has converged with the demand of both U.S. and non-U.S. investors for high yields. "Undoubtedly and indubitably, interest in these markets has skyrocketed," says Rohatyn. "These markets need capital, and they are willing to pay for it at above-average rates of return."

Recently privatized government companies in Mexico, Argentina, Venezuela and Brazil have been bellying up to the debt bar in record numbers. In the first half of 1993 alone, Latin American corporations and governments issued more than $10.2 billion worth of Eurobonds and medium-term-note facilities in more than 95 new issues, nearly twice as much as was raised through bonds in the first half of 1992, according to Frank Fernandez, head of Latin American debt research at Merrill Lynch. He expects perhaps $20 billion in new Latin American bonds to be issued this year, compared with $11.2 billion in 1992. Add in Euro–commercial paper, and the total could rise to $30 billion this year. "Demand is driving this market," says Fernandez. "We are up 20.7 percent year-to-date, compared with 18 percent year-to-date for U.S. junk bonds." The

past three years, he says, the story has also been up, up, up, with few breaks.

Cemex's June issue of the largest corporate Eurobond offering to date — $1 billion of five-year dollar-denominated notes — was to be followed in July by a $1 billion U.S. public offering of five-, seven- and ten-year notes by an affiliate of Petróleos de Venezuela's, the $10 billion state petroleum company. (At press time the deal was still pending.) And that came on the heels of a $200 million deal from Transportación Marítima Mexicana, Mexico's $467 million shipping concern — the first ten-year Eurobonds ever sold by a Mexican company without a sovereign guarantee.

The rush to sell debt is likely to go on

SIZZLING STOCKS

If Latin American bond markets are hot (story), the equity markets are scorching.

In June Argentina blew its stock market wide open with an offering of 160 million shares, some 44 percent, of its $4 billion (sales) oil company, Yacimientos Petrolíferos Fiscales Sociedad Anonima. The YPF deal, through which 65 million American depositary receipts were sold in the U.S., was so massively oversubscribed that the number of shares had to be upped by nearly one third. Argentina raked in more than $3 billion — nearly twice as much as anticipated.

The avid demand should have come as no surprise. There are plenty of takers for Latin American equity. As much as André Roberto Jakurski, who runs non-U.S. money for George Soros out of Rio de Janeiro, likes Latin debt, he likes certain Brazilian equities even better. "The holding company of Brazil's electric company is trading at 20 percent of book, the oil company trades at 40 percent of book and the phone company trades at 65 percent of book," he points out.

Keith Dannemiller

Grupo Santander Mexico's Sanchez García: "In Mexico there are fifteen or twenty companies waiting to go to the equity markets"

Other investment vehicles set up for non-U.S. players, like Baring International's Puma Fund — with $130 million invested in Latin American equities — have also moved in. And smart U.S. managers are active, too: Many top equity growth funds hold the ADRs of stocks like Teléfonos de México and Cemex. Dreyfus Corp.'s Fiona Biggs, who is watching the Latin equity markets carefully, recently bought the YPF issue. "In many cases," she adds, "the bulls like the telecom stocks, and I would second that."

Compared with YPF, other stock offerings in the region have been minuscule, but there are plenty of companies moving ahead smartly nevertheless. Chile recently floated two new issues, Maderas y Sintéticos Sociedad Anonima Masisa, its $75 million wood-products company, and Madeco, its $268 million copper and aluminum powerhouse, for $55 million and $59 million, respectively. And despite disappointing overall returns in Mexico's equity markets so far this year, Grupo Radio Centro, whose broadcasting empire reaches a third of the Mexico City market and has affiliates in 85 U.S. cities, closed a $41 million offering of 2.75 million ADRs on June 30.

In all, a dozen or so corporations across Latin America raised some $4 billion in equity in public markets globally so far this year. That doesn't sound like much vis-à-vis the market for new Latin debt, but in fact there is also a very active market for private equity placements.

Since January 1992 Latin American corporations have raised more than $6.3 billion in at least 26 private deals. Says Brian Watson, head of equity capital markets at J.P. Morgan, "There is a trend toward foreign companies doing registered offerings, but the bulk of offerings are still made through Rule 144A [to U.S. institutional investors], for exactly the reason that the rule was created in the first place: It allows those companies access to U.S. capital markets without going through the expensive and time-consuming process of meeting U.S. GAAP accounting rules."

As in the debt markets, an increasing number of equity offerings are expected. "Raising capital is the only way for these companies to expand," says Sergio Sanchez García, chief economist at Grupo Santander Mexico and co-manager of the closed-end Emerging Mexico Fund. "The governments used the money from privatizations to reduce the national debt. We're talking about billions of dollars in countries where capital is scarce and concentrated. So in Mexico, for example, there are fifteen or twenty companies waiting to go to the equity markets."

Moreover, privatizations of several second-tier companies, such as Argentinean and Venezuelan gas and electric utilities, are expected soon. Opportunists are already lining up. CMS Energy Corp., the World Bank's International Finance Corp. and NRG Energy recently established a $75 million Latin American Trust for Independent Power. To be managed by Scudder, Stevens & Clark, it will invest in the privatization of existing power plants and provide capital for new ones.

A YIELD SAMPLER

Like piñatas, Latin American bonds offer a variety of sizes, prizes and surprises.

Bond	Maturity	Offer price as of 7/6/93	Yield to maturity	Spread over U.S. Treasuries (basis points)
MEXICO				
Televisa 10 percent	11/9/97	108.125	7.75 percent	294
Cemex 10 percent	11/5/99	107.750	8.32 percent	309
Aztec Bonds	3/31/08	92.625	9.20 percent	321
Par Bonds-A	12/31/19	72.625	8.97 percent	245
ARGENTINA				
Telefónica	8/4/95	102.625	6.61 percent	258
Bonex '89	12/28/99	88.857	8.76 percent	425
VENEZUELA				
Republic 9.75 percent	9/11/96	104.750	7.82 percent	343
Debt-conversion bonds	12/18/07	68.625	12.93 percent	731
BRAZIL				
Petrobras 8.875 percent	3/10/95	102.250	7.40 percent	360
IDU bonds	1/1/01	74.250	13.75 percent	862

Source: J.P. Morgan & Co.

for the foreseeable future, as increasing numbers of Latin corporations wade into the commercial paper market and swim on from there. Says Michael Gizang, a partner at Skadden, Arps, Slate, Meagher & Flom: "We recently represented Lazard Frères in connection with a $50 million offering of 30-day Euro–commercial paper for Sideco Americana, one of the largest infrastructure development companies in Argentina. The next step would be to go medium-term and then a note."

Charging bulls

Until recently about half the "new" capital buying up Latin debt was actually flight capital of wealthy Latin nationals. They smuggled their money abroad in the early 1980s debt-crisis days, but now feel better about political and economic developments on the home front and also relish the idea of higher returns than they can get in the U.S. The honey attracting these returning bees is high-yield Eurobonds that virtually eliminate Latin currency risks because they are most often denominated in U.S. dollars. Repatriated flight capital is also a big factor in the demand for new Latin American stocks, at least some of which now look cheap to the region's residents relative to U.S. stocks (see box, page 41).

A good chunk of money is being funneled into the Latin markets through retail mutual funds. Assets of a dozen dedicated Latin closed-end funds trading in the U.S. and another half dozen or so open-end U.S. funds now stand at about $2.3 billion, up from virtually nothing three years ago, according to Lipper Analytical Securities Corp. And new funds — like Bear, Stearns & Co.'s Emerging Markets Debt Fund, Scudder's Latin America Fund and Fidelity Investments' Latin America Fund — are rushing to market to meet retail demand.

Plenty of nondedicated funds are investing, too. Indeed, Scudder has some $1.5 billion worth of Latin securities across all its mutual funds and global private-investment accounts. Fidelity holds some $4 billion in emerging-markets debt in its panoply of funds, and even Dreyfus Corp. fixed-income manager Barbara Kenworthy has placed Latin American debt in three of her funds.

The Latin American bulls began their charge in early 1990, when Mexico issued the first Brady bonds. Since then Argentina and Venezuela have joined the stampede. In all some $78 billion worth of Bradys have been issued by these three countries so far. And that's not including $7 billion of defaulted Brazilian bank loans, called interest due and unpaid, that are known as pre-Bradys.

Some of the bonds have had huge run-ups. Argentina's defaulted bank loans, which traded at 12 cents on the dollar in 1989, currently go for up to 72 cents. And Mexico's defaulted bank debt, which sold in the low 30s in 1989, now goes for up to 83 in the form of discount bonds.

When Brazil joins the Brady bunch — it is expected to do so later this year or in early 1994 — the total of such bonds could easily reach $115 billion. Some experienced speculators are already buying the IDUs — as well as the equivalent bonds of Peru, Ecuador and Panama — in the expectation of cashing in on a second generation of Brady recaps.

Listen to the Latin debt bulls bellowing long enough, and you get the impression that huge returns are to be found everywhere below the U.S. border. On the contrary, the Latin American markets do not trade in tandem; nor, for that matter, do bonds within the same national market. The seasoned investor learns to be a debt picker.

The relatively orderly capital markets in Chile, funded largely by that country's obligatory retirement-savings plans (*Institutional Investor*, November 1992), are a far cry from the roller-coaster markets of Brazil. In the country of the perpetual future, balanced federal budgets will remain nothing more than a fond hope until legislators enact a new constitution that curbs the free-spending, inflation-producing ways of Brazil's states.

Fantastically cheap

Similarly, though debt of first-rank private companies and government corporations often tends to cost more and yield less than government debt in Latin America, it varies issue to issue. Many traders believe that the sovereign debt should in fact yield less than top corporate debt. But Brady bonds are terribly complex instruments, as are many other pure sovereign issues. That explains the often upside-down nature of the Latin debt markets. In Mexico, for example, corporate and quasi-government Eurobonds tend to trade at a steep premium to par, while government bonds — Bradys most notably — go for a discount of as much as 27 percent.

Even separate issues from the same

company can be priced at fairly wide differentials that wouldn't appear to be justified by their varying maturities alone. Though a Pemex issue due in March 1997 recently traded at 105.5 and yielded 6.85 percent to maturity, a Pemex issue due eleven months later traded at a lower premium, 103.375, and yielded 0.51 percent more.

But Mexican government bonds, which look fantastically cheap in contrast with corporates, are also at odds with one another. A Mexican Par Bond due in late 2019 which traded recently at only 73.125, actually sported a spread of 159 basis points less than a pre-Brady multi-year rescheduled amount, or MYRA, due in 2006 and trading at 85. Go figure.

In Argentina, on the other hand, dollar-denominated floating-rate Bonex bonds, which were issued in the Argentinean local markets in 1989 to pay otherwise unpayable government obligations and due to mature in December 1999, recently traded at about 89 and yielded spreads of 425 basis points over U.S. Treasuries of the same duration. Yet a fixed-rate 18.25 Republic of Argentina Eurobond issued in 1992 and payable in October 1997 recently traded at 102 and yielded 7.5 percent to maturity, with a spread of 270 basis points. The market clearly is thinking that bonds issued in the local Argentinean market — dollar-denominated or no — are much riskier than Eurobonds.

In the Argentinean corporate sector, spread variables are also at odds. Telefónica de Argentina notes due in mid-1995 recently traded at a spread of 245 basis points over U.S. Treasuries, while Telecom Argentina notes due in mid-1997 traded at a spread of 301. Even more startling is that the December 1993 notes of Brazil's Telecommunicações Brasileiras, which is still government-controlled but is increasingly regarded as a relatively healthy growth company, recently traded at spreads roughly 17 to 33 percent higher than those of their Argentinean counterparts, which are regarded as fine credits. That pricing reflects the need for increased stability in Brazil.

Despite the disconcerting differentials, the long-term trend of bond prices has definitely been up. Indeed, given the vertiginous level of some bonds, the bulls might be expected to begin pulling back their horns. Yet the hoopla is even now drawing in cautious insurers and pension funds. Among those that have reportedly begun sipping the sangria are Atlantic Richfield Co. and Alaska Permanent Fund Corp. New York Life Insurance Co. has also started stepping into the market. "We are a somewhat conservative organization, and we have not allocated a lot of money," says Heidi Bush, the insurer's assistant vice president of investments. "We are doing this on a small, trial basis."

> **"*Returns like those seen in the early '90s are now much harder to come by.*"**

Of course, sums that for huge insurance companies like New York Life may seem minuscule could still cause prices in certain Latin American markets to go haywire. Says one debt trader, "The pension funds and insurance companies tend to creep in like Bigfoot." Merrill Lynch's Fernandez, switching similes, agrees: "This is a story right out of *Gulliver's Travels*. You can't come in and buy $100 million of a single issue on a single day." Thus many trading desks restrict client orders to $20 million bites on individual issues.

Even some of the wildest bulls agree, however, that returns like those seen in the early '90s are now much harder to come by. And some admit that the biggest gains are largely behind investors. Says Fidelity's Robert Citrone, who runs the nascent New Markets Income Fund: "We are not convinced that long-term U.S. Treasuries are going to go to 5 percent, but with a much greater focus on fundamentals, two of the best countries on a risk-adjusted basis are Mexico and Argentina." Citrone's point is that declining U.S. interest rates can't be counted on to propel the markets much further — now they must rise on their own fundamental merits — and so it's no longer "safe" simply to buy a broad market basket of Latin debt.

Selectivity is the order of the day, but the right choice isn't always obvious. Investors clearly like Brazilian bank debt. It's far pricier than the Brazilian pre-Brady IDUs, which are made up of interest arrears. However, suggests John Purcell, director of emerging-markets research at Salomon Brothers, the market may have got it wrong: "The Brazilian IDUs, with an average life of five and a half years, traded in early July at a spread of 860 basis points over [U.S. Treasuries of the same maturities]. This is much cheaper than the bank debt, which makes it a better relative value, particularly since a company's ability to pay depends on Brazil's willingness to let them pay."

Risk-averse investors should stick to safer debts like Chilean new-money bonds, or even Mexican *cetes*. For yield Argentinean and Brazilian government credits look handsome, and for pure speculative value — at the other end of the spectrum — there are the Peruvian pre-Bradys.

Latin bonds may exhibit a Latin temperament, but some of the fears about the region's markets are exaggerated. By the end of last year, the spate of issues had brought the tally of outstanding external Latin American debt in eight key countries to more than $435 billion. According to the Institute of International Finance, that's roughly 40 percent more than the same countries owed to foreign lenders at the end of 1982, the year Mexico kicked off last decade's debt crisis. The big difference today, says someone who should know — Citicorp vice chairman William Rhodes, who has been the banks' chief sovereign debt negotiator for more than a decade — is that many Latin American governments, if not all, have learned from their mistakes. "The debt you were looking at in 1982 was borrowed mainly by governments and government entities," points out Rhodes. "Today, because of the wave of privatizations, funds are being invested mostly in the private sector."

Moreover, Latin debt markets' liquidity, once no deeper than the Rio Grande in a drought, has been given a decided boost by the huge influx of capital. The more paper that trades, the better for market development.

Too tight?

But every advantage has its downside. The increased demand has also tightened prices on bonds to a level that gives some investors the jitters. Take the pricing on that $200 million worth of 9.25 percent,

ten-year notes issued in June by TMM. Despite their long maturity and the lack of a Mexican government guarantee, the notes were sold at a spread of only 337.5 basis points over that of U.S. Treasuries of the same duration — and that had narrowed to 325 basis points by July.

One argument in favor of such relatively tight pricing is that, even at this level, the returns on Mexican corporate debt compare favorably with those of U.S. junk bonds. That concept makes folks like Oppenheimer Management Corp. global bond analyst Ashwin Vasan squirm. "There are not a great deal of ten-year Mexican corporate bonds, and you had a case where a ten-year issue was priced tighter than a five-year issue in the same country," he says. Vasan complains that the spread curve is relatively flat, no matter what the term of an issue is: "Two-, three- and even ten-year issues trade at the same spread over U.S. Treasuries. That is not normal in the U.S. corporate bond market, particularly in the high-yield market, where the spread curve widens as you go out longer, because there is more credit risk. So why is the curve flat in Mexico?"

That is starting to change. Some of the better and more liquid credits are beginning to tighten compared with the lower-quality ones. But generally the Mexican markets do not yet value the varied risks efficiently.

Shelley Greenhaus, who posted 32 percent average returns in the past two years on the portfolio of high-yield bonds he manages for such well-heeled clients as Harvard University and the Rockefeller Foundation at his Whippoorwill Associates, doesn't buy the argument that Latin debt can be compared with junk. Net-net, he considers the risks of Latin American sovereign paper to be much higher than those of U.S. and European corporate high-yields. "True, you can buy at a big discount to face value," Greenhaus says, "but it's much easier to fix the capital structure of a company than a country, and it's much easier to get your hands on the assets of a company."

Poker game

Meanwhile, investors are currently playing the Latin debt ratings game like high-stakes poker. The expectation that the rating agencies will deal out investment-grade ratings to an increasing number of Latin American sovereign and corporate debt issues has been a driving force behind the market's rise. S&P rated the recent $366 million structured Pemex debt deal as single-A, several steps above its lowest investment-grade level. Similarly, the huge $1 billion Pedvsa offering that was going to market in July was structured in such a way that Moody's Investors Service and Duff & Phelps Credit Rating Co. came in with low investment-grade ratings on the deal. And the markets were buoyed in June when D&P came in with its lowest (BBB-) investment-grade rating on the recent Cemex debt offering and with a step-higher BBB rating for a United Mexican States samurai issue.

Investors' fond hope is that S&P, D&P and Moody's will issue many more investment-grade ratings. After all, the argument among money managers and analysts goes, many Mexican corporate credits are already of equal or better quality than some investment-grade U.S. corporate bonds. But with no credit-rating system in place, the markets are having a hard time figuring out which ones.

But hanging rising prices on such expectations may in some cases be like hanging them on a wing and a prayer. Moody's gives an investment-grade rat-

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ing to Chile's telephone company, but not to its banks. For all other Latin American government debt, Moody's gives a rating of just below investment grade or worse. Venezuela gets a Ba1, Mexico is a bit lower and Argentina is lower still. Then comes Brazil.

Says Moody's debt analyst Guillermo Estebanez, "Obviously we think the ratings we have are appropriate." That, he adds, is because all the Latin American countries are still fairly heavily indebted. Moreover, some are increasing their borrowings — and since local savings levels are low, most of that money has had to come from abroad. Most often companies are handicapped because agencies tend to rate them reflexively at or below the level of their governments' debt. The thinking is that corporations depend on their governments' being able to function; this is no different than it is for the U.S. or anyplace else. Exceptions have largely been because of the way in which specific deals were structured.

If the rating agencies have gone slowly, they have every reason to do so. Look at the history. Ten years since massive defaults is not an eternity. And many Latin American governments have understood the necessity for economic reform for far less time than that. Some still don't get it. Citicorp's Rhodes recommends patience: "Continuity is important. Major countries have begun a reform process to open up their economies, but these things take time. And you may have some steps backward, as we have already seen in Venezuela, where there were two coup attempts in 1992."

Short memories?

Others are even more wary of the current euphoria. Warns Argentinean banker Hector Megy, whose Megy Advisors runs the Megy Income and Megy International funds: "It was only two years ago that Argentina saw the end of hyperinflation. President Carlos Saúl Menem did a very good job. But within two years a bankrupt company doesn't become the best in the world." Neither does a bankrupt country. "Brazil," he adds, "did default on its debts three times in this century."

Scudder's Rathnam counters that Germany has also defaulted three times in this century. He suggests that U.S., U.K. and even French investors, accustomed to versions of British common law that assign a primacy to property rights not seen even in ancient Rome, need to adjust their thinking to the quite different standard that applies in Latin America and elsewhere. "When you enter an obligation in other parts of the world, you have to ask whether the debtor will pay, *and* if it will be in his interest to pay," says Rathnam. He adds that as long as Latin American countries and companies need capital to build plants and to increase their exports, they will make good on their current obligations. Besides, he says, Eurobonds issued under U.S. common law sometimes allow creditors to interfere, which is another reason to expect full payment.

Sounds good. Certainly the kind of extensive economic reforms that have begun in most Latin American countries are legitimate cause for excitement. But just as certainly the sailing is not going to be altogether smooth. Governments are still getting their economic bearings. Political and social problems abound. The markets, despite all the activity, are still not terribly deep — and as all sailors know, the sea during a squall is always rougher in the shallows. Concludes Fidelity's Citrone, "I am bullish for the long haul over one to three years, but the next six months are going to be choppy." ii

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