PROBLEMS IN FINANCING LATIN AMERICAN INVESTMENT†

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I. Introduction

The financial world has, through the years, learned to rely heavily upon the law. The reasons are obvious. Whereas the symbol of justice is the balance and scales, the finance world's scales would heavily weigh its reliance on the skills and wills of its attorneys. There is not a banker in town who sleeps more contentedly when a loan closing that afternoon included an attorney's opinion. It has been said that a legal opinion is like a toothbrush–you would not think of leaving on a trip without one, but it is not of much use if you get your teeth knocked out.

The recent emphasis in Houston is on the word "international." Until the last decade and most certainly in the past five years, the local financial and legal community let the "big boys" in New York, London, and Chicago monopolize the national and multinational Texas companies doing business overseas. From time to time Houston was thrown a crumb or two, but basically Houston was not in the ball game. Local bank management was satisfied to have available for service only what was then popularly known as a "foreign department." The less the customers and especially the management had to open the door, the better. Surely the attorney or accountant in similar situations found a comparable reception. Times have changed, however, and this city is now cognizant of what its citizens must offer in order to attract the business of companies throughout the world which will be vital to the continued growth of Houston's economy.

II. Types of Investments

Foreign investment can be said to include any and all of the following situations:

(a) the individual or corporation opening a demand or savings account in a foreign country denominated in United States currency and/or investment in local stocks and bonds,

(b) the service company committing employees or corporate time to another country which could include a myriad of services such as consulting,

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(c) the commitment of certain fixed assets on a short or long-term basis for development purposes,

(d) the contract for specific technological data required on a short, medium, or long-term basis. Examples could include feasibility studies, seismological evaluations, specific training in technology for local labor consumption, and architectural control,

(e) outright purchase of equity,

(f) capital expenditure for local development of corporate products, and

(g) joint ventures with local or multinational interests to develop proven or venture capital projects.

The list is as interminable as the types of transactions envisioned. The preceding examples show that foreign investment and its financing cannot be deftly wrapped up with a blue ribbon and delivered in a neat package without very special assessment.

III. Evaluating the Investment

Detailed information must be evaluated prior to expending dollars. One thing which must be remembered is that a financing institution should only evaluate the factors after an individual or corporation has weighed and determined the viability of the transaction. In other words, similar criteria should be assessed by the investor prior to the banker. Henry Hartfield, a partner in the New York firm of Shearman and Sterling has said:

> In international lending transactions there are more legal factors than one finds in domestic transactions but the role of the credit equation is the same. Whether the loan is domestic or foreign, the lender must determine whether that determination is what is called credit judgment. Law, economics and psychology are all factors, and it is the judicious weighing of these factors that makes credit credible.

It is necessary to understand the tools used by the lender in making a credit judgment so that attorneys can effectively guide their customers to the successful conclusion of a financing arrangement whenever the opportunity presents itself.

Probably the first and most obvious question will be: Why not go to a bank in the country to which the investment is destined? First, the customer will be interested in dealing with a financial institution that can deal with its total financial strategy. Secondly, in a great many instances, the local foreign bank will be essentially a collateral lender on a short-term basis whereas United States banks usually look to cash flows for term lending. Thirdly, United States banks will have available rate schedules to more closely fit the financing required. Therefore, the logical financial partner will be the company's domestic bank able to service its worldwide requirement.

A step-by-step approach will be used to evaluate international investment financing. Afterwards, specific transactions and parameters which should be kept in mind will be discussed.

Assuming that the borrower has predetermined the necessity of an investment in a given locale, the banker will assess the risk of lending to a particular country. Lenders follow a guideline which is basic to country risk assessment:

Political indicators. Stability is a primary consideration. A country experiencing coups or unrest is certainly on the lower tier of desirability. The country's stability and its attitude towards foreign investment are primary determinants.

Social indicators. A study of the population including per capita income and population growth will assist in forecasting the attitude of the populace to its political and economic surroundings. On a long-term basis, population will also affect the stability of the government and the economy. This socio-psychological factor may influence the acceptance and subsequent profitability of any given investment. Thus, it can be seen that the investor or lender must be conversant in all aspects of country risk assessment.

Economic indicators. Economic indicators must be evaluated and compared for a period of at least five years. These factors include:

1. The government banking system should reveal the role of the Central Bank, its control of the growth of the money supply, and its relative importance to the control of the financial systems as well as to the government's financial management of the nation. The private banking system and its practices should be reviewed.

2. Balance of payments has been said to reflect a country's profit and loss statement—income (exports) versus expenses (imports). In the United States balance of payments a rather large sum included is called "Errors and Omissions." This includes diversification of commodities comprising basic exports and imports and their impact in future years. Also to be assessed are incoming and outgoing capital flows which include foreign investment from corporations or individuals, loans, and foreign aid. As recently experienced by Mexico, one must be alert whenever foreign inflows of this type, which must be repaid in future years, exceed exports and other revenues such as those derived from tourism.

3. Exchange rates must be studied specifically to ascertain the stability of the currency's rate vis-à-vis other currencies. One thing in an investment situation that should be kept in mind is that a great many people believe that if a loan or advance is denominated in United States dollars, for example, there is no exchange risk. However, if the loan is repayable in a currency that is foreign to the borrower, the borrower's earnings are

worthless unless the earnings to repay a loan or recompense the investor are convertible into the currency of the advance at an exchange rate in effect on the date of the advance. In other words, the institution advancing funds in its own currency is not necessarily avoiding a cross-currency risk.

4. All other economic indicators including gross national product, inflation, and natural resources are also analyzed.

An evaluation may also include a weighted factor regarding the knowledge of a given area by the loan officer and/or the caliber of first-hand information which can be obtained from trusted impartial parties. A regional bank cannot afford to have its officers on the road all the time; however, a definite emphasis should be placed on the loan officer's personal familiarity with a given geographical area.

In actuality, until a financial institution has made an in-house commitment and assumes a specific amount of risk in a country, all conversation and feasibility studies will fall on deaf ears. An attorney helping to put a deal together must ascertain from the beginning that the company and the financial institution have resolved this barrier.

Other factors will affect the financing decision. Of utmost importance is the assessment of the commitment and the possible credit impact of the borrower. If this second basis is assessed as a plus, then the lender must pursue (1) an analysis of all pertinent financial data, (2) feasibility and cash flow studies on the investment, (3) term, i.e., length of advances, vis-à-vis country evaluation and cash flows, (4) return (the name of the game, as always, is profits, not only to the investor but to the bank as well), and (5) the future of the relationship with the investor. If at the outset it is a "cold" deal, simply a shopping expedition, the bank will probably pass. In the long run, the financier must assess the future impact of making a loan to either cement an existing arrangement or, hopefully, open doors to future transactions.

IV. Resulting Possible Situations

Attorneys may encounter many different types of transactions and their attendant problems. Here attention will be given to the individual's personal investment in overseas markets and usual reasons for looking beyond the local market. In a great many instances attempts at foreign investments are strictly interest arbitrage situations, that is, investing local funds at cheaper rates in markets paying a premium. Many people have encountered rates paid by Mexican *financieras* (finance-type companies). In 1977, on dollar denominated deposits of one year, the return after taxes was 9 percent versus 6 percent in the United States market. Many individuals will choose to invest proprietary funds while others might choose to augment their return by borrowing a certain portion of the investment.

In such a lending situation one must certainly determine the down side risk. It is no secret that Mexico today is not the same as it was four or five years ago. Under the Echeverría administration, Mexico's balance of payments was definitely written in red ink; the official foreign debt has risen from three billion to something like twenty billion. Public and private debt probably totals forty billion. Politically, there is some unrest on the part of the people; however, it is possible that the news media has blown specific situations out of proportion. Nevertheless, this risk must be determined especially when one considers that 30 to 40 percent of the people are either under-employed or unemployed. Despite the devaluation and the possible unrest, many Americans are seeking higher yielding investments of this sort.

Would a prudent counselor recommend this type of investment to a widowed client with a fixed income? The 11 to 12 percent return on short-term peso deposits is certainly not very attractive. But a dollar investment with a top quality *financiera* bond should be considered. The funds should be lent because traditionally Mexico has depended upon foreign time deposit investments of this sort. Sure, exchange controls might be imposed if the very recent euphoria with the new administration should be tarnished, but such action would probably involve a two-tier exchange market similar to France, Belgium, and Spain where external funds are preferential. In fact, a loan was recently made to a man who pledged some National Financiera bonds on time deposit. However, since this deposit is unpledgeable, unlike the typical certificate of deposit in the United States, the only way to do it is for the *financiera* to accept an irrevocable letter of instruction to pay the bank directly. An additional safeguard is to ask a Mexican attorney to draw up the letter.

While on the subject of Mexico, there is a recent investment law that affected many United States companies. In 1973, a "Mexicanization" law was passed that could have changed the climate of investments. The government began to enforce the existing decree that all companies should have at least a 51 percent Mexican ownership. Although this enforcement caused some alarm, many companies have elected to Mexicanize and, therefore, have enjoyed certain advantages. Others, such as Chrysler, sold the 51 percent to local investors, but when the local company got into financial problems the government allowed Chrysler to increase its ownership to 75 percent.

One day a bright young man came into the office. Because of the recently imposed law, he felt he could form a consortium of wealthy Mexican individuals who would acquire majority ownership of subsidiaries of foreign companies at a reasonable cost. The first acquisition entailed a subsidiary of a United States manufacturing company of products vital to the Mexican market. Additionally, the change in majority equity would not involve any changes in management or product line. A study of the financial statements, cash flows, and projections reflected that the transaction would self-liquidate in a period of five years. The individuals themselves could more than support the debt. Loan documents drawn up by Mexican attorneys would ensure enforceability. The new shares would be issued in two series: an "A" series which is local funds and a "B" series which is the 49 percent that can be foreign. The shares cannot be taken out of Mexico. In this instance, a trust was set up with a Mexican bank to oversee the collateral. This loan, in fact, was liquidated long before the agreed five years period had run.

A number of years ago a Latin American country contacted a firm to do a feasibility study on the infrastructure necessary to open a portion of the interior to a port. It was felt seismic studies would reflect proven oil reserves. In this situation local funds were not available to finance the necessary infrastructure to foment export of produced raw materials, if discovered. Yet the government itself was willing to guarantee the debt of its autonomous agency.

Funds were, therefore, committed to the project in the form of advances against promissory notes in favor of the American contractor, executed by the agency and guaranteed by the Minister of Finance. Six months down the road, all of a sudden, the government was not particularly satisfied with the progress of the feasibility study and arbitrarily cancelled the project. The United States bank had debt outstanding which proved to be, despite the guarantee of the government, more than difficult to collect (although it was ultimately collected).

This is merely an example to illustrate that, as it has been said, in assessing a loan involving sovereign risk one must remember that when a private debtor defaults, he is dragged through the courts; when a government defaults, it is already in the courts—it owns them. As an aside, the debt was finally collected at the expense of a lot of time and effort and, naturally, a "walloping" legal fee.

At times, a United States bank will ascertain the need of a local bank to assist in the financing of a loan package. Some Americans received a mining concession in Latin America where it was felt that control of the product, despite the fact it was ultimately destined for importation to this country, was vitally necessary. As a consequence, local help was sought by contacting the correspondent bank which was willing not only to control the collateral and employ a local warehousing company but also to advance funds for local expenses such as payrolls. Foreign investment was financed by means of a letter of credit opened with the local bank which would be activated upon receipt of evidence of certain expenses or production of product.

Quite often it is important to obtain local commitments in order not only to monitor the loan on a local level but also to obtain a commitment to insure the viability of an ongoing project. There are a number of worldwide and United States agencies that can guarantee risks such as expropriation. These include the Export-Import Bank, the Foreign Credit Insurance Association, and the World Bank.

There are other situations that one encounters from time to time, for example, the oil industry. A large South American country has, for many years, been exploring for oil, but it has not been very successful. At times the country has arbitrarily cancelled certain contracts. The contractor generally cannot afford to pay high import duties on expensive drilling equipment unless he can expect to stay for many years. If this situation occurs with an oil company, in order to avoid paying duties and also to go on record that the equipment is not an importation to the country, a letter of credit in lieu of duties can be opened. If the equipment is not taken out in a period of three years, the government may draw on the bank. But, of course, the letter of credit cannot protect the equipment from being expropriated which is always a sizeable, but unavoidable, risk in international investment.

Questions and Answers

Question: What are the prospects, in terms of the framework of stability, with regard to Mexico?

Answer: Some lenders are optimistic, especially after the new independent study of Mexico's oil reserves. Mexico knows it has only one way to get out of trouble fast, and that is to get the oil out of the ground. Basic food supply and containment of population growth must also be solved.

Question: Is the peso going to stabilize in Mexico?

Answer: This depends on how they control inflation, which is difficult to do. With a high unemployment rate it is very hard to clamp down controls to reduce inflation. Most likely, the President of Mexico, Lopez Portillo, is not going to clamp down on inflation to the degree necessary to bring it down to a palatable level. It will probably stay around 20 percent through June, 1977, but some further erosion can be expected by the end of the year. By that time more will be known about what their petroleum exploration program might be.

Question: How necessary is bribery for survival in Latin America?

Answer: That is the way to do business there. Business is not done any other way. It is the way it has been and the way it will continue to be. It is very shortsighted of the Securities and Exchange Commission and the United States government to make a huge example of these multinational companies. You cannot do business in the Middle East without greasing a palm or two. It seems unethical on this side of the border, but people in other countries accept it as a cost of doing business.

Question: Do United States companies and banks engage in bribery?

Answer: Banks do not bribe. They do not have to, because they have the dollars to lend. Companies will find a way to circumvent it altogether, even if it is done privately by their executives.

Question: What about Venezuela?

Answer: Venezuela is in excellent shape because it has a vast amount of oil, at least for the time being. Their reserves are being depleted at a more rapid rate than they would prefer. The government seems to be alright; there is not that much unrest. For seven to ten years Venezuela will be a good risk.

Question: What about someone who has money invested and tied up in a Latin American country but for some reason, such as nationalization, he cannot get it out; then some big company comes in and tries to dispose of it? Does this happen often?

Answer: Yes, especially in Chile, Argentina, Brazil, and Peru. It is always better to try to help a customer find a user in those countries. If not, there are certain companies that will still operate. Multinational companies can be approached to purchase funds for their use on a local basis.

Question: Compared with large banks such as those in New York, what kind of drawing power do Houston banks have with Latin American countries?

Answer: Houston probably has more Latin American customers than a lot of the New York banks. South Americans traditionally go to Miami; Central Americans and Mexicans, who had traditionally gone to San Antonio, now come to Houston. The major part of the loan portfolio of the Houston banks will be concentrated in Latin America, rather than in Europe or the Middle East. Of the loan portfolios seen in Houston, probably 60 percent are committed to Latin America. Houston banks have also been very successful in attracting deposits. They have a good deposit base from Latin Americans who, because of uncertainties in governments, have always kept money in this country.