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Latin America's Middle Class Growth Slows, Tempering Prospects for Retailers, Banks and Homebuilders

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Over the last decade, strong economic growth, rising wages and increased social spending have lifted more Latin Americans into the middle class than ever before. Many businesses benefitted from this consumption led economic growth, from retailers to protein producers, and from captive finance companies to utilities. But recently growth rates have declined in much of the region and are not likely to rebound to levels seen during the past decade. Most countries, including those that have experienced the greatest gains in domestic demand, will likely see economic growth led by investment and government spending and not consumption as it has been in recent years. Should this slowdown in middle class consumption prolong or deepen, it will have negative credit implications for a wide range of Latin American debt issuers.

Consumer goods firms lose a growth engine. Companies that sell to Latin America's new middle class, especially those who only recently exited poverty, will likely see slower growth in the coming years than what was seen in the past decade. These include retailers, auto makers, homebuilders and airlines, and more specifically, sellers of high-ticket, credit-dependent, non-essential items. The slowdown is already apparent in much of the region, with economic conditions varying by country.

Argentina's consumption boom has gone bust. The country's rebound from its 2002 crisis was largely driven by consumption. This year, uncontrolled inflation, high interest rates and a painful recession have forced consumers to cut back drastically.

In Brazil, consumer-led growth has reached the point of exhaustion. High interest rates and already high levels of household debt will delay a rebound in consumer spending. However, companies are generally well prepared to weather the slowdown.

In Chile and Peru, an economic slowdown in 2014 is dampening consumer spending. In both countries, a decline in mining investments and lower global prices for their export commodities have led to slower growth. In Peru, a recovery in 2015 will be driven by stronger employment and firmer consumer confidence. In Chile, stimulus measures will lead to slightly stronger growth in 2015.

Mexico and Colombia are pulling ahead. Mexico's recent economic reforms will improve competitiveness, leading to faster growth that should benefit middle class consumers over the long term. In Colombia, consumer spending should hold at the current level as the economy continues to expand.

In our report, we detail the changes in economic growth and consumer spending in Argentina, Brazil, Chile, Colombia, Mexico and Peru, or the LATAM 6. We review the earlier expansion of the consumer class and the implications of slower consumer growth for their economies. We also look at which sectors and companies are most exposed to a slowdown in consumer spending, country by country.

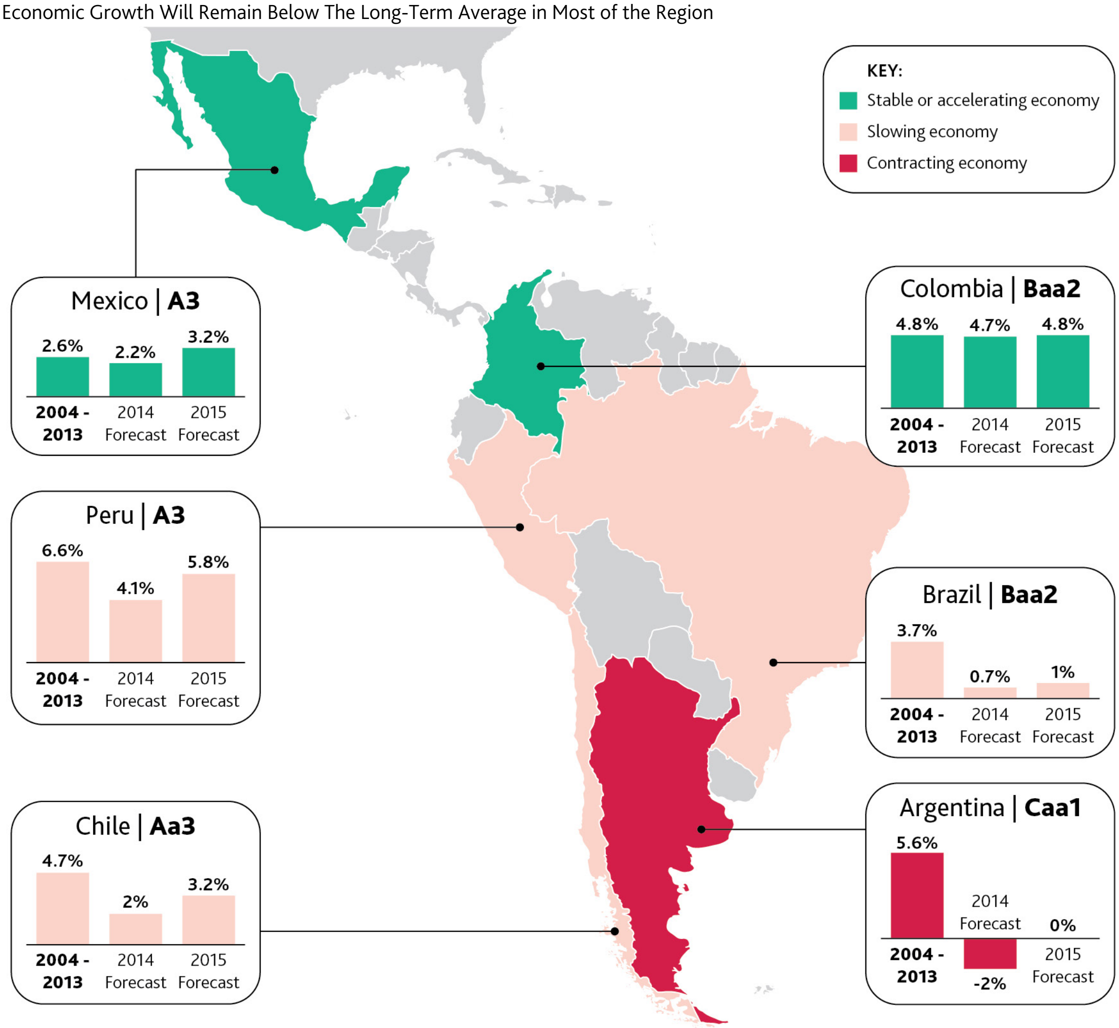
Latin American Consumers Are Cutting Back

Economic indicators are pointing to a slowdown in growth in most of the LATAM 6 at least in the near term. We are forecasting that growth in Argentina, Brazil, Chile and Peru will fall below each country's average growth rate experienced during the 2004-13 period (see Exhibit 1). Peru is decelerating but still growing faster than the rest of the region. In 2015, Mexico is the only country where we expect growth to exceed its historical average, but the country's economic activity has lagged the region's for years.

EXHIBIT 1

The LATAM 6 – Outlook is Dimming

Economic Growth Will Remain Below The Long-Term Average in Most of the Region



Source: Moody's Investors Service (forecasts); National Statistics Offices: INDEC(Argentina), INEGI(Mexico), DANE(Colombia), IBGE(Brazil), INE(Chile), INEI(Peru) (2004-2013)

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

In the first half of 2014, economic growth in most of the LATAM 6 countries was lower than most economists' forecasts. Lower external demand and other country-specific factors have negatively affected consumption and investment which in turn are driving the economic deceleration.

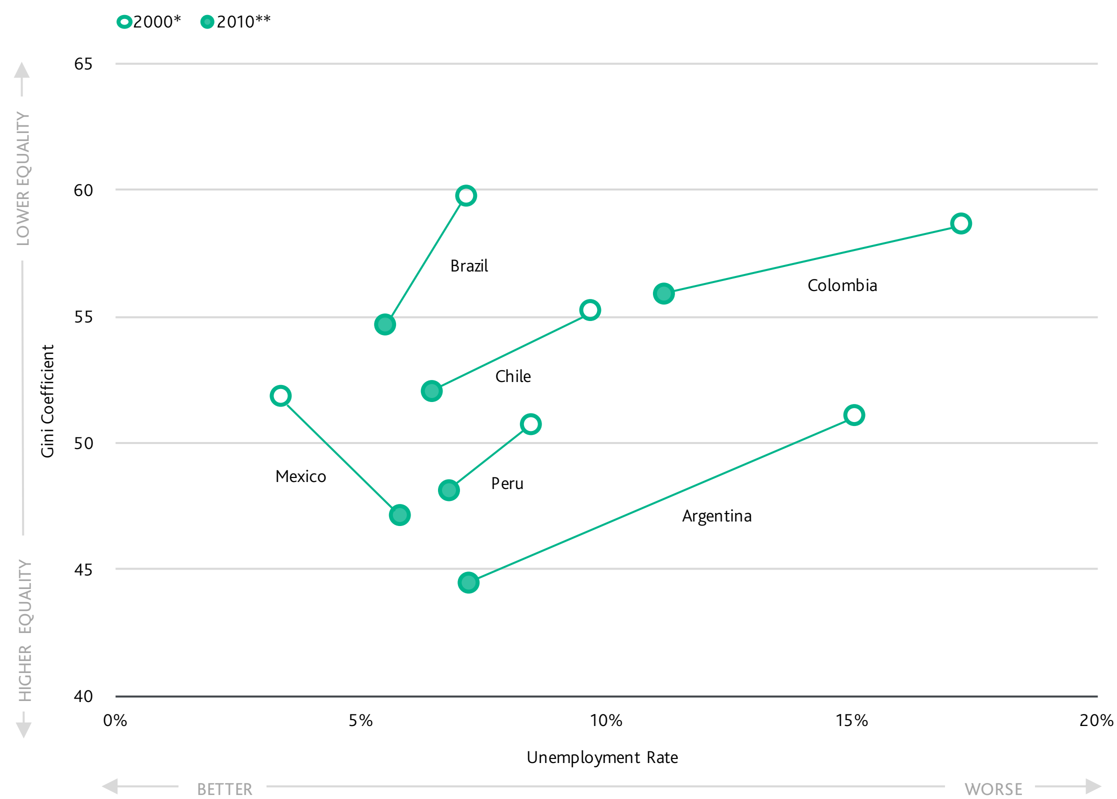
While we expect growth (other than in Argentina) to accelerate somewhat in 2015, consumers will not be leading the recovery. In Mexico, the most likely growth drivers are government spending and stimulus from a more dynamic US economy. In Peru, government spending and mining investment will drive growth, while in Colombia, government spending on infrastructure should help the country maintain a steady pace of growth. While Chile may see a slight rebound in consumption in 2015, provided that consumers respond to recently unveiled stimulus measures, it will not rise to the levels of recent years.

The recent slowdown follows a period of rising economic mobility

According to the World Bank,[1] in the decade before 2010, when the region was growing more rapidly, a structural socioeconomic shift took place. Across the region, the middle class expanded by 50% to 150 million people. GDP per capita increased 31% to $10,500 from $8,000, and income inequality fell, as demonstrated by the Gini coefficient, which decreased steadily from 0.57 in 2000 to 0.52 in 2010.

EXHIBIT 2

Employment Has Increased and Inequality Has Decreased



* Data for Brazil are for 1999.
** Data for Brazil and Chile are for 2009.
Source: Moody's Investors Service, data from CEPAL and The World Bank

Roughly 70% of the poverty reduction in Latin America is the direct result of higher wages and salaries as formal employment grew. With the exception of Mexico, where the unemployment rate has been relatively stable at 5%, the region has also made remarkable gains in employment. The largest decreases in joblessness have occurred in Brazil, Peru and Colombia (see Exhibit 2). These improvements in the labor market have been accompanied by reductions in structural unemployment, with Colombia achieving the largest gains.

[1] See Social Gains in the Balance. A Fiscal Policy Challenge for Latin America and the Caribbean, The World Bank, February 2014.

Not all of the formerly poor workers migrated directly to the established middle class. Some now fall between poverty and the more economically secure traditional middle class. Many of those who only recently left poverty remain in a state of vulnerability, and there is a significant chance they would slide back into poverty, at least temporarily. This "vulnerable middle class" now constitutes the largest single economic group in the region and is a bigger demographic cohort than the poor (see Exhibit 3).

The degree of economic mobility varied in the region, with Colombia (which started at the lowest level among the LATAM 6), Brazil and Peru achieving the largest gains in economic migration. Although the "vulnerable middle class" increased somewhat in Mexico, improvements reversed following the 2008 global financial crisis. In Argentina, a new economic recession has been hurting consumers, reversing some of the recovery that the middle class experienced in the last decade.

Despite these improvements, Latin America lags other regions where growth of the middle class has been more robust, such as Eastern Europe and Central Asia. More recently, poverty reduction has slowed, in tandem with slowing economic growth. A significant decline in real wage growth would imply weaker consumption and may have negative credit consequences for firms exposed to the consumer sector.

How is Latin America's "Middle Class" defined?

Class is strictly defined in income terms, not status or life style. The World Bank's middle class thresholds are US$10 – US$50 PPP (Purchasing Power Parity) per capita per day in the LATAM 6 countries.* People with incomes between US$4 and US$10 PPP per capita per day are defined as the vulnerable class. This segment of the broad middle class represents roughly 40% of the region's population. People with incomes below US$4 per day, the poverty line in the region, are defined as poor.

The rough size of the middle class, excluding the vulnerable middle class, varies by country in ascending order as follows: Colombia (23%), Mexico (26%), Peru (26%), Brazil (32%), and Chile (42%).**

Middle class households in Latin America comprise 3 to 4 people. In richer countries, such as Brazil and Chile, households are smaller, while in poorer countries they are larger. On average, there is less than one child per household. The average age of the household head is 50 and the average years of education of adults rises exponentially with the family income. For example, in Chile and Peru, middle class adults have completed close to 12 years of schooling, the highest in the region. Members of the middle class are primarily employed in the private sector.

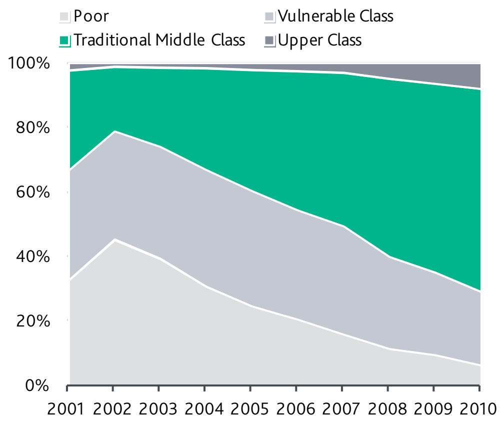
* See Economic Mobility and the Rise of the Middle Class, The World Bank, 2013

** Uruguay, not among the LATAM 6, has the largest middle class (55%) and the smallest share of the poor (less than 10%).

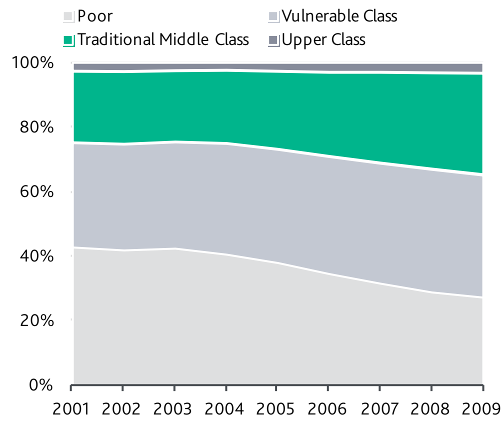
EXHIBIT 3

A Structural Shift – The Middle Class Has Grown

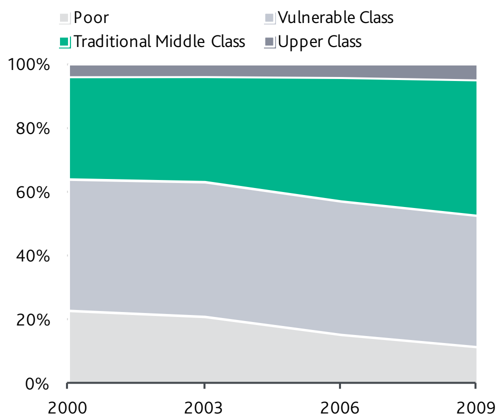
Argentina (Urban)



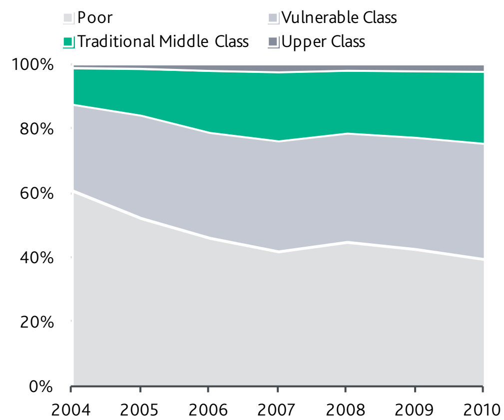
Brazil



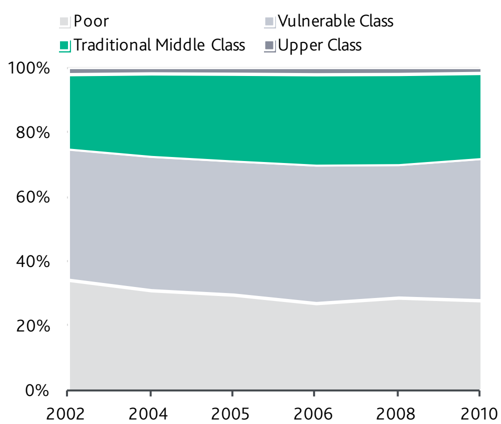
Chile



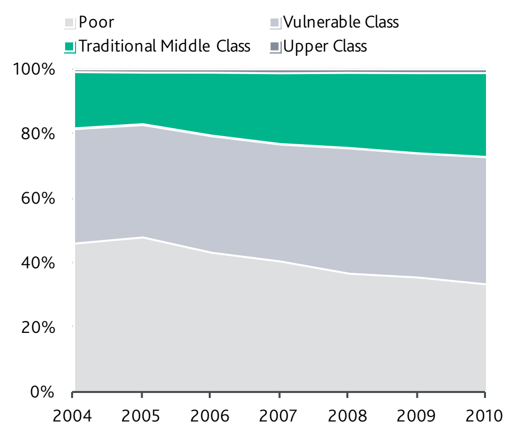
Colombia



Mexico



Peru



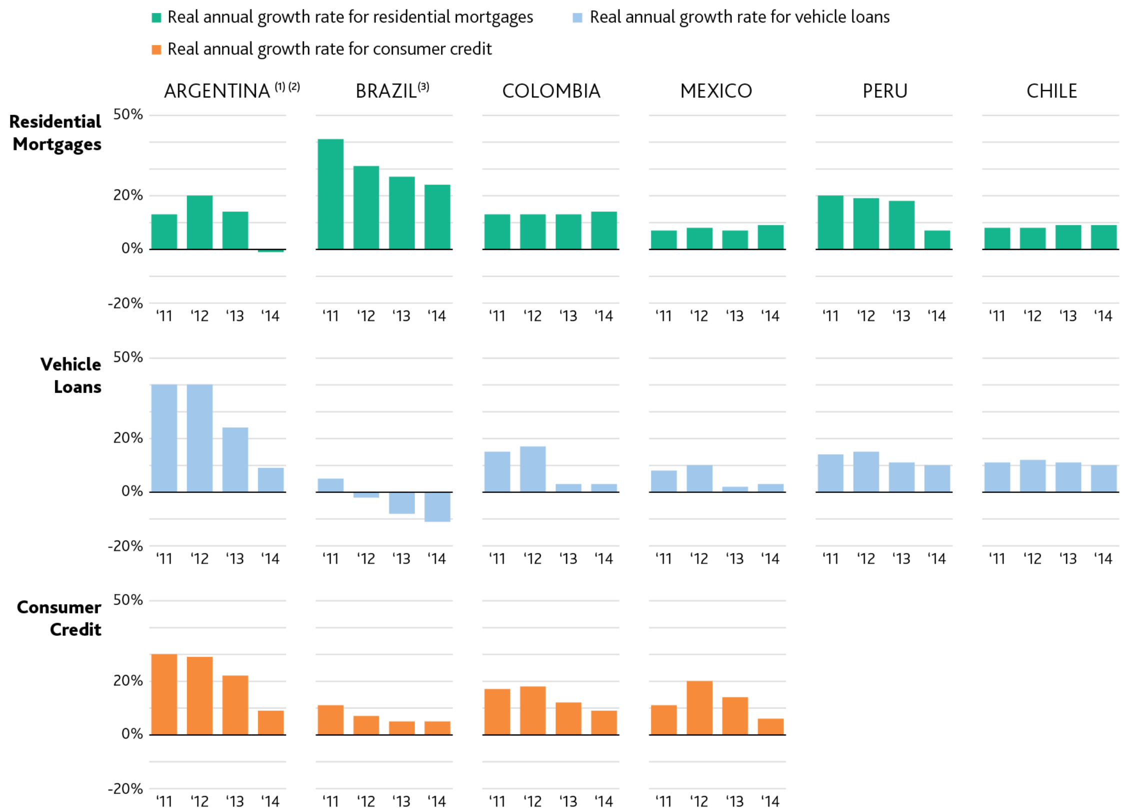
Source: Economic Mobility and the Rise of the Middle Class, The World Bank, 2013 Source: Moody's Investors Service, data from POVCALNET.

Consumer credit has become more accessible, but credit growth is slowing

Although access to consumer credit in Latin America remains below the levels in other emerging economies, rising wages associated with faster economic growth enabled an expansion in the availability of credit in many countries. Despite this, the growth of the main loan products used by middle class consumers has declined in every country in LATAM 6 (see Exhibit 4). In Brazil, for example, vehicle lending has declined three years in a row, causing a contraction in the country's auto industry. This is partially due to the fact that household debt in Brazil had previously surged, reaching levels at which consumers could not afford additional debt-financed consumption.

EXHIBIT 4

Consumer Credit Growth Is Declining



Notes: All figures adjusted for consumer-level inflation in each country. (1) Pledge loans, including personal vehicle and agricultural machinery financing; (2) personal loans and credit cards; (3) personal loans, credit card, overdraft and general goods financing.
Sources: Moody's Investors Service, based on data from Banco Central de la República Argentina; Banco Central do Brasil; Superintendencia de Bancos e Instituciones Financieras de Chile; Superintendencia Financiera de Colombia; Comisión Nacional Bancaria y de Valores de México; Superintendencia de Banca, Seguros y AFP de Perú.

Weaker private sector consumption will weigh on economic growth in the medium term

Household consumption has been a net contributor to growth across the region since 2001 (see Exhibit 5). The boom in commodities exports jump-started growth in the last decade, but domestic consumption became the key driver of the economy.

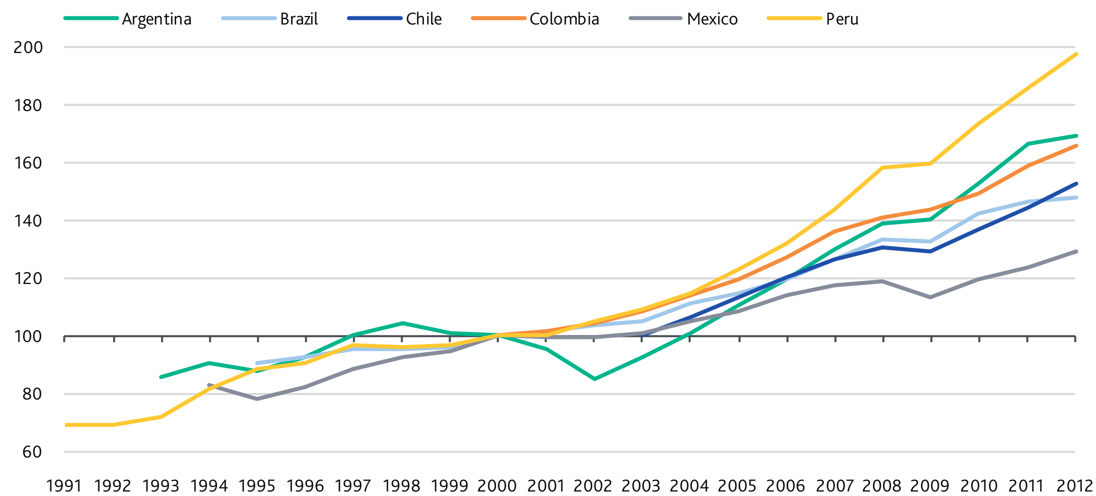
In Brazil, Chile and Peru, high levels of investment have supported economic growth, but consumption has been an important driver as well. Private consumption has also been the main net contributor to growth in Mexico. Meanwhile Argentina, which saw a consumption boom in the last decade, is now experiencing a painful recession led by a drop in consumer demand.

Economic growth, globally and in each of the LATAM 6, will continue to drive economic mobility and consumer purchasing power. However, for a variety of global as well as country-specific factors, consumption will not likely drive growth in the medium term in the LATAM 6. Purchasing power growth is also likely to be weaker than in previous years. This less favorable environment will create challenges for a number of companies and banks operating in Latin America.

EXHIBIT 5

Private Consumption has Contributed Significantly to Growth

Index 2000 = 100



Source: Moody's Investors Service calculations based on data from National Statistics Offices: INDEC(Argentina), INEGI(Mexico), DANE(Colombia), IBGE(Brazil), INE(Chile), INEI(Peru)

Insurance, a Bellwether for Latin America's Middle Class

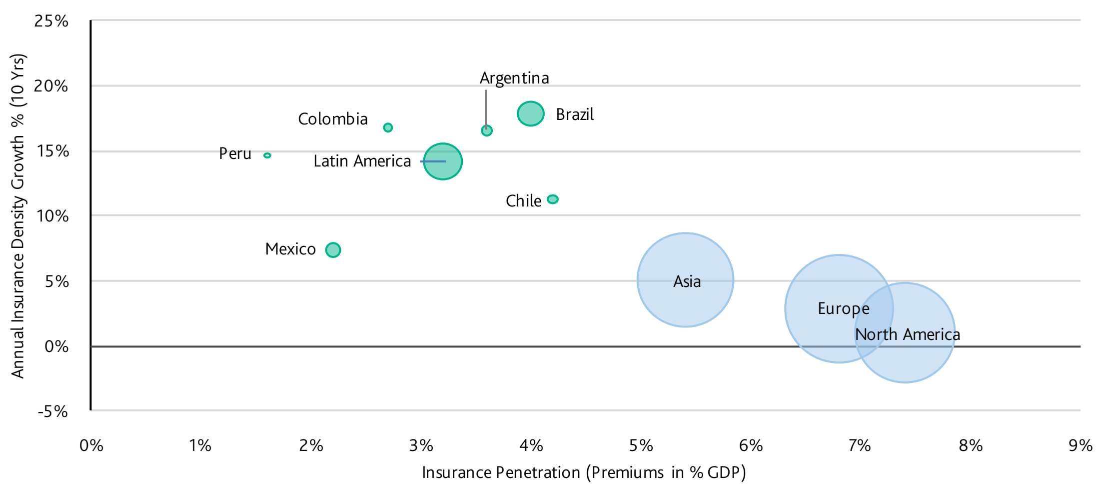
A slowdown, stagnation or regression of income growth affecting Latin America's middle class would have a dampening effect on the insurance sector in the region for which a rapidly expanding middle class has been a key driver of growth over the past decade. Sales of insurance products – which provide asset, income, health and credit protection, as well as longevity protection through retirement savings vehicles – have experienced considerable growth as a result of sharply increased earnings, savings and consumption of consumer goods by the region's middle class. Insurance, therefore, parallels the countries' economic and social development, and Latin America has been the fastest growth region worldwide for insurance over most of the past decade (see Exhibit 6).

Pension and Life insurers would be most negatively affected by a slowdown. Demand for these products has surged thanks to rising incomes and increased concern among the population about the future adequacy of social security programs. In addition, these products have benefited from the subdued inflationary environment in most of the major economies. Brazil, Mexico and Chile account for most of this growth, due to the high degree of development of the private pension markets. Consequently, a decline in salary growth and/or disposable income would impair savings, reducing flows to private pension and life products. Nevertheless, the industry's asset profile would be relatively unaffected, given that most of these products are tax-advantaged and are not subject to withdrawal or disintermediation by policyholders.

By contrast, **Property and Casualty** insurers would be considerably less affected, because of the legally mandatory nature of most of these protections. The automobile insurance line is the largest product segment in the region and has been among the fastest growing over the past decade, in large part because of the vast expansion of credit available to middle class consumers. Although growth in the sector is correlated to new auto purchases, legally mandated coverage provides a very significant buffer against contraction.

EXHIBIT 6

LATAM is the World's Fastest Growing Insurance Market



Notes: (1) Insurance Density is the ratio of total insurance premiums (in US dollars) to total population, and is a component of Moody's Insurance Operating Environment Score for each country; (2) Insurance Penetration is the ratio of total insurance premiums to total GDP, and is also a component of Moody's Insurance Operating Environment Score for each country; (3) the size of the bubbles represents total premiums in US dollars as of 2013.

Source: Moody's Investors Service, data from Sigma – Swiss Re

With respect to credit implications, and despite the varying sensitivities of the different product segments, we do not foresee significant credit deterioration risk for insurers in comparison with other industry sectors, as insurers' operating performance is generally based on fortuitous non-economic loss, and exposure to credit losses from customers are generally limited. That said, given the generally open-competitive environments in Latin America's insurance markets, we would expect to see increased pressure on premiums rates should business opportunities decrease, as insurers would likely seek to preserve their market share, potentially undermining their underwriting discipline and possibly leading ultimately to credit deterioration.

Argentina

The ongoing decline in Argentina's economy threatens to unwind much of the progress made in the social recovery that followed the 2001 sovereign default and the resulting economic crisis, though we do not expect conditions to deteriorate to the same level. According to the World Bank, which relies on official economic data, the middle class as a share of the total population grew to 57.2% in 2009 from 43.5% in 2003. Labor market conditions in this period were favorable, and the unemployment rate gradually fell to 7.0% in 2013, from a post-crisis high of 20.4%. A boom in consumption ensued.

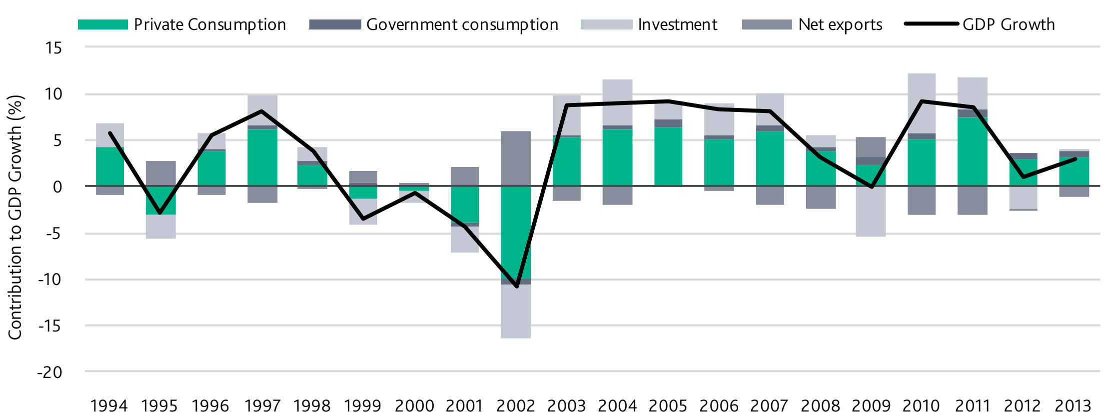
Private consumption was the main contributor of growth until 2013, when the economy began to weaken (see Exhibit 7). Private consumption was driven by negative real interest rates on bank deposits, which added momentum to an already high propensity to consume. In addition, foreign exchange controls trapped cash inside the country, stimulating spending on autos as well as other goods and services. However, in the past year, the effect of both high inflation and declining nominal wage growth have undermined consumer demand, resulting in a contracting economy that is likely to lead to higher unemployment and a decline in real wages. In addition, the government's sovereign default in July will continue to limit funding options for businesses, and lead to further devaluation of the peso, which will add to inflationary pressures.

We expect that GDP will contract by 2% in 2014, marking a substantial worsening of the recession that began in the fourth-quarter 2013. We also expect that inflation will rise to as high as 40%.

EXHIBIT 7

Argentina's Consumption Boom Has Come to an End

The Latest Sovereign Debt Default Will Deepen the Recession



Source: Moody's Investors Service calculations based on data from INDEC

Corporate debt issuers in Argentina that rely on sales in the domestic market benefited from the recovery of the middle class, which gained easier access to consumer credit during the past decade. However, the unfolding recession makes these issuers vulnerable, given that demand for their products is sensitive to consumers' spending priorities. The following companies are exposed to the purchasing-habits and -power of the country's salaried class.

» In the consumer goods segment, **Pilisar S.A. (Caa3 stable)** is suffering from ongoing losses, weak liquidity and high debt. **Newsan S.A. (B3 stable)** and **Longvie S.A. (Caa1 negative)**, on the other hand, benefit from very low leverage, with debt levels at less than 1x EBITDA.

» Retailer **Carsa S.A. (Caa1 negative)** is vulnerable on two fronts. As the firm operates only domestically, deteriorating consumer demand will negatively affect its sales of consumer electronics and appliances. In addition, reduced market liquidity and diminished access to securitization funding heighten refinancing risks.

» Auto sales will drop in 2014, leading to losses in the industry. Firms that are vulnerable to weak demand for cars include **Mirgor S.A. (Caa1 negative)**, a small climate control equipment manufacturer that relies on the car industry for 25% of revenues, and **Car Security S.A. (Caa1 negative)**, which markets recovery systems for stolen vehicles and related servicing. However, Car Security's services business and its more secure flow of revenue from insurance companies will help mitigate the business risk associated with the recession.

» Frozen foods producer **Quickfood S.A. (Caa2 stable)** already has a weak credit and financial profile, and the decline in consumer demand will further strain its financial performance, especially in the highly competitive food industry. However, because food spending is less discretionary, the food industry is not as vulnerable as other consumer goods segments.

Bank lending and securitizations

The lending rate in Argentina is distorted by both high inflation and the interest rate caps imposed by Argentina's central bank on personal loans, credit cards and auto loans. As the economy worsens, the distortions become more acute. Year to date, loan origination volumes have been declining between 20% and 30%.

» Financial institutions that are more vulnerable to this environment include **GPAT Compañia Financiera S.A. (B2 negative)**, **PSA Finance Argentina (Caa2 negative)** and **Banco Cetelem Argentina (Caa2 negative)**, which specialize in auto loans.

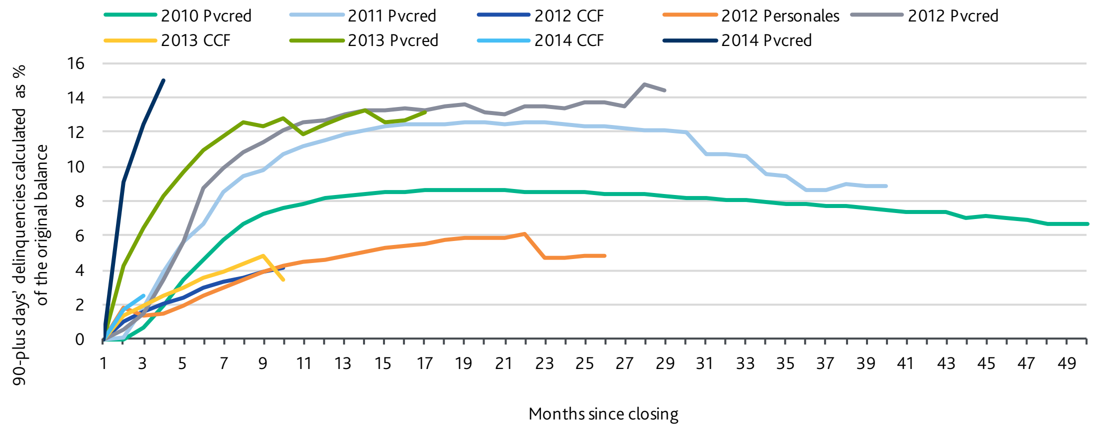
» The decline in consumption and deterioration in asset quality will hurt **Cordial Compañia Finaciera S.A. (Caa2 negative)** and **Compañia Financiera Argentina S.A. (Caa2 negative)**, which offer unsecured personal consumption loans.

The domestic securitization market, although small, has provided an alternative funding option to consumer finance companies. Unsecured consumer loans constitute the largest asset class of asset-backed securities (ABS) in Argentina. Approximately 70% of securitization issuance in 2014 is backed by consumer loans, personal loans, or credit card receivables.

The asset quality of securitizations of unsecured consumer loans, especially those originated by consumer finance companies and backed by non-direct-debit loans, will deteriorate. As a result of the recession, consumers will be more likely to miss loan payments, and delinquencies and defaults in collateral pools will rise. Some loan securitizations issued in 2014 are already performing worse than issues from the same sponsor sold a year earlier (see Exhibit 8).

ABS backed by personal loans with payments automatically deducted from the borrower's paycheck or debited from the borrower's checking account (direct debit) will perform better. Protection features such as automatic deduction in securitization structures will generally support the credit quality of these securities as the economy deteriorates.

EXHIBIT 8
Rising Consumer Delinquencies Lead to a Decline in Argentine Securitization Performance

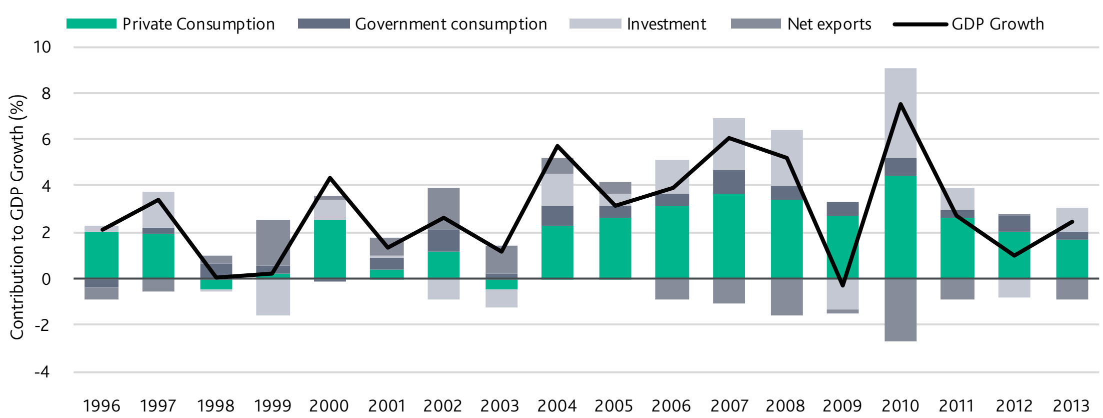


Source: Moody's Investors Service, Moody's Performance Data Service, periodic investor/servicer reports

Brazil

Although the long-term outlook for Brazil's middle class remains positive, consumer and investor sentiment has been worsening significantly for three years now, leading to substantially lower growth than the long-term average. In 2014, we expect that GDP will grow only 0.7%, significantly lower than the 3.7% average during 2004-13 (see Exhibit 9). Lower consumer demand will affect to varying degrees the industries and companies discussed here, which are part of the most diverse portfolio of rated companies in Latin America.

EXHIBIT 9
Brazil Has Latin America's Most Diversified Economy



Source: Moody's Investors Service calculations based on data from IBGE

Homebuilding

The Brazilian homebuilding industry stands out for its high revenue exposure to the middle class. Even so, supportive government policies channeled through large-scale housing aid programs such as Minha Casa Minha Vida (MCMV), along with an unsatisfied demand for housing, somewhat mitigate the negative implications of a deceleration in consumption. Lenders have benefitted from a strong legal framework which streamlines the collateral process, and from low delinquency rates on home loans, allowing them to continue offering mortgages despite the economic slowdown.

The country's homebuilding market experienced unprecedented growth between 2007 and 2011, driven by the country's economic expansion and the higher purchasing power of an emerging middle class. Despite accelerated housing construction in recent years, Brazil still has a large housing deficit of about 5.4 million units. Launched in 2009, the MCMV program aims to reduce this deficit. So far, the program has delivered 1.6 million units out of a planned 3.6 million. The program offers mortgages at below-market rates, extended maturities and subsidies to low- to middle-income homebuyers.

Since 2012, Brazilian homebuilders have endured more challenging business conditions as a result of higher costs and contract cancellations driven by the rise in household leverage in the low-income segment. Currently, housing prices are growing at rates close to inflation, and we do not foresee a housing bubble. However, limited price adjustments, particularly in some cities in the Brazil's north and northeast, where housing supply has outpaced the demand growth, are likely. An increase in unemployment and/or a drop in disposable income could further hurt housing prices.

» Moody's-rated homebuilders are exposed to concentration risks related to their reliance on sales to lower middle class households, with income levels above BRL5,000 per month and residential unit prices between BRL200,000 and BRL750,000. However, many firms, including **Brookfield Incorporações (B1 negative)**, **Gafisa (B1 negative)**, **PDG (B1 negative)**, **Viver (Caa1 negative)**, **Even (Ba3 stable)** and **Cyrela (Ba2 stable)**, have managed to minimize that risk by diversifying into other residential income segments and into commercial construction. In addition, funding for middle class home purchases is supported by other long-term housing financing programs, further reducing business risks for builders.

Commercial real estate

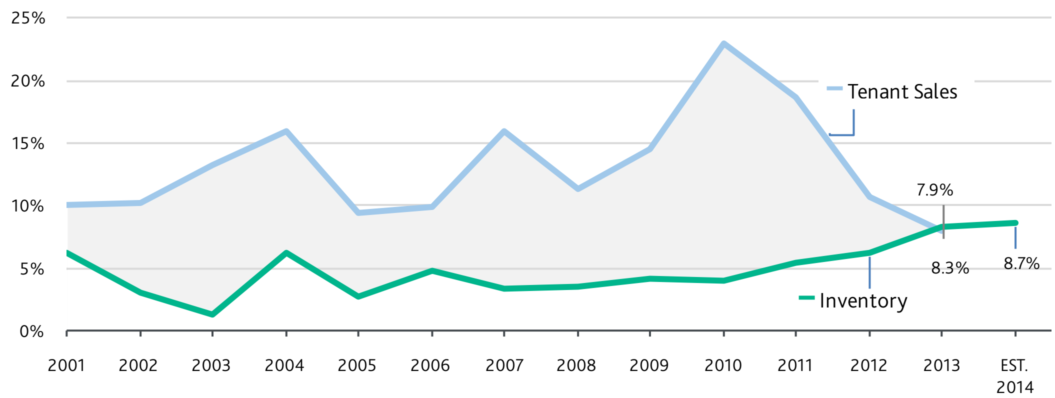
The growth of the middle class in not only Brazil but also other countries of Latin America over the past 10 years has resulted in an expansion of commercial real estate, especially in the retail, industrial and office sectors.

Slower economic cycles tend to result in lower retail sales, higher unemployment and lower levels of international trade as a result of reduced demand. The decline in purchasing power of the middle class will have a negative effect on commercial real estate tenants first, then landlords who are somewhat protected because they sign long-term contracts with tenants. In addition, rated Latin American commercial real estate companies benefit from well-diversified portfolios of properties and a variety of tenants, reducing exposure to weaker performance at any single property or tenant.

The general trend in Brazil has been towards a reduction in ground-up development, which is highly capital-intensive, as supply has begun to surpass demand. In the shopping mall market, for example, the growth of mall inventory has surpassed growth in tenant sales (see Exhibit 10). As a result, rated commercial real estate companies in Brazil have halted all new development projects and are focusing on managing their core portfolios.

EXHIBIT 10

Brazilian Shopping Mall Inventory Growth Has Exceeded Tenant Sales Growth Since 2013



Source: Moody's Investors Service, based on data from ABRASCE

Retail

Most of the retail segments will experience slower sales growth in the near future as a result of declining consumer confidence and credit availability, which makes consumers more cautious in their spending habits, especially those with lower incomes. However, secular trends, such as demographics, rising incomes, acquired consumer habits and the very low penetration of many consumer product categories, should support further expansion of Brazil's retail market.

Brazilian retailers to watch include the following:

» Packaged goods company **Hypermarcas (Ba2 stable)** sells only in the Brazilian market and has a high level of exposure to the middle class. Nevertheless, the company will continue to grow faster than the broader market as it benefits from offering a wide range of low-ticket items that remain affordable to middle class consumers. In addition, the firm has a strong financial position, with sufficient cash on hand to cover short-term debt.

» **Brasil Pharma (B1 negative)**, a pharmaceuticals retailer, is somewhat protected from a slowdown in spending because of the non-discretionary nature of its products. The market will likely continue to see secular growth over the long term. However, the firm has suffered operating losses, and its leverage indicators are weak.

» In the food and beverages segment, sales continue to grow. Large players, such as **Ambev (A3 stable)** and **BRF (Baa3 stable),** are heavily exposed to the middle class customer, with domestic sales accounting for 60% of each firms' consolidated revenues. However, both are well positioned given their scale, dominant market share, strong brands and their broad product portfolios.

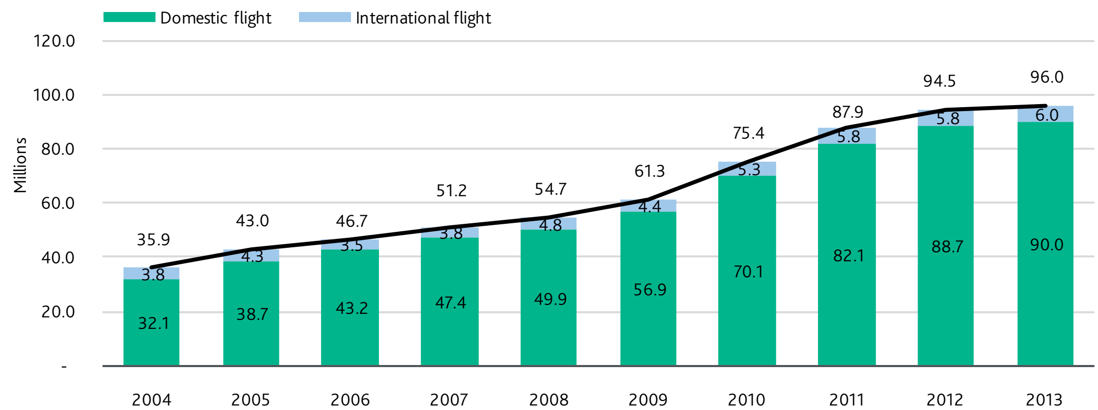
» Retail fuel distribution could also experience earnings volatility as new car sales decline. However, Brazil's active used car market and the increase in the country's fleet in recent years partly mitigate business risks. The strength of this specific segment of the auto market will continue to favor companies such as **Ultrapar (Baa2 stable)** and **Raízen (Baa3 stable).**

Transportation, logistics services and toll roads

Leisure travel is highly correlated with consumer confidence and purchasing power, as it is discretionary. A decline in leisure travel would hurt revenue for airlines, car rental firms and toll road concessionaires. However, certain Brazilian firms could still benefit if travelers choose to vacation domestically instead of abroad, or more generally vacation closer to home.

» **GOL - Linhas Aereas Inteligentes S.A. (B3 positive)**, a leading Brazilian airline, relies primarily on revenues from business travel, which accounts for 65% of all Brazilian passenger traffic, and is highly correlated with the country's economic conditions. Airline traffic volume in Brazil, which has grown 11.5% annually over the past decade, has declined in the past year but remains strong (see Exhibit 11).

EXHIBIT 11
Passenger Volume at Brazilian Airlines Remains Strong



Source: Moody's Investors Service, data from Agencia Nacional de Aviação Civil – ANAC

» **Localiza Rent a Car (Baa3 stable)** relies on leisure travel for 15%-20% of total rentals. However, it has a much larger base of business traveler clients, which somewhat reduces the risk associated with a downturn in consumer demand.

» In the past 10 years, light vehicle traffic on Brazilian toll roads has surged from 411 million vehicles to almost 1.2 billion vehicles per year, fueled by an expansion of the middle class. Toll road operators depend on steady toll revenue growth to meet their financial and contractual obligations. Concessionaires, including **Concessionária Auto Raposo Tavares S.A. – CART (Ba2 stable)**, **Rota das Bandeiras S.A. (Ba1 stable)**, and **Concessionária Das Rodovias Ayrton Senna e Carvalho Pinto S.A. (Ba2 stable)**, are required to make large capital investments pursuant to their concession contracts, leaving them most exposed to a slowdown in toll road usage.

Industrials

Producers of consumer durables oriented to home construction, auto manufacturers and appliance makers will face a more challenging environment.

» In the steel industry, **Usiminas (Ba2 stable)** relies on the automotive industry for about 32% of domestic sales, while 17% of sales are to construction and consumer durables. **CSN (Ba1 stable)** is less exposed, with about 20% of steel sales to the automotive industry and 11% to consumer durables. Likewise, **Tegma Gestão Logística S.A. (Ba2 negative)** is the largest logistics company for the automotive industry in Latin America and is facing a difficult business climate as a result of the drop in car sales and reduced availability of vehicle loans.

» **Votorantim Participações (Baa3 positive)** is exposed through its cement operations as 69% of total sold volumes of **Votorantim Cimentos (Baa3 stable)** are offered in bags, most of which are used in home construction.

- **Braskem (Baa3 Negative),** a petrochemicals producer, is also at risk, given that the company supplies goods, packaging, building materials and other products associated with middle class consumption.

Power Utilities

From 2005 to 2009, Brazil added 20 million new electricity consumers. Higher purchasing power and greater access to consumer credit allowed many consumers to acquire new household appliances, which contributed to an increase in electricity consumption. If demand declines, the power generating companies will report lower profits. However, net cash balances will not be affected, because lower operating cash flow will be counterbalanced by lower capital expenditures. **Transmission companies** will be the least affected given that revenues are fixed as long as their distribution lines remain available.

If demand declines significantly, planned investments in power generation and transmission could be delayed because the federal government will reduce the size of investments required to participate in electricity auctions.

- Profits will diminish at distribution firms with a larger residential consumer base. Among these are **AES Eletropaulo (Ba1 stable),** which derives 45% of sales from residential customers, followed by **Light SESA (Ba1 stable),** with 41% of sales from residential clients, **CELTINS (B2 positive)** and **COELBA (Baa2 stable)**, each with about 39%. As investment declines, these firms will have to distribute their fixed costs across a smaller pool of assets, which will weigh on profitability.

Banking

In Brazil, the increase in the purchasing power of low- and middle-income consumers over the last decade was closely matched by credit expansion. Macroeconomic stabilization, lower interest rates and falling unemployment strengthened households' capacity to consume, which in turn stimulated the demand for residential mortgages, vehicle loans and general goods financing.

Rapidly growing consumer credit, coupled with larger banking penetration, proved to be a sizeable source of earnings for the banks. In 2010, expenditure on financial services from the middle class as a whole was 29% larger than the amount spent by the high-income segment, according to data from the World Bank.

- Large universal banks have become more selective, shifting focus away from unsecured credit towards mortgages and payroll-linked loans, which have lower risk. These banks include **Banco do Brasil S.A. (Baa2 negative)**, **Itaú Unibanco S.A**. **(Baa2 negative)**, **Banco Bradesco S.A. (Baa2 negative)**, **Banco Santander (Brasil) S.A. (Baa2 negative)** and **HSBC Bank Brasil S.A. – Banco Múltiplo (Baa2 negative)**.
- Consumer-oriented mid-sized lenders such as **Banco Pan (Ba2 stable)** and **Banco Votorantim S.A. (Baa2 negative)** have also become more selective, but deleveraging has become more challenging because of their more limited options.
- Government-owned **Caixa Econômica Federal (Baa2 negative)** drove the expansion of housing finance towards low-income segments and continues to expand in all product lines, bucking the trend seen at privately owned banks. As a result, Caixa is the most vulnerable to a prolonged recession or period of high unemployment which would lead to a rise in nonperforming loans (NPLs).

Securitization

Consumer credit from banks and financial companies is closely intertwined with securitization, as it provides additional funding for expansion as well as a credit risk management tool. Policy makers have raised interest rates to control inflation which currently is at the top of the central bank's target range. Interest rate hikes will erode borrowers' purchasing power, leading to a mild deterioration of existing auto loan portfolios, especially for subprime borrowers and for used vehicles. The collateral quality of newly securitized loans will also weaken as some lenders relax their underwriting standards to accelerate origination. This decline in collateral quality is more likely to occur in the portfolios of banks and financial companies focused on subprime borrowers and/or used vehicles.

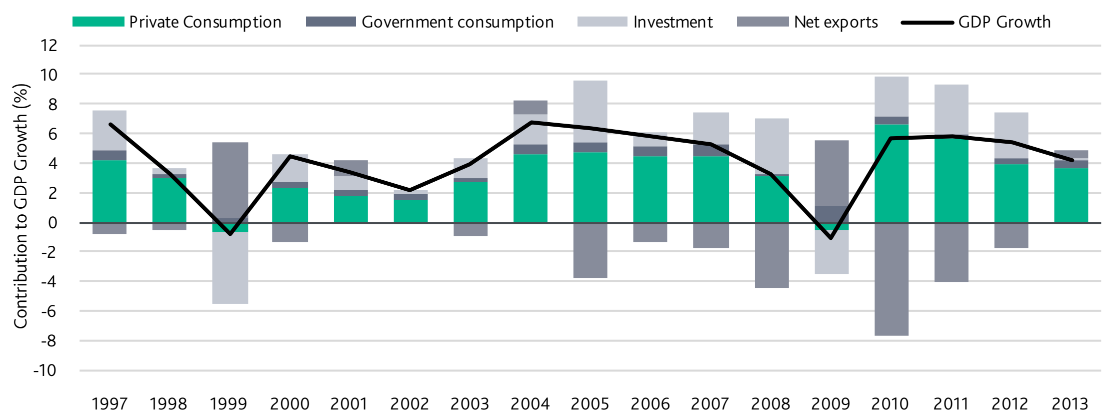
Chile and Peru

Chile and Peru have suffered in recent months as global prices for their commodities exports have declined, and investment in the mining sector of each country has slumped.

In Chile, uncertainty surrounding the economic and financial impact of structural tax reform has led to a decline in both business and consumer confidence. Inflation is rising and the peso is depreciating more than most emerging market currencies. We expect the Chilean economy to grow only 2.0% in 2014, compared with the average of 4.7% in 2004-13, on account of stimulus measures and higher external demand (see Exhibit 12).

EXHIBIT 12

Recently Chile's Economic Growth Has Depended More on Consumption than on Exports

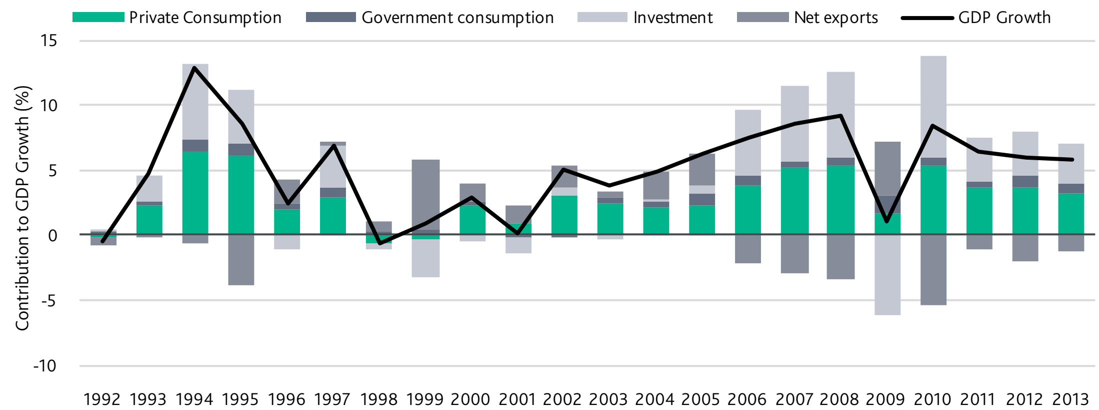


Source: Moody's Investors Service calculations based on data from INE

In Peru, business confidence and investment declined in the first half of 2014, reflecting investors' concerns about global demand for the country's mining exports. In addition, an inefficient bureaucracy at the local and regional level has created more impediments to investment. While authorities have sought to reduce these burdens, reforms will not begin to have a positive effect until next year. We forecast that growth this year will decelerate to 4.1%, compared with Peru's long-term 6.6% average. For 2015, we expect that recovery in exports, improvement in consumer confidence and rise in government spending will fuel pick-up in growth to 5.8% (see Exhibit 13).

EXHIBIT 13

In Peru, Investment Has Become a Key Growth Engine



Source: Moody's Investors Service calculations based on data from INEI

Consumer-oriented companies to watch in Chile and Peru include the following:

» **Cencosud (Baa3 negative),** a Chilean retailer, derives 74% of its revenue from supermarket sales. The rest of its revenue comes from home improvement stores, department stores, financial services and shopping centers. Home improvement and department stores will be the segments most affected by weaker demand from the middle class. However, their contribution to total net income is low, at 14%.

» **SMU (Caa2 rating on review for downgrade),** another Chilean supermarket retailer, has seen a decline in performance, as reflected in its weak credit metrics, including high leverage, low interest coverage, and negative free cash flow generation. The company's track record as an integrated retailer is limited. SMU defaulted on a portion of a syndicated loan; this non-payment event, if not remedied, could trigger a default on its cross-border bonds. SMU's restructuring plan, which includes selling its construction and home improvement retail segments, should help alleviate some of the financial distress.

» **Automotores Gildemeister (B2 negative)**, a Chilean auto retailer, is vulnerable because automobile purchases are discretionary and the depreciation of the Chilean peso has reduced consumers' purchasing power. The company is also losing cash as a result of its high leverage. Nevertheless, the firm's position as one of the country's top automotive firms, with businesses including imports, distribution, retail, and auto servicing, position it well to take advantage of a rebound in growth over the long term.

» **Maestro Perú (Ba3 negative)** has a leading position in the home improvement retail industry and would be vulnerable to a decline in middle class consumer demand. The company has a weak liquidity profile, and its leverage ratios have deteriorated over the last four years. A decline in revenue would negatively affect its credit metrics and increase funding costs. Although the company could cap its expansion plans to strengthen its liquidity, a prolonged devaluation of the sol would increase leverage and hurt cash flow, given the high portion of the company's US dollar-denominated debt. We view the acquisition by **Grupo Falabella (unrated)** as a credit positive event. Falabella is one of the largest retailers in Latin America.

» **Intercorp Retail (Ba2 stable),** another Peruvian retailer, would also be vulnerable to a slowdown of the economy that hurts the middle class. Like other Peruvian and Chilean companies in the retail segment, it is highly leveraged. However, the company has a strong market position and its dependence on middle class consumers is limited because of its multiple supermarket store format.

Banking

In Peru and Chile, banks have experienced double-digit consumer credit growth since the 2008 financial crisis, capitalizing on strong economic growth, rising wages and credit demand to build up recurring earnings. Although economic growth has slowed to below trend in both countries, credit demand in the consumer segment remains relatively healthy because of low inflation and interest rates. In Chile, annual per capita income has been growing, on average, by 6.5% a year on a PPP basis in US dollars, and is currently about $15,800, the highest in the region. In Peru, per capita income growth has been even faster, rising 7.5% a year to $6,700.

Nevertheless, economic growth has slowed in Chile and Peru, which has led to a slight increase in unemployment from historically low levels. Because of lower growth expectations and the potential for increased loan delinquencies, banks in both countries have tightened their credit standards. However, a credit crunch is not likely because banks' consumer exposures, which are generally considered higher-risk, are lower than the banks' commercial lending exposures, at just over one-third of total loans. Nonperforming loans also remain manageable, as the bulk of consumer exposures are related to secured mortgage products.

Peruvian banks' higher rates of loan growth in recent years make them more vulnerable to a weakening of middle class credit-worthiness, particularly because the middle class is a less tested customer base. However, after peaking at 22% in 2011, consumer credit growth in Peru declined to 16% in 2012 and to 12% in 2013 and the first half of 2014. Mortgage lending growth has also slowed, rising 14% in the first half of 2014, after expanding 23% on average between 2010 and 2013. These declines reflect not just slowdowns in growth and consumer demand, but also the impact of regulators' tighter capital and liquidity rules since 2012, which have curbed banks' consumer risk appetite.

» In Peru, the largest lenders to consumers are **Banco de Crédito del Perú (Baa1 stable)** and **Banco Internacional del Perú-Interbank (Baa2 stable)**. The latter has a larger-than-average exposure to unsecured consumer lending as a percentage of its total portfolio (48% versus 30% for its large peers).

» Banks such as **BCP** and **Scotiabank Perú (Baa1 stable),** with important small- and medium-sized enterprises and microfinance business clients, as well as niche municipal and rural lenders would also be exposed to a slowdown in the middle class. These lenders have reported higher loan delinquencies during the past 18 months.

In Chile, consumer credit, primarily installment loans, has also grown strongly since 2010, peaking at 18% in 2011. But growth declined to 15% in 2013, as banks restricted consumer credit, largely due to non-recurring events that led to a temporary rise in delinquencies. In contrast, residential mortgage growth has been steady, rising 12% per year.

» **Banco Santander Chile (Aa3 stable)** and **Banco del Estado de Chile (Aa3 stable)** are the most active consumer lenders in the country, with around 45% of their loans directed to consumers, including residential mortgages. **Banco de Chile (Aa3 stable)** follows with 38%, and **Banco de Crédito (A1 negative)** with 32%. However, because mortgages account for the bulk of these banks' consumer exposures, particularly at **Banco Estado** (about 80%, versus 60% for the other banks), their collateral structure and more restrictive loan-to-value (LTV) standards help shield them from asset quality deterioration.

» Specialized banks associated with Chilean retailers such as **Banco Ripley, Banco Falabella**, and **Banco Paris**, which are fully dedicated to unsecured consumer credit, would be the most vulnerable to asset quality pressures. In addition, the retailers themselves, which offer unsecured credit to consumers directly, would be vulnerable to a weakening in consumer credit-worthiness.

Mexico and Colombia

Long-term prospects for the middle class in Mexico and Colombia remain encouraging. In Mexico, where growth has lagged much of the region, we expect an acceleration in 2015. In the case of Colombia, we expect the economy will maintain the healthy rates of growth of the past decade.

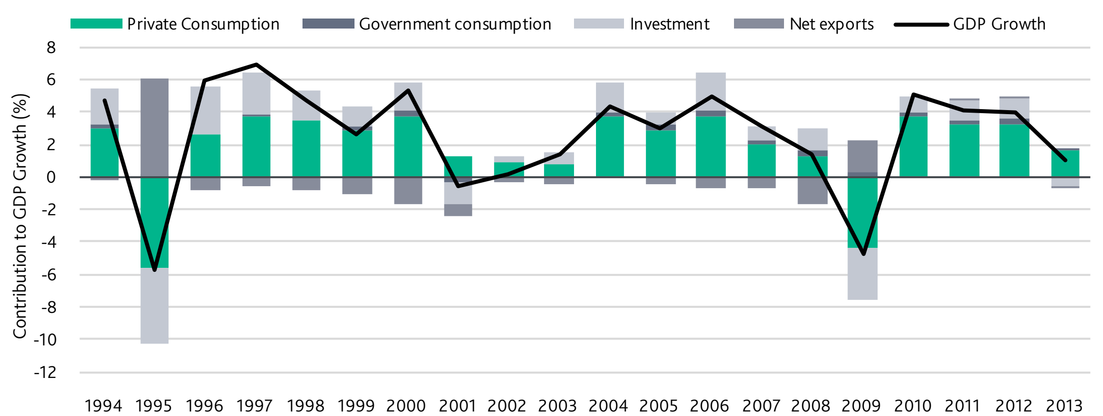
Mexico

Mexico's economic performance has been disappointing since early 2013 because of low government spending, greater policy uncertainty associated with a change in administration, tax increases on income and consumption, and slow growth in the US, which is Mexico's top export market. At the same time, real wages have remained flat, with salary increases only matching the pace of inflation. These setbacks have weighed on the performance of a broad range of industries, including those oriented towards middle class consumers, such as housing, tourism and retail.

However, the outlook is improving. We expect growth will accelerate in 2015 to 3.2%, fueled by higher government spending, especially on infrastructure projects, and an acceleration of the US economy, which will boost external demand. These developments should lead to faster job creation and higher wage growth. Over the long term, the economy should also benefit from reforms in the energy, telecommunications and financial sectors passed this year.

EXHIBIT 14

Mexico's Economy Relies on Investment and Consumption



Source: Moody's Investors Service calculations based on data from INEGI

Mexican companies that are sensitive to middle class consumers include the following:

» **INFONAVIT and FOVISSTE,** which provide mortgage loans for low- and middle-income workers, remain the most active issuers of residential mortgage-backed securities. Mortgages issued by the government agencies will likely continue to perform well because loan payments are deducted directly from borrowers' paychecks. The government has also unveiled a set of policies designed to support the housing sector, including subsidies, guarantees, new policies to expand access to government-supported mortgages, and co-financing agreements.

» Homebuilders such as **Consorcio ARA (Ba2 stable)** and **Vinte Viviendas Integrales (B1 stable)** will benefit directly from government programs designed to boost demand for housing. Builders stand to gain from the recently adopted relaxation of eligibility criteria for mortgage and other subsidized housing finance programs. The new rules should make homeownership more accessible to middle income buyers, allowing companies to shift their homebuilding portfolios towards more expensive and higher-margin homes. Generally, the housing industry in Mexico is more sensitive to changes in government housing policies than to consumer behavior.

» Higher income taxes and value-added taxes (VAT) in border regions (implemented in 2014) have hurt tourism companies such as **Grupo Posadas (B2 negative) and Playa Resorts (B3 stable)**. For companies targeting higher-income segments, such as **Playa,** the impact will be less significant.

» **Controladora Comercial Mexicana (Ba1 positive),** a supermarket company, has managed to weather the recent challenging environment because of its diverse portfolio. The company is one of the top four supermarket retailers in Mexico and operates several supermarket formats that focus on middle- to high-income customers. Disposable incomes in this market segment are more stable, making the company less vulnerable to a slow economy.

» **Coca Cola FEMSA (A2 negative)**, Coca Cola's largest bottler, benefits from a wide geographic footprint and a large product portfolio that targets consumers in all income segments. Mexico is one of the world's largest markets for carbonated soft drinks. The bottler is exposed to variations in consumer demand, but so far, it has not been affected by the new consumption tax.

Banking

Macroeconomic indicators, including unemployment, consumer confidence and economic activity, are showing signs of improvement, but the soft economy in 2013 and the first half of this year has taken a toll on banking. For the next 12-18 months, we expect only single-digit loan growth, down from a 13% increase in lending last year.

Loans to small- and medium-sized enterprises and mortgages will support growth. Consumer loans will also continue to expand, but at a slower pace of around 8%, compared with 24% as recently as 2012. This reflects weaker consumer demand related to higher taxes and increased household indebtedness.

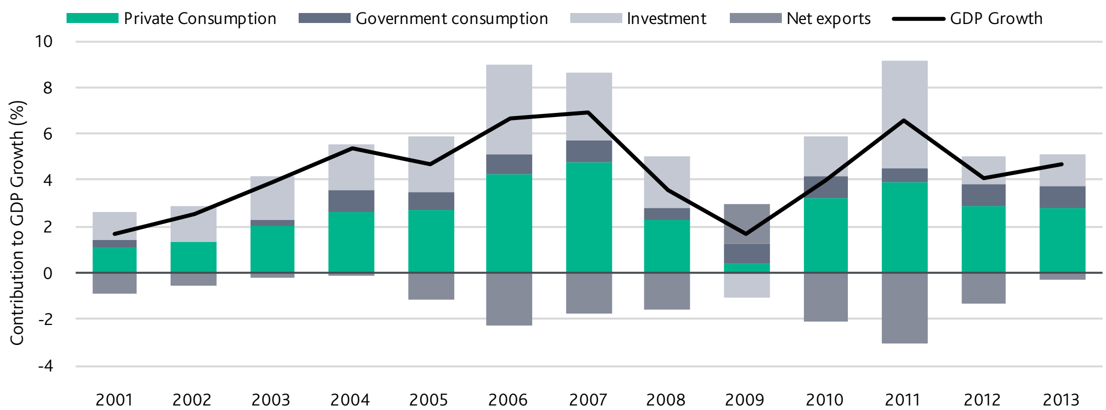
Forward-looking leading indicators suggest that consumer delinquencies will remain high, but should stabilize, especially if the economy accelerates. Mexico's consumer confidence index points to a stabilization of consumer delinquencies at around 5.5%.

Colombia

Economic conditions in Colombia remain favorable. Even as growth in other countries in the region has slowed, Colombia continues to experience robust growth, which accelerated to 4.7% in 2013 from 4.0% the year before. We estimate that the country's potential growth rate could increase to 5.0%-5.5% over the next five to 10 years, compared with our current estimate of 4.8% for 2014.

EXHIBIT 15

Consumption and Investment Fuel Colombia's Sturdy Economy



Source: Moody's Investors Service calculations based on data from DANE

Banking

Mortgage and payroll-linked loans have grown the most among loan products oriented towards the middle class, as individuals have taken advantage of low interest rates, attractive financing conditions due to competition among banks, and subsidies for mortgages introduced by the Colombian government. However, exposure to these products remains modest. As of March 2014, mortgages constituted just 11% of loans, and payroll-linked loans, about 9%.

Record-low unemployment levels and price stability have also supported demand for credit. Both mortgages and payroll-linked loans expanded 17% year over year through March 2014, while auto loans grew 6%, and overall consumer loans, 12%. For the remainder of 2014 and into 2015, loan growth will remain strong, but is likely to slow down as the central bank tightens monetary policy.

Real house prices have increased consistently by about 6% every year over the last five years, more than twice the rate of inflation, signaling a somewhat heated housing market. Nevertheless, banks' ample loan loss reserves for past-due loans, strong asset quality, as well as conservative loan-to-value (LTV) ratios of below 60% on average,[2] should counterbalance a slowdown in the housing market.

» The quality of consumer loan portfolios would deteriorate, especially among leading banks that have expanded aggressively, should economic growth slow, leading to lower consumer demand from the middle class, lower wages and salaries, or a decline in house prices,. In the mortgage market, these banks include **Scotiabank's Banco Caja Social S.A.** (unrated) which has notched

[2] LTV data from BanRepública's Financial Stability Report with data as of year-end 2013, published in March 2014. LTVs are capped at regulatory maxima of 70% for non-social housing (73% of total mortgage loans) and 80% for social housing.

20% annual loan growth; government-owned **Fondo Nacional del Ahorro** (unrated) with 19% loan growth; and market leaders **BBVA Colombia S.A. (Baa2 stable**)**,** with 18% annual growth, and **Banco Davivienda S.A. (Baa3 stable**), with 17% growth. These banks account for more than half of the mortgage market.[3] In the payroll-linked loan market, **Davivienda** led with 30% annual growth, followed by **BBVA Colombia**, with 23% growth.

[3] BanColombia S.A. is the largest mortgage lender in Colombia, with a 25% market share, but has expanded its portfolio modestly by 8%. Banco de Bogota S.A. grew the most of all, by 289%, but mortgages still constitute a negligible portion of its loan portfolio and only 2% of all mortgages, including securitizations, in Colombia, as of March 2014.

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