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Latin American Equities: More Than Meets the Eye

INSIGHTS

Despite the uncertain global macro backdrop, the combination of long-term structural trends and attractive current valuations is presenting a compelling opportunity in Latin American equities.

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Latin America was one of the best performing markets globally in 2022. The region benefited from robust commodity export prices that were driven by global supply constraints, largely as a result of the war in Ukraine. This has stood in contrast to many developed and emerging countries which have suffered from inflationary pressures and fading growth.

Looking ahead, while the outlook for the global economy is subject to near-term uncertainty and a potential recession in developed markets, we believe Latin American equities will continue to present unique long-term growth opportunities, which arguably remain unrecognized by many investors today. In particular, there are a number of supportive long-term trends benefiting the region—from the rise in nearshoring manufacturing, to the increasing importance of food security, to the urgency of the energy transition. In our view, companies that are directly or indirectly exposed to these sectors look poised for further growth.

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1. Nearshoring

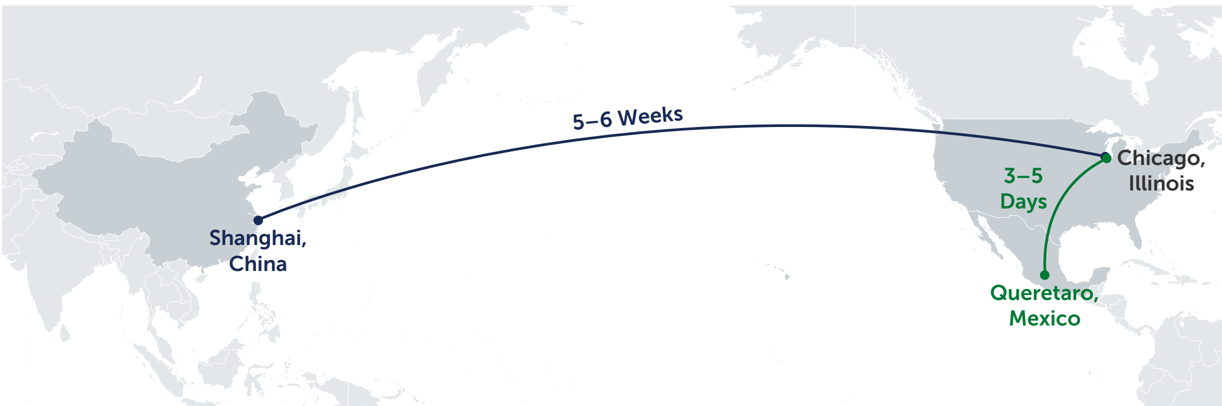
The practice of nearshoring—when companies invest in the production of finished goods closer to their home country to mitigate the challenges stemming from global sourcing—has accelerated rapidly post-COVID. As countries like the U.S. move to bring their supply chains closer to home, Mexico in particular stands out as a key beneficiary. In addition to its large and relatively young population of more than 120 million people,[1] the country's proximity to the world's largest economy has cemented Mexico's position as an emerging global manufacturing leader. This position is further reinforced by the numerous trade deals, including the United States–Mexico–Canada Agreement (USMCA), that Mexico has with over 50 countries.

As the nearshoring phenomenon continues to play out in the U.S., we believe Mexico will see significant investments which will stem from U.S. policies aiming to bring back production from Asia to North America. The recent supply disruptions globally have added fuel to this trend, with many companies moving from a 'just-in-time' to a 'just-in-case' mindset. Further underscoring Mexico's attractive positioning, it takes less than five days to transport finished goods from a Mexican manufacturing base to the U.S., compared to five to six weeks on a container ship from Shanghai—and this can often be done at a considerable cost discount.

1. Source: United Nations Population Data. As of January 2022.

Evidence of this nascent shift can also be seen in Mexico's foreign direct investment (FDI), which increased 29.5% in the first nine months of 2022, exceeding its total FDI for 2021.[2] This increase was led by investments in the manufacturing sector, and while dominated by the U.S.—which represented around 40% of total FDI—it was also supported by an increase from European nations, as well as China and Japan. This further supports our view that companies in Mexico with exposure to the nearshoring theme, such as manufacturing firms, look well-positioned to benefit going forward.

Figure 1: Mexico vs. China: Time and Costs of Container Transport



Sources: Barings; Vesta company data. As of March 2022.

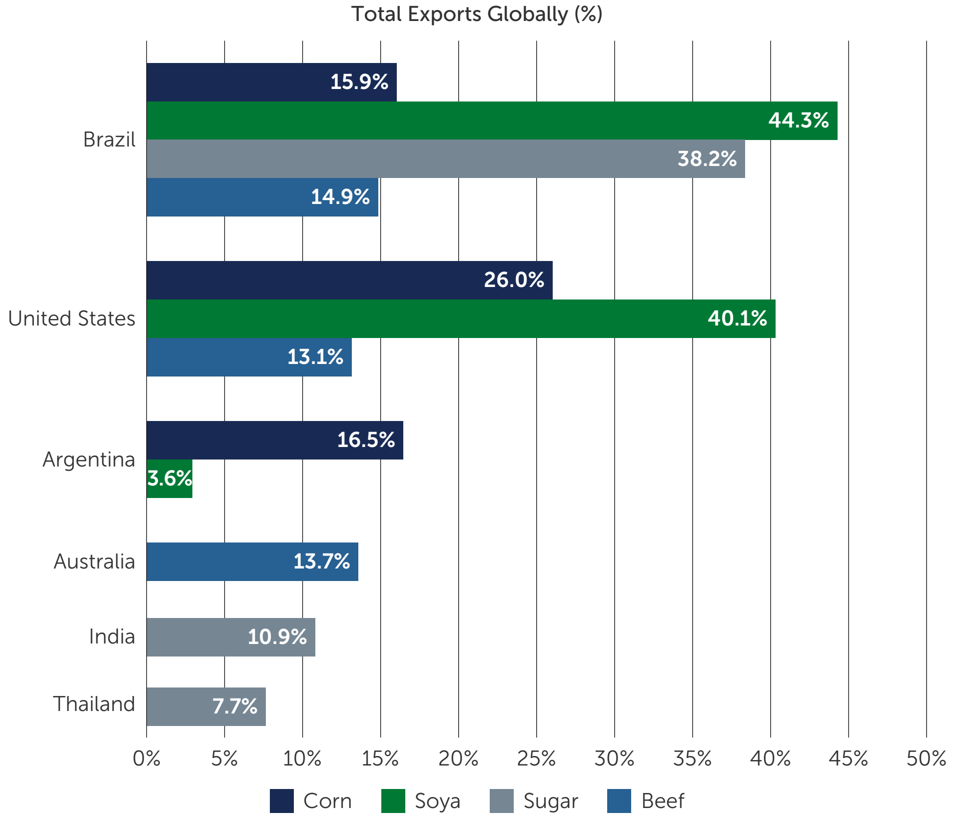
2. Food Exports

The global population is set to continue rising, with the world projected to feed an additional two billion people by 2050.[3] To meet this requirement, more food will need to be produced than ever before. At the same time, competition for land will increase from rising urbanization and industrialization. Combined, these factors have pushed the issue of food security higher up the global agenda.

Across this theme, a number of Latin American countries—and consequently, companies—are uniquely positioned to benefit. In particular, Brazil, which is the fifth-largest country in terms of area, is among the few countries worldwide that has the potential to significantly increase agricultural land. Brazil is a major global supplier of soybeans, corn, cotton, sugar, coffee and meat, competing on a global stage with some of the largest soft commodity leaders, including the U.S. This is largely due to Brazil's unique climate conditions—namely that it benefits from a mild climate and fertile soil. Most notably, the region's climate allows for two crop harvests per year, and for the vast majority of planting to be done without irrigation, as water needs are met with precipitation.

2. Source: The Economy Ministry of Mexico. As of November 2022.
3. Source: United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects.

Figure 2: Brazil is a Leading Producer of Meat and Grains



Source: World's Top Exports. As of December 2021.

The combination of these factors is shaping a compelling opportunity in Brazil's food-producing companies. Structurally, this crucial industry benefits from strong local property rights and developed financial institutions that are prepared to lend to farmers, while logistics continue to evolve to improve efficiency and reduce spoilage. While the ability to invest in direct beneficiaries of this theme is limited today, given the limited number of investible companies, the strength of the sector is supportive for growth in jobs and per capita income. This, we believe, should be beneficial not only for companies that operate within the region, but also for the consumption patterns of consumers as they become wealthier—which can already be seen in the above-average growth of Mato Grosso, a key agricultural production state in Brazil.

Another area of investment opportunity is in companies that have exposure to the infrastructure that supports the food industry. For example, Brazil's logistical infrastructure remains heavily reliant on road transportation, which represents more than 60% of all cargo.[4] We also believe there is potential for growth in areas such as rail transportation that, compared to road transport, are better placed to connect remote agricultural areas in the center west and northern Brazil with costal ports for export.

4. Source: Rumo company data. As of September 2022.

3. Energy Transition

Investor attention around the energy transition tends to focus on renewable energy companies, mainly wind and solar, which will be key players in the replacement of hydrocarbons. However, there are many other companies that will—perhaps somewhat counterintuitively—enable the transition, and are therefore crucial to the development of this theme. Mining companies, as well as metal and commodity producers, are examples. The reality is that without a significant increase in the production of steel, copper, aluminum, cement and lithium, global efforts to decarbonize will remain significantly constrained.

Copper in particular is becoming one of the biggest beneficiaries of green-focused infrastructure plans in the U.S., China and Europe, and is playing a growing part in the global energy mix—both in helping reduce emissions and in the push to develop and deploy green, renewable energy. For instance, a traditional fossil fuel-driven power plant requires around 1t/MW of copper compared to an offshore wind turbine, which requires more than 15 times that amount. The vast amount of copper that will be required suggests that prices will need to rise to incentivize new supply as demand grows.

From an investment standpoint, mining companies and commodity producers in Chile and Peru look well-positioned to benefit from the expected growth in copper demand. Chile is the largest copper producer in the world, accounting for 27% of global copper production, followed by Peru, which is responsible for 10% of global production **(Figure 3)**. Chile is also home to the two largest mines in the world, Escondida and Collahuasi.

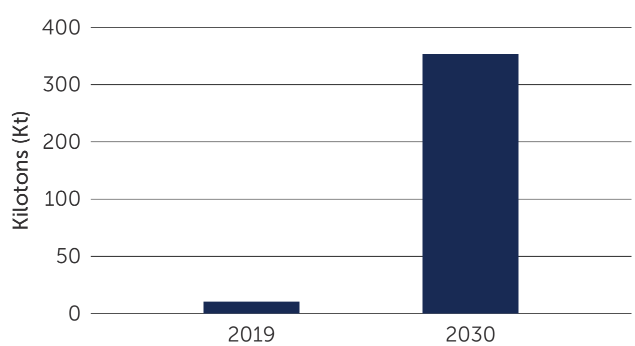
Another key commodity required for the energy transition is lithium, a crucial component of lithium-ion batteries, a type of rechargeable battery used in electric vehicles (EVs). Latin America is a dominant producer of lithium, with deposits found within the salt flats of the so-called lithium triangle—made up of Argentina, Chile, and Bolivia—which combined contain roughly half of the world's known lithium. Chile, the world's second-largest producer of lithium, has seen notable benefits to its economy as lithium prices have risen against a backdrop of swelling demand and limited supply. This position will likely be strengthened within the updated EU-Chile trade deal, which is expected to be signed in November 2023. Under the agreement, Chile is set to provide the EU with access to lithium—a crucial tenet to meet the goals of the EU's green pact—which is strengthening the growth opportunity in Chile's lithium-producing companies.

Figure 3: Chile and Peru Stand to Benefit From Increasing Copper Demand

Country	Copper Production (Mn Tons)	Share (%)
Chile	5.6	27%
Peru	2.2	10%
China	1.8	8%

Source: World Economic Forum. As of December 12, 2022.

Figure 4: Annual Lithium Demand for EV Batteries Expected to Surge



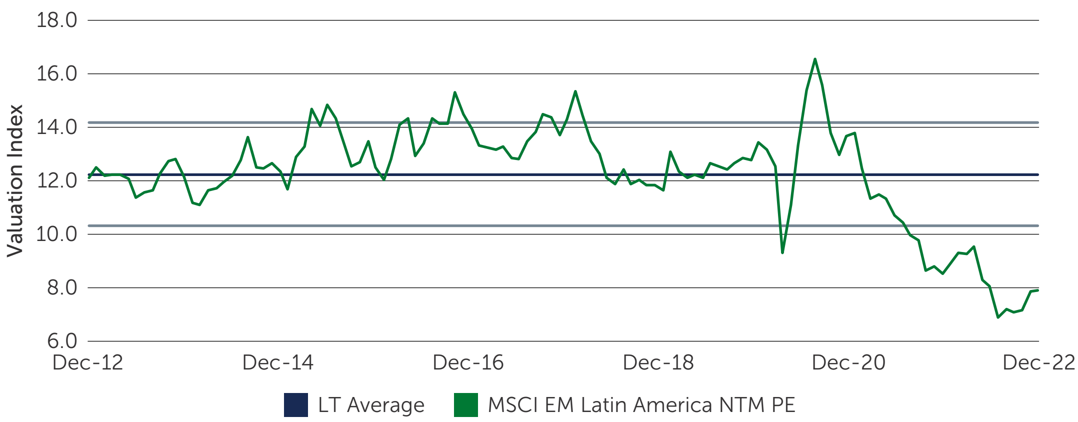
Source: International Energy Agency (IEA). As of July 2022.

> *"Given the promising prospects for Latin America, particularly the region's position to benefit from themes like nearshoring, food security and the energy transition, we believe that current equity valuations do not accurately discount the medium-term earnings opportunity."*

Attractive Valuations

Given the promising prospects for Latin America, particularly the region's position to benefit from themes like nearshoring, food security and the energy transition, we believe that current equity valuations do not accurately discount the medium-term earnings opportunity. Indeed, the region's valuations remain at very attractive levels compared to its own history **(Figure 5)** and are significantly discounted compared to its developed markets peers. This suggests there is the potential to positively surprise going forward, even on the back of the region's robust performance in 2022.

Figure 5: Latin American Equity Valuations Appear Attractive vs. History



Sources: Barings; Factset; MSCI. As of November 2022.

Key Takeaway

Looking across Latin American equities today, we believe opportunities exist in companies that are exposed to a range of secular growth trends—in particular, companies with flexible business models, as well as those with improving franchises, unrecognized growth opportunities and other competitive advantages. As a fundamental, bottom-up manager, we monitor companies closely to best identify strong management teams that are aligned with shareholders and all other stakeholders to the business. While near-term risks and uncertainties—whether around the lasting impacts of the pandemic, politics or economic growth—will likely continue to drive headlines for the foreseeable future, the long-term growth opportunity in Latin America remains compelling.

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