S&P Global Ratings

Latin American Entities To Largely Skirt Fallout From Sanctions On Russia

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This report does not constitute a rating action.

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Key Takeaways

Sovereigns. A prolonged deterioration in global economic health could hurt regional sovereign ratings, despite the limited positive impact of high commodity prices in a few countries. Rising prices would exacerbate domestic inflation, forcing governments and central banks to raise interest rates further to avoid losing monetary policy credibility while they balance the need to sustain GDP growth.

Corporates. Transportation and food companies are likely to remain the most vulnerable to a scenario of high commodity prices, while export-oriented sectors like metals and mining; forest products and packaging, and agribusiness will continue to thrive, despite also facing margin pressures. Performance will largely depend on companies' ability to pass through cost increases to prices, which could be difficult to achieve if macroeconomic conditions weaken and cause sales volumes to drop, which in turn would also impair profit margins.

Power and infrastructure. The relatively large base of hydropower in the region lessens the exposure to international oil and gas prices, so high spot market prices don't represent a material threat at least through 2023. However, water scarcity in 2021 hurt Chile, which prompted some Chilean power companies to secure gas in 2022 if dry conditions continue. We expect average spot prices in Mexico to increase in 2022 given its dependency on imported gas in the energy matrix.

Financial Serives. In our view, the direct impact of the armed conflict in Ukraine will be limited for Latin American financial institutions because they have minimal direct exposure to Russia and Ukraine, but the situation has increased uncertainty globally and could lead to indirect effects on the sector. The main risks to financial institutions in the region are from second-round effects stemming from higher oil prices, increasing inflation and interest rates, and weaker economic growth, which in turn could slow credit growth and pressure banks' asset quality and profitability.

Structured Finance. In general, Latin American structured finance transactions don't have direct exposure to Europe, so a scenario of prolonged sanctions to Russia doesn't pose a material threat to our rated portfolio.

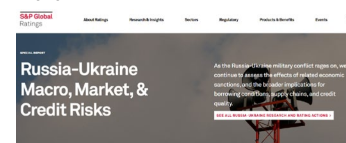
While Latin America is comparatively isolated from the effects of the Russia-Ukraine conflict, the sanctions the West has imposed on Russia have caused ramifications that are affecting other regions and multiple sectors. In this article, we explore the potential fallout if such sanctions remain well into 2023, regardless if the conflict ends sooner.

We think a scenario of prolonged sanctions may be plausible, because the geopolitical tensions that the conflict sparked are widening and may demand long and complex negotiations before they ease. In addition, as the conflict continues, the world is adapting to the new reality and creating ways to bypass the need to buy and sell goods from and to Russia –even though in the short term that creates serious price distortions as seen in recently in the power, metals, food, and fertilizer sectors.

In addition to the uncertain duration of the sanctions, some markets will experience price disruptions well into 2023, because the world's capacity to produce wheat, oilseed, corn, barley, and fertilizers won't be able to recover instantly after the conflict ends, given that the conflict has materially damaged the human resources, machinery, and land previously used to produce these. We consider this another reason why considering a likely continuation of the price disruptions is key for better assessing credit risks.

Links

S&P Global Ratings Special Reports on Russia-Ukraine Macro, Market, & Credit Risks:



Sovereigns

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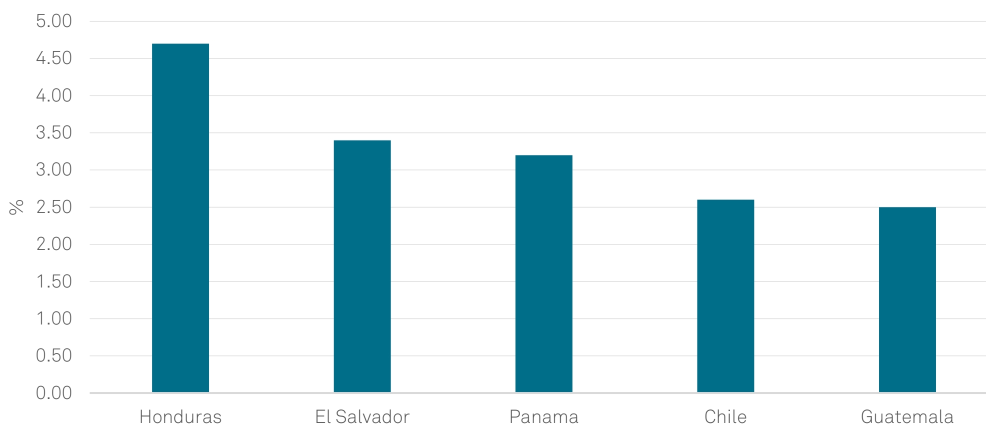
The direct and indirect impact of the conflict between Russia and Ukraine will reduce the room to maneuver for most sovereigns in Latin America as they grapple with the difficult economic and political fallout of the pandemic. Prolonged conflict in Europe would exacerbate the disruption in supply of a wide range of goods and rise in inflation and interest rates. That, along with the fall in global business confidence, would limit the Latin American region's GDP growth prospects.

A prolonged deterioration in global economic health could hurt regional sovereign ratings, despite the limited positive impact of high commodity prices in a few countries. Rising prices, which lower consumer purchasing power, would pose difficult trade-offs in economic policy as governments and central banks balance the need to sustain GDP growth with the need to raise interest rates to avoid losing monetary policy credibility due to persistently high inflation. Growing risk aversion among investors and higher interest rates in more developed economies may also raise the risk of abrupt outflow of capital from the region absent higher domestic interest rates. However, higher interest rates would also reduce near-term GDP growth, which, in turn, could hurt domestic job creation, enlarge fiscal deficits, and raise sovereigns' debt burden.

Higher energy prices will hurt most of Latin America, which imports fuels (see Table 1), but a small number of countries that are net commodity exporters (mainly Colombia, Bolivia, and Ecuador) stand to benefit from higher export revenues from energy products, along with higher fiscal revenues from the sector (see Table 2). However, the positive impact of higher energy prices on the current account balance and fiscal revenues could be offset by higher government spending to subsidize domestic energy prices, especially in sensitive sectors like transportation. Fiscal balances could also worsen in energy-importing countries if governments raise domestic subsidies to compensate for the higher costs, compounding the weakening of the current account balance.

Chart 1.

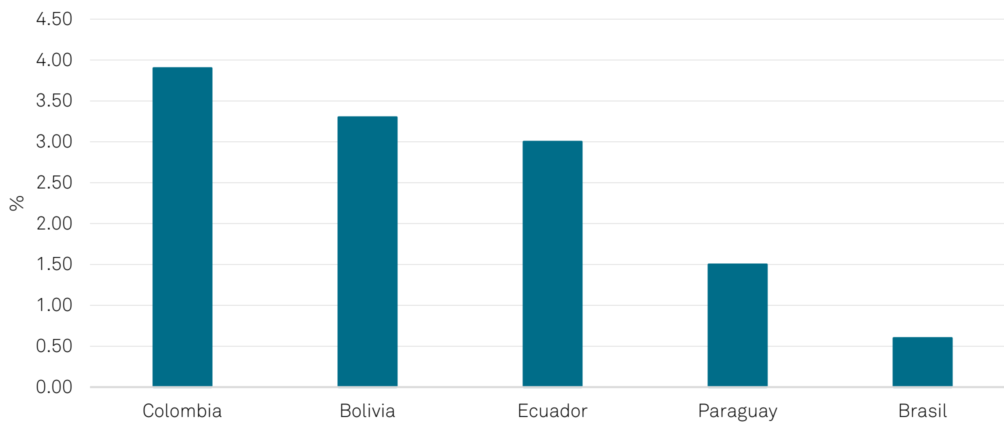
Net Fuel Imports/GDP



Source. UNCTAD (2020 data). Includes coal, petroleum, and natural gas.

Chart 2.

Net Fuel Exports/GDP

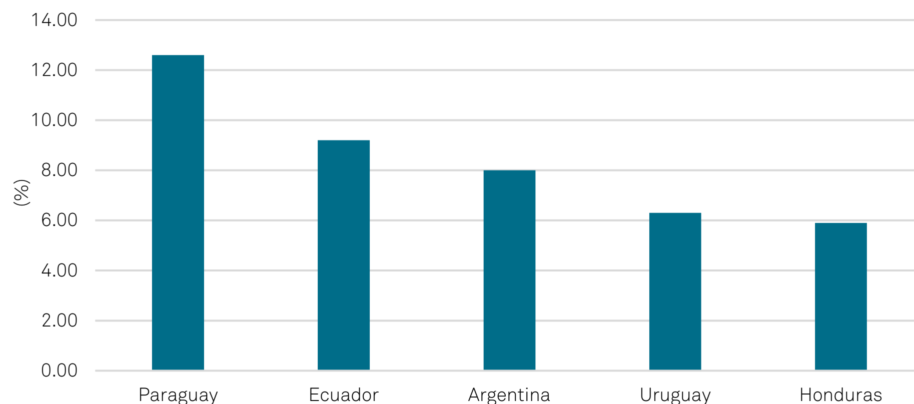


Source. UNCTAD (2020 data). Includes coal, petroleum, and natural gas.

Higher energy prices, along with supply disruptions in food and fertilizer production, would also contribute to high global food prices. Several countries in Latin America, mainly in South America, stand to benefit from higher food prices thanks to their net exports of food products (see Table 3). Higher food exports would boost their current account balances and domestic income. However, higher domestic food prices could create unrest and political discontent in countries where the recent recession and rising inflation have already reduced the purchasing power of large segments of the population.

Chart 3.

Net Food Exports/GDP



Source. UNCTAD (2020 data).

The fallout of the Russia-Ukraine conflict, on top of the effects of the COVID-19 pandemic, is likely to moderately worsen existing economic vulnerabilities in much of the region, potentially weakening public finances. However, most central banks in the region have been raising interest rates in line with rising inflation, safeguarding the monetary policy credibility and flexibility obtained in the last two decades before the pandemic. A similarly moderate fiscal policy balancing the need for social spending with a credible medium-term fiscal trajectory could contain the negative impact of recent developments, sustaining sovereign creditworthiness.

Corporates

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In this section, we discuss the results of a stress test we applied to a sample of rated issuers operating in main relevant sectors: agribusiness; food and beverage, forest products and packaging, metals and mining, oil and gas, and transportation. With the test, we aimed to gauge the potential impact on companies' revenues, margins, and leverage profiles and compare the results to their respective rating triggers--leverage tolerance information that we typically include in the outlook sections of our articles. We present the conclusions of the leverage impact on the tested entities as normal distributions, which we calculated by computing the gap between leverage outcomes relative to current rating triggers. So, for each sector we produced two curves: one with the leverage gaps based on the base case and one with the gaps based on the stress scenario.

Leverage conclusions may indicate ratings' upside and downside potential, but meeting or missing leverage triggers aren't the only catalysts for rating changes. In fact, many of these entities have their ratings capped by sovereign-related risks or simply by their business scale. For practical purposes, in this analysis we use the expressions ratings "upside" or "downside" as if leverage were the exclusive rating driver.

Our conclusions are theoretical and have the sole purpose of helping the reader navigate complex and turbulent times. We defined the prolonged sanctions scenario by altering price and cost assumptions only, leaving all other model variables unchanged. We note that we didn't change capex or dividend assumptions, which are important levers of credit quality in times of stress. We also assumed very little capacity to raise prices beyond general inflation levels, which may not be the case in many of the sectors we tested. The table below shows the main general assumptions we used, and the sections below table 1 discuss the results of the test.

Table 1

Commodity Price Assumptions

Commodity	Base			Prolonged sanctions scenario		
	Rest of 2022	2023	2024	Rest of 2022	2023	2024
Brent oil $/bbl	$85	$70	$55	$130	$110	$85
Copper $/ton	$9,500	$8,700	$8,700	$10,000	$9,500	$8,700
Iron ore 62% Fe $/ton	$130	$90	$80	$140	$130	$90
Wheat (CBOT) $/bushel[1]	$7	$7	$7	$11.2	$10.5	$8
Corn (CBOT) $/bushel[1]	$5.7	$5.7	$5.7	$7.5	$7.5	$6.5
Pulp BHKP Europe $/ton	$1,020	$850	$800	$714	$750	$800

Note: The prices in the prolonged sanctions scenario were defined assuming extreme conditions and aren't a formal consensus variable to be used by S&P Global analysts. Their only purpose is to test the companies included in the sample in different market conditions. [1]Also, the base case prices we used for wheat and corn were derived from recent price trajectories, rather than from published price guidelines.

Agribusiness

Brazilian sugar and ethanol producers predominantly drive the agribusiness sector in Latin America. Ethanol prices correlate positively with gasoline prices because they're mostly consumed domestically as a gasoline substitute, so prices are benefitting from oil price hikes. Sugar prices are also high, and we expect them to remain elevated in the next few quarters.

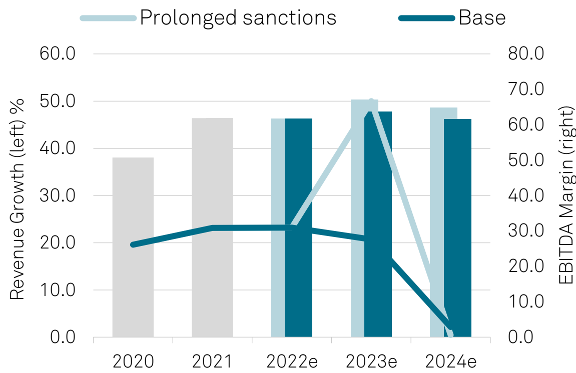
Even though fertilizers make up 5% to 10% of production cash costs and fertilizer prices are climbing--nitrogen, phosphorus, and potash are the most prevalent--most Brazilian producers have bought what they need for the 2022-2023 season, so the effect on costs will be limited. In addition, most farmers have the option to skip fertilizing for a season at the expense of a mild decline in crop yields.

Considering these issues, we tested a sample of ethanol and sugarcane producers, which resulted in very strong performances in both scenarios. As chart 4 shows, revenues and EBITDA margins

would continue to climb in 2023, even amid prolonged sanctions. The strong performances would strengthen leverage profiles significantly, giving these companies considerable upside potential (see chart 5).

Chart 4

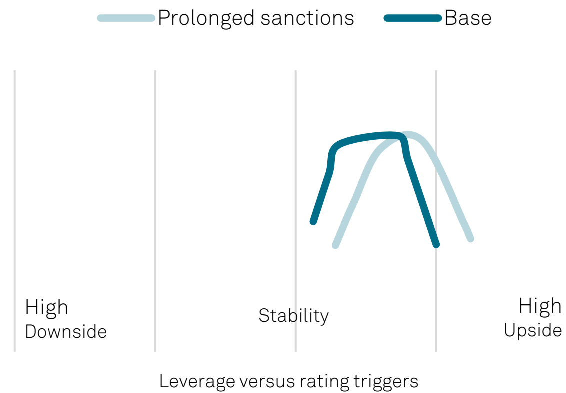
Revenue Growth Rate (Line) And EBITDA Margins (Bars)



Source: S&P Global Ratings calculations.

Chart 5

Distribution Of Leverage Outcomes Relative To Current Rating Triggers



Source: S&P Global Ratings calculations.

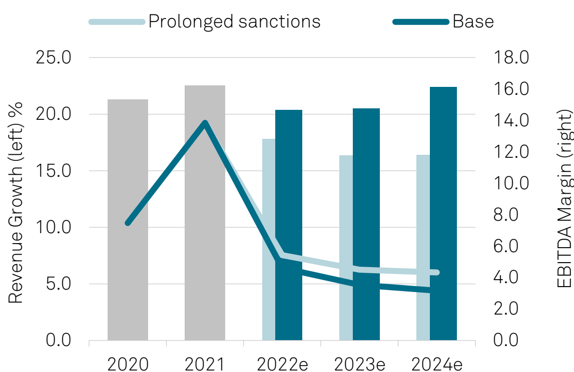
Food And Beverage Companies

Our sample of food and beverage companies include protein producers as well as other types of producers that have food commodities as their main costs. As we expected, these companies would need to deal with cost inflation more than any other sector, which will in general erode EBITDA margins, as seen in chart 6. One important caveat is that Brazilian beef producers are generally less exposed to corn prices versus U.S. producers, because Brazilian cattle are mostly grass fed and only spend 10% of their upbringing time in feedlots (where they are fed mostly with corn and soybeans) as opposed to the U.S. where cattle are mostly raised in confinement.

Pork and chicken producers are exposed to rising corn prices because it makes up to half of their total cash costs. Other food producers included in the sample heavily rely on wheat, and they will suffer from material margin compression if they aren't able to fully pass cost increases to prices. As seen in chart 7, leverage profiles are on the stronger side in our base-case scenario, but under the prolonged sanctions scenario, the weaker profiles would slip into the rating downside territory.

Chart 6

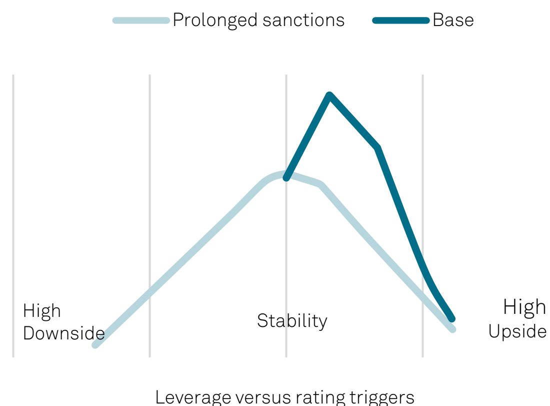
Revenue Growth Rate (Line) And EBITDA Margins (Bars)



Source: S&P Global Ratings calculations.

Chart 7

Distribution Of Leverage Outcomes Relative To Current Rating Triggers



Source: S&P Global Ratings calculations.

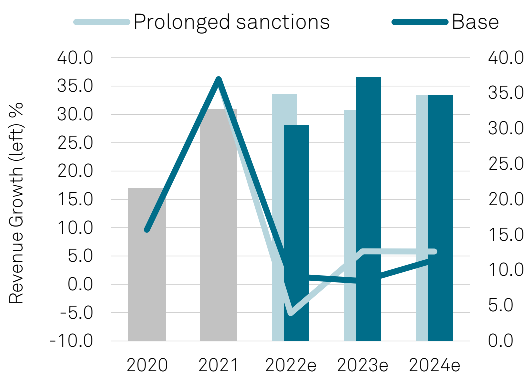
Forest Products And Packaging

Our main assumption for pulp producers is that pulp prices will suffer from a drop in demand, especially from Europe, as energy scarcity forces paper capacity out of the system. That would drag down prices in the second half of 2022. Still, and given that demand from the rest of the world should remain fairly healthy, we believe prices would remain profitable for low-cost producers, such as those in Latin America. Currency appreciation would also curb margins for pulp exporters (see chart 8).

However, the impact on leverage would be for the most part neutral, given the strength of the sample, which has main metrics in the neutral zone in both the base case and in the stress scenario (see chart 9).

Chart 8

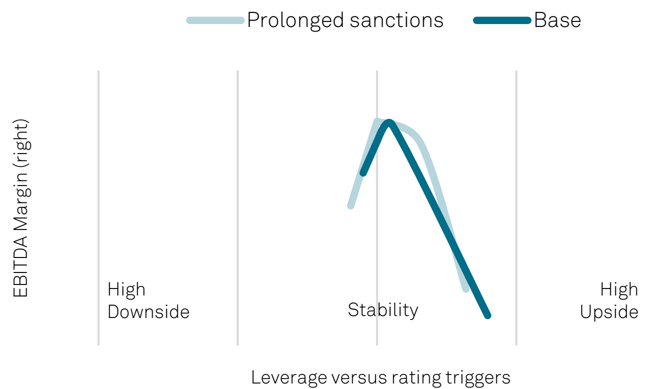
Revenue Growth Rate (Line) And EBITDA Margins (Bars)



Source: S&P Global Ratings calculations.

Chart 9

Distribution Of Leverage Outcomes Relative To Current Rating Triggers



Source: S&P Global Ratings calculations.

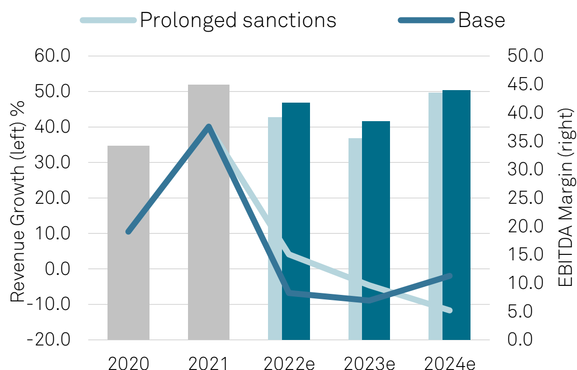
Metals And Mining

Our sample of rated metals and mining companies incorporates the region's predominant business profiles: copper and iron ore producers and integrated steelmakers. We believe these entities would face some margin pressure due to higher energy costs (mainly in Chile, please see the Infrastructure and Power section below), some appreciation of domestic currencies, and overall higher inflation impact on their cost structures.

Nevertheless, most of the companies in the sample have been performing strongly since 2021 due to the rise of metal prices. Thanks to that, their leverage profiles are in general very strong. Therefore, despite some margin erosion, price momentum would continue favoring them and keep their leverage metrics consistent with higher ratings.

Chart 10

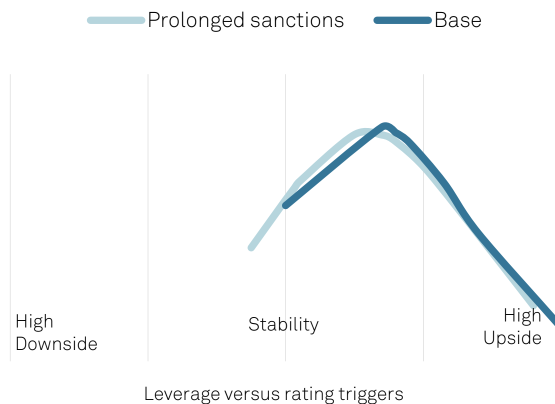
Revenue Growth Rate (Line) And EBITDA Margins (Bars)



Source: S&P Global Ratings calculations.

Chart 11

Distribution Of Leverage Outcomes Relative To Current Rating Triggers



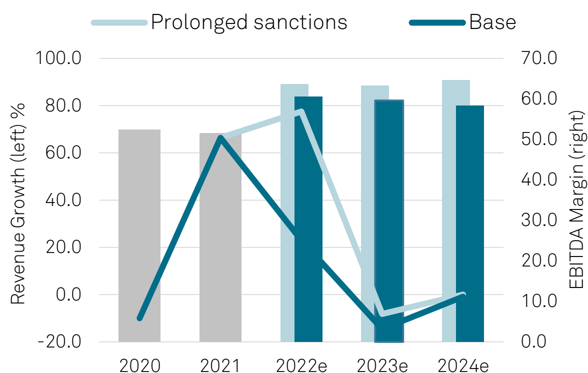
Source: S&P Global Ratings calculations.

Oil And Gas

Evidently, oil and gas producers would thrive in a context of soaring oil and gas prices. But the burning question that remains is whether domestic sales would match import parities, or, as seen in the past, there would be some gaps due to political decisions to limit domestic price increases. For this test, we assumed full alignment of domestic prices with import parity levels in each of the countries of the issuers included in the sample. As a result, margins and revenues would soar and leverage profiles would improve consistently (see chart 13). The results are consistent with scenarios of upgrades, although their materialization, in most cases, is subject to other factors like the fact that some are owned by the government and we limit the ratings by those on the sovereigns.

Chart 12

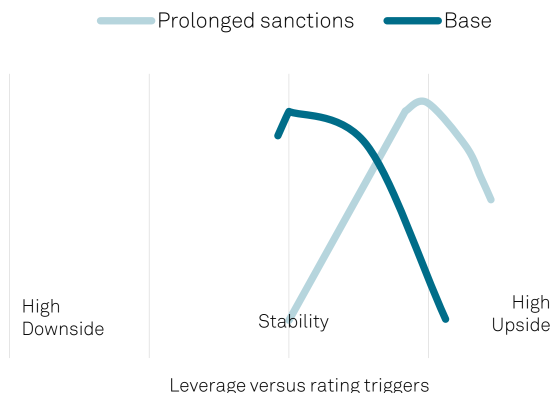
Revenue Growth Rate (Line) And EBITDA Margins (Bars)



Source: S&P Global Ratings calculations.

Chart 11

Distribution Of Leverage Outcomes Relative To Current Rating Triggers



Source: S&P Global Ratings calculations.

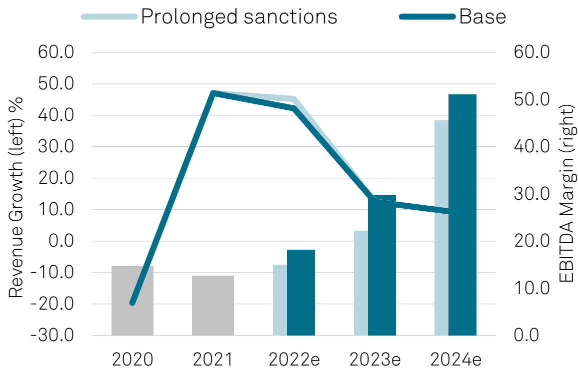
Transportation

Our sample of transportation companies includes mostly airlines and logistics companies. In general, a scenario of prolonged sanctions that keep oil prices high would materially delay margin recovery across the whole sector. Some of the entities in this sector do have some capacity to pass

through fuel increases to prices, especially those offering logistics services for which the customer pays for the fuel. Nevertheless, some of the entities in this group, particularly airlines, would struggle under the stressed scenario and as a result, their leverage profiles would weaken further, exposing them to potential downgrades, as seen in chart 15.

Chart 14

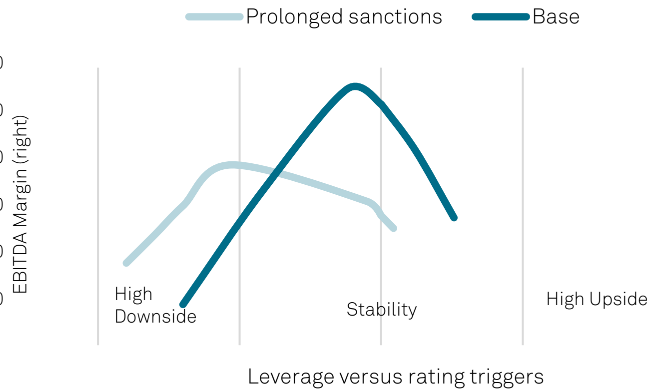
Revenue Growth Rate (Line) And EBITDA Margins (Bars)



Source: S&P Global Ratings calculations.

Chart 15

Distribution Of Leverage Outcomes Relative To Current Rating Triggers



Source: S&P Global Ratings calculations.

Power & Infrastructure

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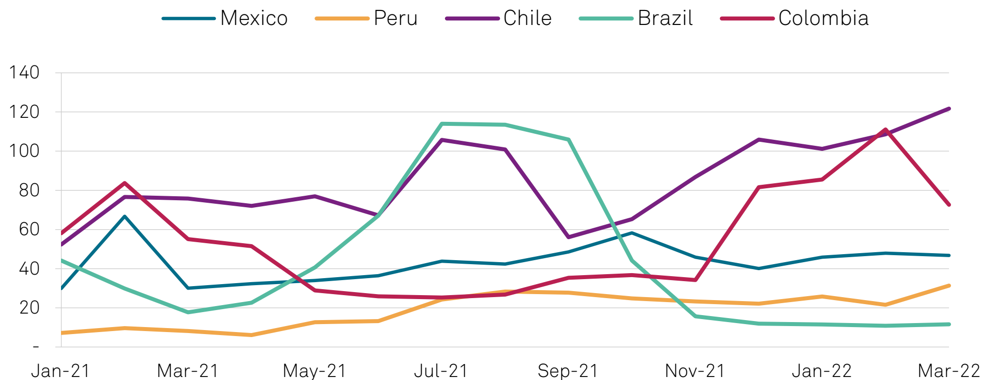
Unlike in EMEA, where spot prices soared as a result of the gas supply shortage, we don't expect a direct impact to Latin America utilities across the region, because the energy spot market wasn't hit by high prices after the conflict started (see chart below). In our opinion, the potential downside impact on energy prices would happen starting in 2023, and the indirect impact of a prolonged conflict would vary in each of the Latin America's largest economies.

Chart 16

Energy Spot Prices In Latin America ($ per MWh, until end of March 2022)



Source: S&P Global Ratings calculations.

Favorable hydrology in the countries with mainly hydro-based installed capacity, such as Brazil (62%), Colombia (69%), and Peru (40%), should shield the short to medium term impact to oil prices in the spot market and in consumers' energy bills under normal hydrology conditions. Brazil has recovered from the 2021 drought, ending this summer with all electricity reservoirs above 60% and spot prices trading at the regulatory bottom of about R$55/MWh ($10/MWh). Colombia had a favorable rainy 2021, which compensated for the energy gap caused by the construction delay of the 2.4GW Ituango hydro plant, which will gradually start operating in 2022. The remainder of Colombia's energy matrix is composed of 10% from coal and 10% combined cycle gas, both supplied locally if thermal dispatch is needed. Similarly, in Peru, hydro capacity generated almost 60% of the country's energy last year.

While Chile's hydro installed capacity corresponds to almost 30% of its energy matrix, the atypical 2021 drought prompted some generators to secure gas supply at higher-than-historical volumes for 2022, with fixed prices before the conflict began in Europe. As such, we expect the surge in oil prices to pressure spot prices only in 2023. However, if hydrology conditions are worse than we expect, and the Chilean players need to buy additional gas and coal in the spot market, we would expect an impact in 2022. For Argentina's majority gas and combined-cycle based energy matrix (48%), the regulatory framework continues to pose a challenge. The regulator has applied discretionary tariff adjustments since April 2020, increasing the mismatch between the cost of supply denominated in dollars and the tariffs denominated in local currency, well before the Russia-Ukraine conflict. Also, Argentina is a net gas importer during April to September due to a lack of transport capacity. That restriction is likely to weigh on the country's fiscal position rather than on already weakened Argentine power companies. Finally, Mexico's dependence on imported gas to support its 60% combined-cycle thermal energy matrix exposes it to natural gas price volatility. For example, the country saw natural gas prices spike to $67/MWh in February 2021 due to the extreme winter weather in Texas. In this context, we expect average spot prices in Mexico to increase in 2022 given that the energy matrix mainly depends on fossil fuel along with continued high inflation, which we project at 5.3% in 2022.

In addition, all countries in the region are developing large nonconventional renewable programs, which could be exposed to supply chain disruptions and cost-overruns. Demand for equipment

could outpace the existing supply base as European countries decide to invest more heavily to diversify their energy matrix in order to reduce their dependence on imported gas.

Our portfolio of Latin American oil refineries-- Empresa Nacional del Petróleo (BB+/Stable/--), Petroperu (BB+/Watch Neg/--), and Administracion Nacional de Combustibles Alcohol y Portland (BB+/Stable)--is composed of government-owned entities, which will likely follow each respective government's policy on the timing to pass through the spike in oil prices to end consumers. This could result in working capital pressure in their liquidity positions, which in our view would be mitigated by ongoing and extraordinary government support.

We don't expect a material short- to medium-term impact on transportation infrastructure assets in the region because the demand for roads, ports, mass transit, and airports is mostly driven by local economic factors. The majority of transportation infrastructure assets recovered quickly to pre-pandemic levels by the end of 2021, including airports, driven by domestic flight demand and demand for short haul flights between the U.S. and Mexico and the Caribbean. However, the downside risk relates to the indirect impact of prolonged inflationary pressure on operating costs, because the ability to pass through inflation via tariffs might be controversial to the population and cause social unrest due to affordability concerns, as we've already seen in the past in Brazil, Chile, and Colombia. In addition, supply chain disruptions could pressure maintenance capex and new investments, given the industry's high capital-intensive nature.

Financial Institutions

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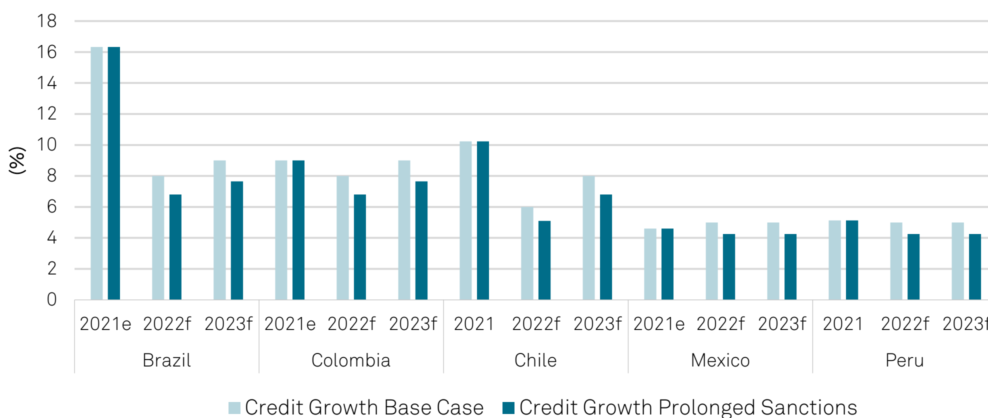
- We believe the direct impact of the armed conflict in Ukraine will be limited for Latin American financial institutions because their direct exposure to Russia and Ukraine is minimal. However, the situation has increased uncertainty globally and could lead to indirect effects on the sector.
- The main risks to financial institutions in the region involve second-round effects stemming from higher oil prices, increasing inflation and interest rates, and weaker economic growth, which in turn could result in lower credit growth and pressure banks' asset quality and profitability.
- In addition, weaker investor confidence could also result in higher financing costs for the region's financial institutions. That said, most of the region's banking systems have relatively low dependence on external funding--Latin American banks are mainly funded through deposits--which should somewhat mitigate this risk.
- We don't expect the direct or indirect consequences of the armed conflict, on their own, to lead to immediate rating actions in the sector.

We expect lending growth to be slower in 2022 than historical levels, due to the soft economic performance and political uncertainty that is curtailing private investment and internal demand. We forecast retail loans to grow more quickly, thanks to the high demand in this sector, versus corporate loans due to limited growth prospects for companies. In a scenario of prolonged sanctions, we expect credit growth to be even lower. This is because even though corporates will have lower access to the international debt markets and may increase their demand for credit from commercial banks, we expect this demand to be still relatively low because we don’t anticipate major growth in investment. In addition, we think banks will probably take a conservative approach and tighten underwriting standards both in middle market and consumer lending. Moreover, we don’t expect to see the type of government measures we saw during the pandemic because governments now have lower fiscal capacity to offer such measures.

Chart 17

Lending Growth Should Moderate



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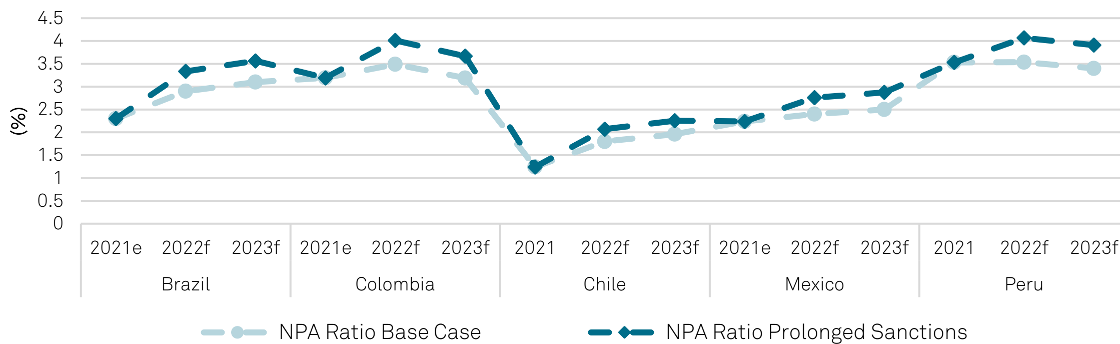
Asset quality metrics remain stronger than we expected, although we think they'll weaken due to the likely flagging economic growth, still sluggish labor market, and modest credit growth in 2022. Still, asset quality should remain manageable thanks to banks’ conservative growth strategies that they implemented before the pandemic. However, in a scenario of prolonged sanctions and weaker economic growth, combined with lower credit growth, we expect asset quality to worsen more significantly.

Chart 18

Asset Quality Will Likely Weaken



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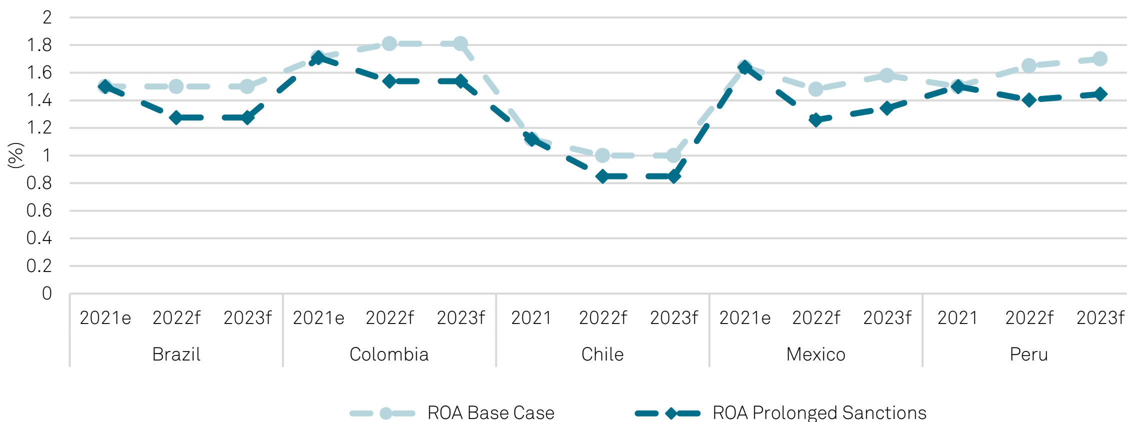
In our base-case scenario, Latin American banks' profitability will stabilize this year after the improvement last year, because banks will need to generate more provisions due to the expected sluggish economy. As interest rates pick up, net interest margins should be resilient thanks to banks' ability to transfer the higher funding costs to the ultimate borrowers and given the high share of variable-rate loans and the short tenor of the bulk of fixed-rate loans. However, in a scenario of prolonged sanctions, weaker asset quality, and lower credit growth, we expect profitability to suffer because banks' credit costs will rise. Moreover, because overall credit portfolios have shifted toward a higher share of corporates (as explained above) and a lower share of middle market and consumer loans, which typically offer higher margins, banks' profitability will also suffer.

Chart 19

Profitability Will Slightly Temper



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Residual stress is a key risk for the small to midsize enterprise (SME) and retail sectors, given that their recovery so far has been uneven. Government-guaranteed loans have been key in supporting the SME sector, but the expected weak economic performance in 2022 could pressure the solvency of struggling companies. If sanctions are prolonged and economic growth is weak, the middle market segment is the one that will suffer the most. This is because banks typically decrease their appetite to lend to this segment during downturns, since it has lower capacity to withstand a tough economic scenario. Banks focused on this segment will face the most significant risks.

Structured Finance

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In Latin America, we don't rate any transactions that are directly exposed to assets originating in Russia or Ukraine. Therefore, we're monitoring structured finance securities for any indirect effects, such as lower economic growth and higher inflation. We continue to observe significant market activity in Brazil, and we have observed increased interest from international market participants in the cross-border segment. Year-to-date, structured finance issuance in the region was about $3.0 billion and our 2022 new issuance forecast is $24 billion.

In general, collateral and ratings performance has been stable across all asset classes. However, the recent downgrade of Peru resulted in the downgrade of 10 structured finance transactions backed by obligations of the Peruvian government and bank diversified payment rights (see "Peru Long-Term Foreign Currency Rating Lowered To 'BBB' On Political Stalemate Limiting Growth Prospects; Outlook Stable," published March 18, 2022, and "Ratings Lowered On 10 Peruvian Structured Finance Transactions Following Sovereign Rating Action," published March 22, 2022).

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