Jones Day Partner María Luisa Cánovas: "Countries like Colombia, Chile and Brazil have announced their intention to increase government spending in infrastructure, energy and regional development projects." (Photo: Jones Day)

Manuel Romano and Marcello Hallake, Jones Day; Ramon Moyano, Beccar Varela; Guillermo Morales, Morales & Besa and Jaime Cubillos, Posse Herrera Ruiz. (Latinvex collage)

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Perspectives

Latin America M&A's: Fourth Quarter Comeback?

A closer look at deal outlook in Argentina, Brazil, Chile, Colombia, Mexico and Peru.

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According to Mergermarket's 1Q20 M&A report, Latin American deal value plummeted to $8.7 billion in the first quarter of 2020, 50 percent lower than in 2019. At that time, Covid-19 had not fully impacted the region, and the drop was explained in large part by the political uncertainty that made 2019 a difficult year for the region. Deal values and M&A activity as a whole dropped further in the second quarter of 2020, as Covid-19 continued to spread. According to Refinitiv, M&A in Latin America plunged 69 percent in the first half of 2020.

Overall, M&As are expected to start a comeback in the fourth quarter, as economies stabilize and the impact of Covid-19 on valuations becomes easier to ascertain. Sectors hit hard by the pandemic, such as hospitality, travel and retail are expected to see an increase in restructurings and distressed M&A transactions, while the health and digital industries are expected to receive a much needed investment boost. Generally, countries in Latin America have not enacted policy measures designed to restrict or further review foreign investment. To the contrary, countries like Colombia, Chile and Brazil have announced their intention to increase government spending in infrastructure, energy and regional development projects, which are likely to include measures aimed at attracting foreign investors. A generalized depreciation of local currencies against the U.S. dollar since early March will also help in that regard.

The sectors identified above are all highly regulated and associated with corruption risk, which has only been heightened by the pandemic. There are other challenges to keep in mind when doing deals in the region, including (i) protracted timelines as government authorities slowly return to work, which are likely to impact the granting of authorizations and issuance of permits; (ii) new workforce retention and reinstatement requirements, freezes on salaries, and energized unions; (iii) currency volatility and, in some cases, foreign exchange restrictions; (iv) new change of control limitations associated with government loans; (v) abrupt changes in applicable law (case in point: Mexico's new regulations in the renewable energy sector); (vi) heightened risk of violent civil unrest (particularly in Bolivia, Chile and Ecuador, as a continuation of the 2019 protests); and (vii) large valuation gaps, which will give rise to the use of earnout provisions and associated litigation risks. All these challenges will need to be addressed in transaction documents, and investors will need experienced lawyers in the region to structure their transactions and successfully bring them to a close.

ARGENTINA

Following a decline in M&A activity in Argentina throughout 2019 (a volatile election year), the M&A market in the country has continued its slowdown in the first quarter of 2020. However, the nationwide isolation policies implemented in March in response to the Covid-19 pandemic have significantly accelerated this pattern of decline, with the first trimester of 2020 only reaching 30 percent of the deal value for the same period in 2019. The slowdown has created opportunities for transactions carried out by operators in the local market. These local operators have acquired businesses from foreign companies, which as a consequence of the country's existing economic crisis and the strict lockdown regulations, fast-tracked their decisions to abandon the Argentina market.

One of the main factors that will determine the future of the M&A market in Argentina is the result of the negotiations between the newly-elected government and the country's international bondholders. The current expiration date to reach an agreement is August 4, a deadline which has already been extended six times and has caused Argentina's debt to be downgraded to restricted default. If the negotiations are not successful, it will become even more difficult to access financing. In addition, restrictions already in place for accessing the foreign exchange market have increased during the isolation stage and the devaluation of the Argentine currency continues to accelerate. The official exchange rate (which can be accessed with various restrictions) maintains its slightly upward trend and the implicit exchange rate resulting from bond transactions (for which there are also certain restrictions) has increased sharply in recent weeks. Finally, inflation remains at high levels. The accumulated figure for the first quarter of the year is approximately 10 percent and everything indicates that this trend will only increase. This is in response to, among other issues, large government spending to cover financial needs during the pandemic crisis.

The reactivation of the M&A market will depend, among other factors, on the date in which the isolation stage in the country ends. Although various activities have already restarted, compulsory isolation is still in force in various regions of the country. It is expected that the sectors that will be most attractive during an upswing will be those most affected by the isolation (such as tourism, entertainment and gastronomy). If the government does not resolve some of the economic variables previously mentioned, it is estimated that the economic crisis and the fall in investments in the local markets will worsen, which will cause several companies to enter into financial crisis or even insolvency, which is already happening.

BRAZIL

After an active 2019, which bolstered market confidence among investors, M&A activity in Brazil slowed down significantly with the start of the Covid-19 pandemic. Although a number of M&A deals still closed during the first quarter, such as the purchase of Brazilian soybean producer Tec Agro by Nutrien, several potential M&A transactions and securities offerings were put on hold during the same period, including the sale of the Outback Steakhouse restaurant chain and the sale of telecom company Oi, as well as share offerings by JBS and Banco BV. In addition, the Brazilian government postponed forthcoming sales, such as the sale by the hydroelectric company Eletrobras of 45 companies (mostly windfarms), which has been pushed back to the second quarter. Covid-19 has also clouded deal certainty, with the most notorious example being the termination of Boeing's purchase of Embraer for US$4.3 billion, although, notably, no express reference was made to the pandemic in the termination notice.

The Brazilian government has not enacted protective measures or foreign exchange controls that would per se hinder cross-border transactions. The slowdown in M&A activity is explained by the market uncertainty and sharp decline in economic activity triggered by the pandemic. Additionally—and not entirely related to the pandemic—recent clashes between the Brazilian Federal Government, Congress and the Supreme Court have called into question the passing of structural reforms, such as tax reforms that were expected to stimulate M&A activity in the country. Finally, across the world's media, there is a negative perception of Brazil's response to the Covid-19 crisis, which compounds the inherent political instability risk associated with its emerging market and makes it difficult for the country to attract foreign investment until there is less uncertainty across the board.

A rebound in M&A activity is generally expected not before the later part of the second semester of 2020, when the government may resume its program of privatizations and concessions, and the private sector starts to deal with the fallout of the pandemic.

Entertainment, restaurants, and tourism are some of the most affected sectors and are expected to recover slowly after the pandemic, which may give rise to M&A opportunities. We also see potential activity in connection with Brazilian companies with dollar denominated debt and otherwise distressed entities, which may need a range of services from a variety of practices such as M&A, capital markets and restructuring. Assets are cheaper as a result of the depreciation of the local currency, which has devalued by almost 50 percent since the beginning of the year. As the currency stabilizes, it may be easier for investors to more accurately price assets and their future earnings at attractive prices.

CHILE

In Chile, transactions fell 58 percent in the first quarter of 2020 compared with the first quarter of 2019. Most buyers postponed or walked away from deals, and sellers pushed to close even though it might have meant to do so on less convenient terms. The M&A pipeline dried up, with only a few transactions withstanding the impact of Covid-19, mainly in infrastructure (such as toll roads and hospitals) and in energy. Also, a few M&A transactions were signed or closed during the first quarter; for example, the acquisition by Global Forest Partners of relevant forestry assets of Masisa, and Mitsubishi Materials investment in Mantoverde copper mine.

Covid-19 and social unrest pose the biggest challenge for Chile: uncertainty. The pandemic has debilitated the Chilean economy and exacerbated the market uncertainty that started in 2019 with the advent of social unrest protests that shook the country throughout the last months of the year. High unemployment and levels of indebtedness, an increase in insolvency proceedings (including reorganization processes of large companies), fiscal fatigue and currency fluctuations are all additional factors that compound the difficult situation for Chile in 2020.

It is generally expected that Chile should see an increase in M&A activity in the second semester of 2020, including MetroGAS, Sonacol, Gasmar, and the sale of Telefonica's LATAM business, among others. Investors from China, Europe and the US have been the most active investors on those sectors. Everything points to asset prices coming down, mainly due to the uncertainty of the market, the fall in the Chilean economy triggered by the social unrest, and most recently, the pandemic. Foreign direct investment is expected in the following sectors: infrastructure, energy, agriculture, logistics, and e-commerce. In addition, we are expecting distressed M&A activity in heavily leveraged businesses and sectors hit hard by the pandemic, such as the retail sector and hospitality sectors, with shops, casinos, restaurants and hotel chains coming up for sale (even within insolvency proceedings or reorganization agreements, as companies may find that the sale of the whole or part of a business is the best alternative to cope with insolvency). Finally, we anticipate that Chile will be generally attractive to foreign direct investors given attractive prices and exchange rates.

COLOMBIA

During the first months of 2020, M&A activity in Colombia has experienced a significant slowdown in comparison to the first quarter of 2019. This slowdown can be attributed mainly to the challenges derived from the Covid-19 pandemic, which has created uncertainty, currency depreciation, and in general, a recession in the country's economy. This situation is making asset valuation increasingly difficult, which has deterred investors, with many deciding to wait until the economy reopens and valuations adjust prior to coming back in the fry.

Notwithstanding the global situation, M&A deals in Colombia have slowed down but not stopped completely. At the very beginning of the pandemic, deals were still entered into or closed. As time went by, deals died or slowed down, particularly in sectors such as transportation and energy, oil and gas. Interestingly, we have seen a new crop of deals come up. These new deals are in industry sectors that have not been negatively impacted by the pandemic such as such health, technology, food, infrastructure and retail.

Prior to the Covid-19 pandemic, Colombia was becoming an attractive target for investors abroad. Although the country has been hard hit by the Covid-19 pandemic, not everything has been lost. By joining the OECD (Organization for Economic Cooperation and Development) in early 2020, Colombia boosted its competitiveness as compared to other countries in Latin America. In addition, two recent actions by the Colombian government are particularly investor-friendly: President Duque's "Orange Economy" promotes foreign investment into creative industries (i.e., goods and services based on intellectual property), and the most recent tax reforms progressively reduce the income tax rates for companies. Finally, the sharp depreciation of the Colombian Peso in early March has created an opportunity for investors interested in distressed financing, as local companies are seeking investors to keep their businesses afloat. Therefore, one of the main challenges for M&A in Colombia during the Covid-19 pandemic will be to maintain an activity level close to that of recent years and to hopefully increase it through new investment opportunities arising out of the public health crisis.

As the year progresses, foreign direct investment will most likely be focused on health, infrastructure, technology, retail and other sectors that have not been heavily impacted by the pandemic. It is expected that as the economy slowly reactivates and in an effort to stimulate foreign direct investment, the Colombian government may launch new project finance infrastructure deals, such as an expected road-building project as well as a program to sell government-owned assets. Finally, the need for distressed financing and the launching of reorganizations and insolvency proceedings are likely to become more common among local companies, which may represent investment opportunities for foreign players.

MEXICO

In the first quarter of 2020, M&A activity in Mexico decreased by approximately 20 percent in the number of transactions and 80 percent in deal value. The pandemic has intensified economic challenges that were already present in 2019. The Mexican federal government's failure to foster economic growth through infrastructure plans and to increase government spending in wealth generating projects has exacerbated its inability to support the private sector during the pandemic. In particular, it is expected that new measures issued by the federal government with respect to the electric system will increase regulatory risk and negatively impact renewable projects currently in development or in operation, and make the renewable energy sector significantly more expensive for newcomers. In addition, the government's role in the cancellation of the Mexico City new international airport, which was about one-third complete, and the rejection of a USD $1,500 million plan to build a new brewery plant in Baja California by U.S. company Constellation Brands—where close to USD $900 million was already invested—bodes badly for foreign investment and the rule of law in the country generally.

On the bright side, there are at least two factors that may help orchestrate a swift rebound. First, the massive U.S. stimulus may help spark U.S. investment in Mexico, particularly in light of the passing of the replacement of NAFTA, the USMCA trade agreement, in summer 2020. The year 2019 was dominated by trade tensions between Mexico and the U.S., which had a negative impact on U.S. investment in Mexico. As of the first quarter of 2020, after the USMCA's passage, U.S. investment represented close to 40 percent of all foreign direct investment in the country. Second, with Covid-19 exposing the fragility of modern supply chains, Mexico's large, diversified labor pool and its proximity to the U.S. is likely to attract Asian and U.S. companies looking to diversify production away from Asia.

The general expectation is that economic activity will pick-up after the country gradually re-opens throughout the months of July and August, and that M&A activity will resume during the second semester of 2020. According to figures provided by the Mexican Ministry of Economy, the main sectors receiving foreign direct investment during the first quarter of 2020 were manufacturing (44.1 percent); financial and insurance services (24.9 percent); trade (8.3 percent); and electricity, water and gas (5.1 percent). It is expected that any new foreign direct investment will follow this same pattern. In addition, there is likely to be distressed M&A activity in industries hit particularly hard by Covid-19 such as the air transportation industry (airlines have seen an 85 percent decline in activity) and the hospitality industry. Renewable energy companies may also be putting their assets up for sale given the hostile regulatory environment they are now operating in.

PERU

While strong M&A activity in the fourth quarter of 2019 and early 2020 indicated a transaction-rich year to come, the advent of the Covid-19 crisis has dramatically reduced M&A activity in the first quarter of 2020, leaving both buyers and sellers re-evaluating their business decisions, and deals already in the stage between signing and closing on the verge of being called off.

Based on the micro and macroeconomic implications of this crisis—which have paralyzed entire sectors of the Peruvian economy—and in looking at other countries' experiences with reopening, it is generally expected that Peru will see M&A activity resume towards the end of the year or early 2021. Before then, however, Peru may see private equity firms that successfully closed fundraising rounds last year seeking opportunities to acquire distressed companies and/or assets in the country.

The Peruvian government recently modified its new antitrust regulations, delaying their enforcement from August 2020 to March 2021. These new regulations, under Legislative Decree Nº 1510, will subject M&A transactions to ex ante antitrust control and will eliminate the popular “first landing” or “new player” exception, which excluded from the scope of antitrust regulations any M&A transactions involving economic agents with no prior market share. Furthermore, Legislative Decree Nº 1510 states that transactions that close before the regulations come into force are exempt from notifying the antitrust regulator and shall not be subject to ex ante control, which creates uncertainty for transactions signed but not closed before March 1st, 2021.

Peru can also expect an increased interest in direct investment, mainly in technology, education, healthcare and logistics, among other sectors that have proven resilient enough to overcome the current crisis conditions. Finally, while the Peruvian M&A market has been characterized as being acquisition-centred and true corporate mergers have typically been scarce, we are seeing for the first time a lot of opportunities opening up for large corporate mergers resulting from the cash crunch that companies are currently undergoing.

Additionally, although Peru’s lockdown continues through the end of June, Peru is implementing plans to revive its important tourism sector, which has already lost over three billion U.S. dollars in 2020. The reopening of Machu Picchu, a popular tourist site, demonstrates some of the challenges of bringing back tourism, including border closures to foreign tourists. Peru’s economy also relies on the mining industry, which, despite widespread testing, has seen outbreaks of cases among workers.

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