Latin American Construction Companies' Woes May Not Be Over, Yet

By **BROCK EDGAR** *and* **DEVI RAJANI**

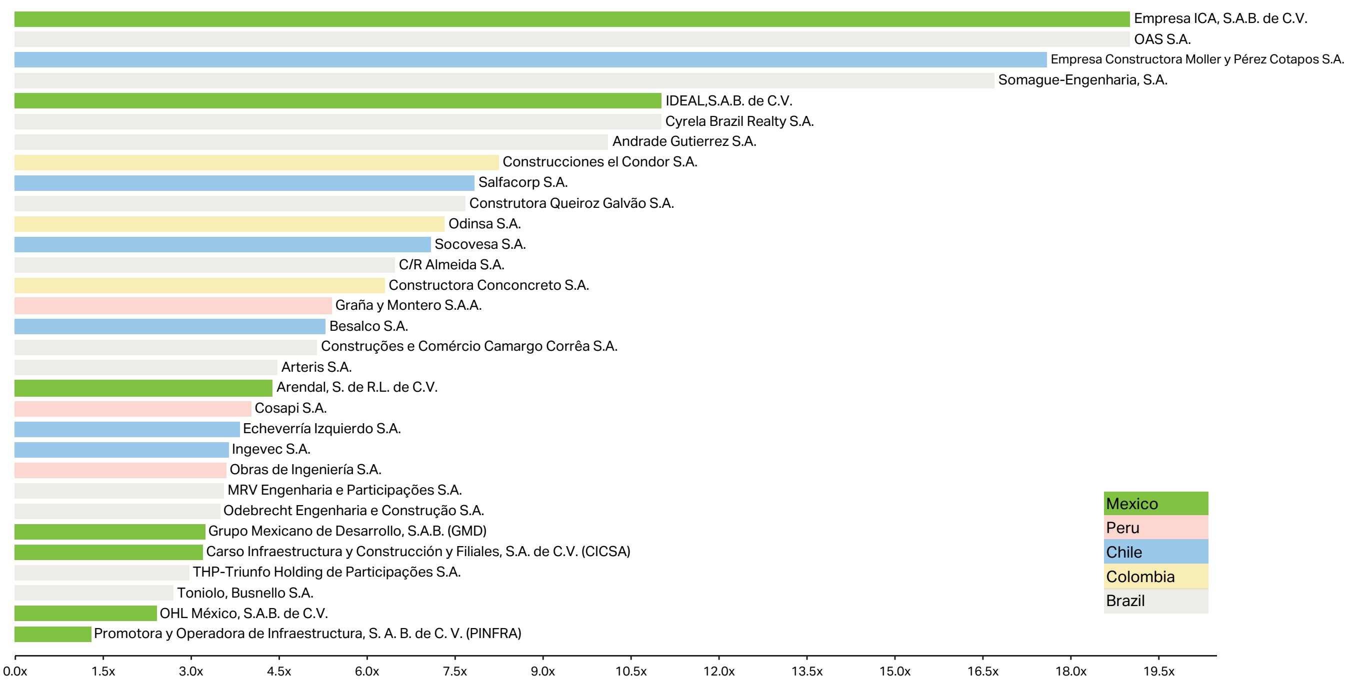
Can Latin American construction companies survive an expected plateau in gross fixed capital formation in a region that so desperately needs infrastructure investment?

In recent years, Latin American construction companies have faced deteriorating cash flows due to overexpansion at home or abroad, limited financing availability due to changing regulations and/or government investigations (i.e., "Lava Jato" in Brazil, also known as the Car Wash Investigation), falling commodity prices (primarily oil) and cutbacks in government spending; all of which have led to over-levered financial positions.

Many regional construction companies have experienced or will likely be going through restructurings. In Mexico, the three largest homebuilders went through restructurings between 2014 and 2016 and one of Mexico's largest engineering and construction companies, Empresas ICA, S.A.B. de C.V., is currently being restructured. Similarly, in a process that has been ongoing since 2015, one of Brazil's largest engineering and construction companies, OAS S.A. is also currently being restructured. Looking ahead, the fallout from Odebrecht's admission of foreign bribery will likely affect its engineering and construction business, as well as its consortium partners throughout Latin America where projects are being cancelled, triggering sureties and bank guarantees.

Against this backdrop, the uncertainty with respect to future economic development makes capital investment decisions difficult. This is even truer today following the election of

Debt/EBITDA for Select Latin American Construction Companies (2015/2016)



Source: FTI Analysis based on latest public information from Capital IQ and company websites. Leverage ratios vary from 2015 to 2016. Odebrecht E&C's leverage is based on a Fitch 2016 estimate.

President Trump in the United States and the potential impact on global trade (particularly for its neighbors to the south), the strengthening dollar, flattish oil prices and the moderating growth outlook for China. For Latin America specifically, economic growth is further restricted by depressed commodity prices in metals and mining (gold, iron ore, copper, etc.). Indeed, although Bloomberg Analyst Consensus Forecasts show flat to modest price increases in these commodities from their troughs in 2015/2016, these prices are still below the prices of 2013, which was a year removed from the peak years of 2011/2012.

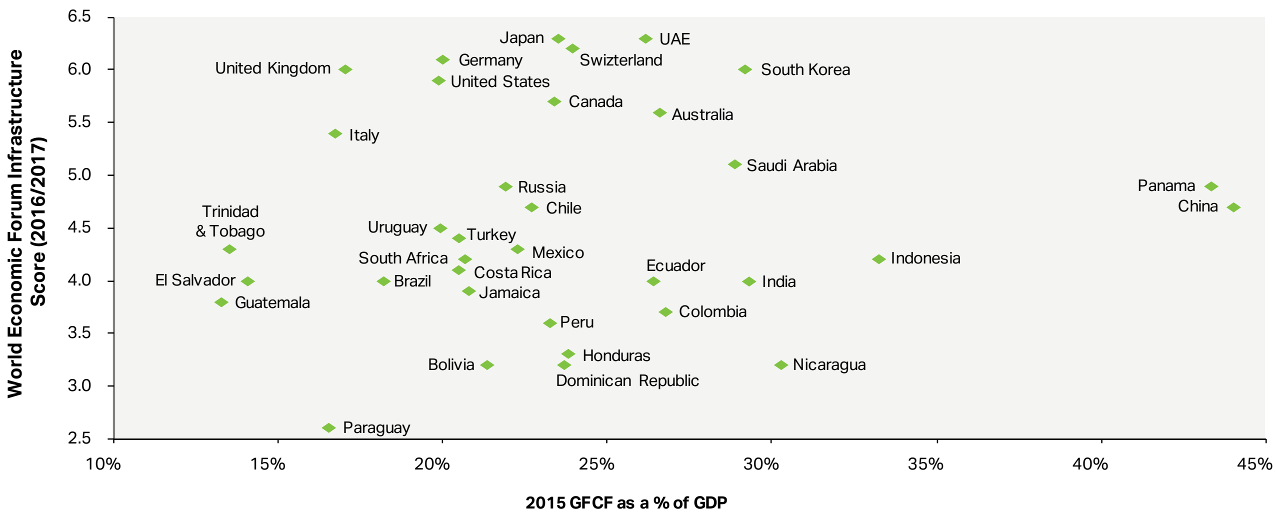
However, uncertainty in gross fixed capital formation ("GFCF") and/or capital investment is not something the region can afford; the lack of investment and infrastructure in the region further deepens the deficit the region faces, impacting economic growth.

The World Economic Forum's Global Competitiveness Report (2016-2017) ranks the infrastructure quality of 138 countries on a scale of 1 to 7 (7 being the best). The highest ranking country in the Latin American region is Panama at #36 (with an infrastructure quality score of 4.9), followed closely by Chile and Uruguay at #44 (4.7) and #47 (4.5), respectively. Panama's ranking is not surprising given that it has one of the highest ratios of GFCF as a percentage of GDP, similar to that of China. However, most of the Latin American region has an infrastructure score under 4.5 which compares unfavorably to the highest score of 6.7 achieved by Hong Kong SAR. Developed economies, such as United States, Canada and Europe generally have scores above 5.50.

Gross fixed capital formation ("GFCF") as defined by the World Bank includes:

- **land improvements (fences, ditches, drains, and so on)**
- **plant, machinery, and equipment purchases**
- **the construction of roads, railways, and the like**

Infrastructure Quality vs. GFCF as a % of GDP



Source: World Economic Forum, "The Global Competitiveness Report 2016–2017", World Bank national accounts data, and OECD National Accounts data files, FTI Analysis

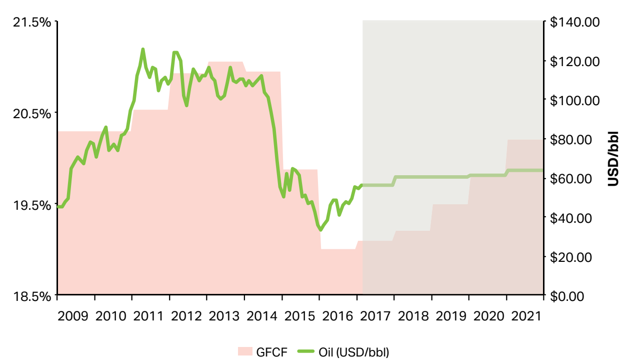
One reasonable conclusion from the somewhat linear trend of the foregoing chart is that Latin American countries seem to be underspending (and/or have historically underspent) on GFCF as a percentage of GDP compared to developed countries with higher scores. For example, Brazil (4.0), the largest economy in Latin America, spends less than 20% of its GDP on GFCF, and Mexico (4.3) fares only slightly better, spending between 20%-25%. Similarly, it appears that Ecuador (4.0), Colombia (3.7) and Nicaragua (3.2) are making heavier investments, presumably trying to compensate for historical underspending in an effort to improve their scores to levels of developed economies. The spending gap is even more apparent when considering that, while developed economies seem to spend around the same GFCF as a percentage of GDP as the average Latin American country, they already have high infrastructure quality, thus requiring less investment towards their infrastructure gap.

Along the same lines, according to the McKinsey Global Institute, Mexico is expected to have a projected infrastructure gap between actual spending and its infrastructure needs of USD 1.1 trillion between 2016 and 2030. Brazil's projected gap over the same period is estimated at USD 0.7 trillion. Indonesia (USD 1.3 trillion), South Africa (USD 1.2 trillion) and Saudi Arabia (USD 0.9 trillion) are expected to have larger infrastructure gaps than Brazil. Yet interestingly enough, both Indonesia and Saudi Arabia spent more in GFCF as a percentage of GDP than Mexico and Brazil in 2015.

It is therefore concerning that GFCF has declined in Latin America since 2014 and is expected to remain at low levels with limited growth over the next few years when there is clearly a need in the region for investment which drives economic growth and prosperity.

The largest drop in GFCF as a percentage of GDP occurred in 2015 and 2016, coinciding with the decline in oil prices. Similarly, the growth in GFCF between 2011 and 2014 seems to have been at least partially driven by oil prices. The outlook for oil is relatively flat over the next few years, and GFCF is expected to grow at a tempered pace, not reaching historical levels that would benefit the region. Will the low rates of GFCF as a percentage of GDP last just 2-3 years as forecasted or will the situation be worse than expected?

Latin America's GFCF (% of GDP) and Oil Prices (Brent)



Source: Bloomberg, World Bank national accounts data and OECD National Accounts data files, Economist Intelligence Unit Forecasts (December 20, 2016), FTI Analysis. Latin America is comprised of Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay, and Venezuela.

Oil's modest outlook has far reaching implications for Brazil and Mexico's economies. Brazil is already feeling the effect with a decline in royalties, special participations and income tax revenues from oil production. Cash received from royalties declined 25% in 2015 and 29% in 2016, reaching similar levels last seen in 2009. The combined impact in both years is over USD 5 billion in fewer funds received by all three levels of government (federal, state and municipal). This has directly impacted governments that are already cash strapped and/or had committed to projects assuming these sources of funds would continue near historical levels. While oil production in Brazil is increasing, financial crisis has impacted Petrobras' (Brazil's semi-public multinational crown oil corporation) expansion plans and, as such, the pace of exploration has been delayed. Petrobras has calculated that for the next 8 years, the government will lose out on about USD 12 billion of royalties, special participations and income tax.

Odebrecht Engenharia e Construção S.A. (OEC) is the largest engineering and construction company in Latin America

Odebrecht's operations reached far beyond its Brazilian borders and into over 10 Latin American countries during 37 years. These countries included Peru, Colombia, Argentina, Mexico, Ecuador, Dominican Republic, Panama, Guatemala, etc. However, due to the fallout from their admission of guilt regarding foreign bribery in the United States, Brazil and Switzerland, the company is under investigation in several of these Latin American countries and, in certain cases, has been excluded from participating in any other projects while the investigations are ongoing. These investigations may yield additional penalties and fines to the already staggering and historic USD 2.6-3.5 billion penalty it has already agreed to pay. The effects on the company's cash flows will be compounded not only by the financial penalties but also from the restrictions that some foreign governments have applied to the company and the subsequent effects on its backlog, as well as gloomy prospects at home. According to Debtwire's February 2017 OEC tearsheet, 77% of OEC's backlog was located outside of Brazil (56% in Latin America, excluding Brazil).

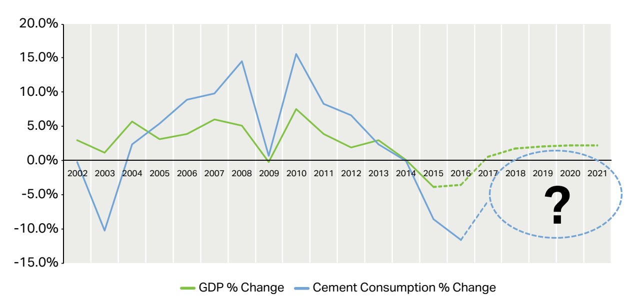
Similarly, Mexico's capital expenditure budget for 2017 has been reduced 23% (in real terms) compared to 2016's approved budget, signaling a large contraction in investment expected by the Mexican Federal Government. Of the decline, about 60% of the reduced budget affects Pemex (Petróleos Mexicanos, Mexico's state owned oil company) directly. So while Mexico has become less dependent on oil revenues to drive economic growth, the effects on government capital expenditures are clear. Pemex's oil production has fallen from over 3 million barrels per day (pre-2007) to just 2 million barrels per day in 2017, the lowest levels since 1980. The cut in oil investments, lower production and low oil prices in Mexico are having their impact on investment. Furthermore, with the current outlook for oil prices, future capital expenditures by the Mexican and Brazilian governments may be limited.

So what's in store for Mexico and Brazil, Latin America's two largest economies? Construction activity is not looking promising in the short term

The Brazilian cement producers' union (SNIC)'s consumption data show the correlation between GDP and cement consumption. Cement consumption is closely correlated to construction activity and economic activity and, hence, to GDP.

Since its peak in 2010, cement consumption has been declining rapidly despite the investment in construction for the 2014 World Cup and the 2016 Summer Olympics. While 2016 appears to be the trough year, the tempered GDP growth forecast does not signal a great improvement for cement consumption in the country.

**Brazil:
Percentage GDP Change vs.
Percent Cement Consumption Change**

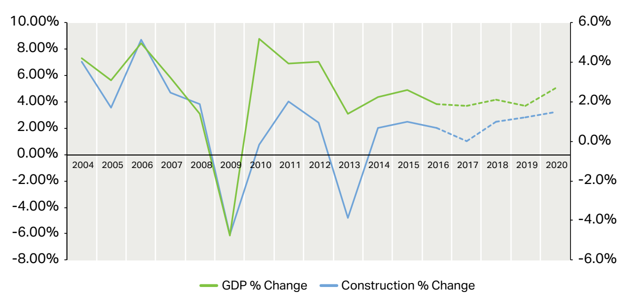


Source: World Bank, Economist Intelligence Unit, Sindicato Nacional da Indústria do Cimento -SNIC and FTI analysis.

The President of the SNIC has recently stated that the consumption of cement in Brazil for 2017 is expected to decrease 5% to 7% from 2016, implying that economic activity and/or construction activity will be subdued in 2017 as well. The Economist Intelligence Unit's (EIU) latest assumptions (February 1, 2017) are consistent with the SNIC, as they expect GDP to have contracted 3.5% in 2016, with 2017's GDP increasing slightly by 0.5%. However, the EIU notes that the weak activity in the fourth quarter of 2016 may further weaken 2017's GDP projection, and that due to a projected growth slowdown in China and the US, GDP growth is not expected to exceed 2% until 2019.

Mexico's construction activity is not expected to fare any better. The CMIC (*Camara Mexicana de Industria de la Construcción*) is expecting a relatively low growth scenario for construction in 2017, of between 0.5% and 1% due to economic uncertainty, and average annual growth of 2.3% in the next few years, when the industry has potential growth of 4% to 5%. Mexico's GDP is expected to grow moderately at just approximately 2% per year through 2019.

Mexico:
Percentage GDP Change vs.
Percent Construction Change



Source: INEGI (*Instituto Nacional de Estadística y Geografía*), CMIC (*Camara Mexicana de Industria de la Construcción*) and FTI analysis.

Construction companies in the region have already been negatively impacted by the decrease in GFCF with leverage increases over the period. With the contraction in international construction and the less than stellar prospects at home, many construction companies have already undergone restructurings and/or retreated from international operations, either by choice or necessity (e.g., as the result of exclusions from countries due to foreign bribery and corruption allegations).

While more restructurings in the sector are anticipated in the short term, particularly in Brazil, they provide an opportunity for right-sizing the capital structure and operations of construction companies, allowing for survivors of this turbulent period to be well positioned to capitalize on the vast but more distant opportunities in the region. ■

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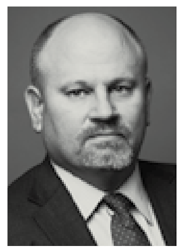

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