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Investing for a world of change

Notes from the road: Quality pays in Mexico's corporate credit market

A research trip to Mexico by analyst Antonio Luiz Gomes highlights favourable dynamics – at home and abroad – that are lifting some of Mexico's leading companies to create compelling corporate credit investment opportunities.

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Prior to joining the firm, Antonio worked for Triton Partners as a distressed debt analyst. Before this, he spent four years at Fitch Ratings in London and New York in various roles covering retail and consumer sectors.

Background

On-the-ground research trips to engage with local companies represent an important part of our emerging market (EM) corporate credit process. These in-person meetings give us valuable insights that are not always available via traditional research channels, helping to gain or reaffirm our investment conviction in corporate credit issuers or flag any potential concerns. On my trip to Mexico – where we have uncovered many interesting investments in recent years – I met with the management of key companies across a variety of sectors. In addition to confirming our constructive bottom-up views on these companies' debt, the trip also revealed positive structural trends supporting the broader Mexican corporate debt market.

High-quality corporate issuers – the survivors

The Mexican corporate debt market can be defined as a 'tale of two tails', with very high-quality issuers that have weathered multiple market cycles contrasting with companies that have riskier credit profiles and have faced severe challenges. Regarding the latter, in many cases these have restructured and left the market in recent years.

A strong economy has benefitted the highest-quality cohort, which was resilient during COVID and returned to growth quickly thereafter. This explains the outperformance of Mexican investment-grade debt (JP Morgan CEMBI IG+ Mexico) relative to the broader EM corporate debt market (JP Morgan CEMBI IG+) by more than 500bps since the end of 2019. In contrast, in the high-yield segment (JP Morgan CEMBI HY Mexico), Mexican credit has underperformed the broader EM universe (JP Morgan CEMBI HY+) by around 11% over the same period. In Mexico, quality pays and this trip reiterated that.

Figure 1: Investment grade and broader index, rebased

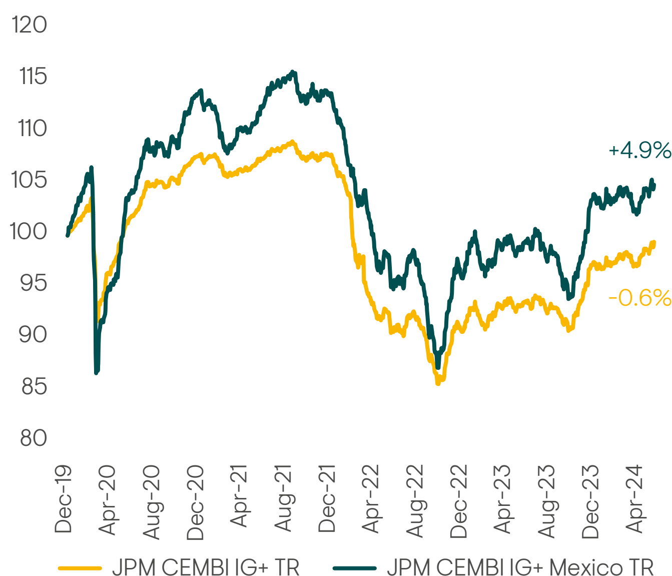
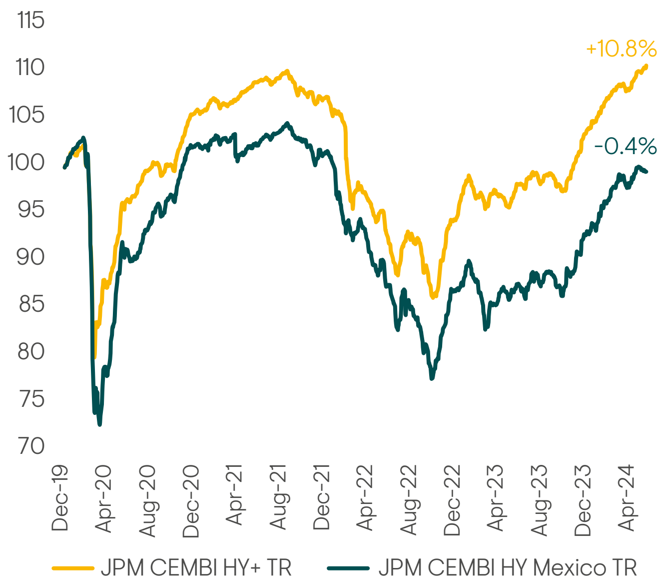


Figure 2: High yield and broader index, rebased



Source: JP Morgan, Bloomberg, 12 June 2024.

Benefitting from economic strength at home and in the US

The Mexican economy has been impressive in the last few years, with 12 consecutive quarters of growth since Q2 2021 thanks to several structural tailwinds. These include strong US growth, 'friend-shoring', and redistributive government policies (increasing disposable income for consumers with a higher propensity to spend).

An important driver has been a robust US economy and Mexico's close relationship with it. This has led to strong demand for Mexican exports and significant remittances, which – when combined with significant minimum wage increases – have boosted consumption. The result is robust growth (reflected in recent bond market outperformance) among issuers like **Alsea** (Starbucks and Domino's franchise owner in Mexico) and **Grupo Axo** (clothes retail operator, with brands such as Gap, Nike and Tommy Hilfiger) as discretionary consumption has increased. Both companies' management teams outlined how consumption continued to be very strong, as reflected in continued sales growth, and shared their belief that they had significant room to grow via store openings and increases in same-store sales.

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Capitalising on 'friend-shoring'

Mexico's economy has also been a beneficiary of geopolitical developments in recent years, as countries have sought to locate manufacturing capacity closer to home. This 'nearshoring' trend has seen the US reduce its imports from Asia, particularly China, while increasing its imports from countries in closer proximity, including Mexico. It is proving particularly helpful for companies in sectors such as manufacturing, construction, and real estate, while boosting consumption (indirectly), providing strong positive tailwinds while the rest of the EM investment universe has been more challenged.

My meeting with the management of **CEMEX** – one of the largest cement companies in the world, with a global footprint and investment-grade rating from all three major rating agencies – shed light on the sheer scale of nearshoring benefits. Officials I met at the company's impressive head office confirmed that nearshoring – on top of rising US infrastructure spending under the Inflation Reduction Act – has driven a large increase in the demand and that CEMEX is now focusing on growth. It expects to divert c.60% of its free cashflow to this area of the business, with the rest towards shareholder returns and debt reduction. Overall, I learned that CEMEX expects earnings to remain steady, and I retain conviction in the company's fundamentals – as reinforced by the recent upgrade to investment grade, which management says it is focused on maintaining.

Nearshoring has also led to significant increases in energy demand, creating an opportunity for the two largest private power generators (**Saavi Energia Group** and **Valia Group**) that have existing public and private supply contracts. Both companies see a private solution to Mexico's energy demand challenges as the only way forward, despite political noise around the topic. While the future relationship between the private sector and the government is uncertain given the recent presidential election, early signs appear encouraging, with newly elected President Claudia Sheinbaum proactively engaging with companies like Valia.

Elsewhere in the economy, the real-estate sector shows signs of significant growth potential from the tailwinds outlined above. My meeting with **Fibra Uno** - the largest commercial real estate investment trust (REIT) in Mexico and Latin America – which is currently in a bidding war for the industrial portfolio of another Mexican REIT – revealed a sizeable increase in demand for warehouses as US businesses have sought to bring operations closer to home. This is expected to benefit the industrial space first, before spreading to retail and office projects as more offices are opened in Mexico.

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Transition investment opportunities

The cement industry is a notoriously heavy emitter, and CEMEX has announced world leading emission intensity reduction targets to 2025 and to 2030, both of which are aligned to keeping global warming below 1.5 degrees, according to the Science Based Targets Initiative. It is also working hard to get to net zero, developing the world's first solar clinker technology with the goal of displacing the need for fossil fuels to produce clinker, and investing in a number of carbon capture and storage technologies to get to carbon neutrality. The opportunity to invest in the transition to net zero via innovative and leading companies like CEMEX is sizeable. CEMEX came to market with its green perpetual bonds in 2023 and these have outperformed the broader market.

CEMEX is not the only Mexican company to watch from a transition investing perspective. Nemak, a global automotive parts manufacturing company – positioned as one of the leading providers of cylinder heads and engine blocks – is another interesting company. It is leading the way in electric vehicle (EV) transition having gained a number of prominent contracts to supply EV cars with its parts. Nemak has benefitted from strong contract wins to supply both the US and Europe, leveraging its position as a low-cost producer. During my research trip, I learned that the structural components that Nemak produces can be used in both internal combustion engines and EVs, making the company agnostic to consumer demand between the two. The company conveyed plans to deleverage over the next 18 months, with an ambition to be rated investment grade by all three agencies.

In summary

My trip to Mexico reinforced our constructive view on local corporate debt issuers, both by confirming the positive structural trends at play in the country and by reaffirming our conviction in the companies we invest in.

Since my trip, recent elections resulted in a larger majority for the incumbent populist party, Morena. However, early signs of pragmatism have allayed market concerns over a shift to an unsustainable path for Mexico's economy.

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