



Alpha investment strategies in emerging markets: Assessing the potential and competitiveness of Latin American firms



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ABSTRACT

Capital flows into Emerging Markets and Developing Economies (EMDEs) have grown significantly in the last decades and have even intensified in recent years. In the current environment, characterized by high levels of uncertainty and risk, Latin American firms face the challenges of making themselves known to investors and taking advantage of these resources to sustain growth, consolidate operations and internationalize business. The purpose of the paper is to propose a methodology that would allow advisors to match investors' preferences with the sources of value of firms. The paper starts with: 1) an analysis of the push and pull factors that determine the patterns of international capital flows and investments; 2) an analysis of the role of country, industry and company factors in top-down and bottom-up investment selection strategies; and, 3) a review of the theoretical foundations of the sources of value of a company. The methodology proceeds in three stages. First, we use discriminant analysis techniques to determine if there is a correlation between a country's risk factors and the performance of firms. Second, the investment selection strategies of investors, based on their risk preferences, are aligned with the operational and financial potential of firms. Finally, based on the results of the first stages, we suggest a strategy for firms to access financial and capital markets to improve their competitiveness and ensure their successful integration into the global economy.

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1. Introduction

1.1. Capital flows into emerging markets and developing economies

Over the past two decades, investments in companies and projects have grown steadily in Emerging Markets and Developing Economies (EMDEs).¹ These inflows of capital have resulted, in part, from the high liquidity of Developed Markets (DM) and the comparative lower yields that investors have obtained in these markets. These conditions or “push factors” have increased investors' appetite for opportunities that can not only offer higher yields, but also allow them to diversify their portfolio risk. The intensification of capital flows has also resulted in improved macroeconomic fundamentals, a better investment climate and lower perceived country risk in these markets. Goedhart and Hade (2003) and Agénor (1998) point that these “attraction factors” have been enhanced by the growth potential and improved competitiveness of companies participating in these markets.

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¹ Developed countries are high-income economies with capital markets characterized by, among other things: a sound Market and Regulatory Environment; high-quality broker services; liquidity to support global investment; reasonable transaction costs and efficient trading mechanisms. Emerging markets are nations with social or business activity in the process of rapid growth and industrialization, with operating capital markets. Currently, there are around 27 developed markets and 28 emerging markets, following the classification of MSCI Barra, Inc.

As Cavaglia and Vadim (2002) indicate, during the 1990s, “Top-Down” investment strategies dominated capital flows into EMDEs. The highest proportion of capital flows was channeled towards countries with low political and economic risk, stable exchange rates, and investment selection focused on consolidated industries and high-performance firms. Top-down strategies were associated with more conservative investors that are ready to seize the consolidated companies and focus on specific countries, such as Brazil, Russia, India and China (the BRICs). In addition, investors incorporated a country risk premium in the discount rate for the valuation of companies and the evaluation of projects.

As Cavaglia and Vadim (2002) also indicate, “Bottom-Up” strategies have prevailed in the last decade, as investors' appetite for risk has increased, and they have started to look for undervalued companies or those that had not fully achieved their potential to create value, either by increasing their operational efficiency or by optimizing their financial structure. Concerns over country risk and exchange rate stability have declined as the economic globalization and internationalization of enterprises have grown. Such globalization and internationalization have reduced companies' vulnerability to the internal conditions of their country of origin or operation—as London and Hart (2004) point out—and investors rely on coverage mechanisms to manage and reduce exchange rate and country risks. This perspective is more typical of investors with a greater appetite for risk, who focus more on superior returns than on their predictability.

1.2. Purpose of the study and performance indicators

This study has three purposes. The first is to evaluate whether country risk factors currently seem to affect the performance of companies operating in EMDEs and in Latin America, when compared to those operating in DEs. The second is to propose a methodology that would allow financial advisors to identify, based on an investor's profile, suitable opportunities in EMDEs and Latin America. And the third is to suggest a strategy for the company to develop its full potential in terms of value creation.

We use a set of financial indicators to characterize the condition of companies participating in capital markets, for which historical information is publicly available. With the following indicators, we attempt to capture the impact of management and the potential associated with operational efficiency, liquidity and solvency conditions, inherent risk, and the profitability of firms:

- Return on investment (ROI): as an indicator of the quality of business and the basis for value creation.
- Cash to Firm Value (C/FV): to measure the liquidity condition of the company.
- Debt Ratio (D/FV): the debt level as the ratio of financial debt to capitalization of the company as an indicator of financial exposure.
- The company's levered beta (β): as an indicator of sensitivity and exposure to external and market factors.
- The return on capital (ROE): as a target to evaluate performance and the potential to create value for investors.

1.3. Sources of information

To fulfill the three purposes of this study, the information has to allow for the separation of companies by regions and by countries. In addition, it also requires the separation of the types of investors (i.e., from and into EMDEs). The information used for the analysis comes from three different sources. First, statistics on international financial flows come from the International Monetary Fund's "Coordinated Portfolio Investment Survey" and "Coordinated Direct Investment Survey."² These statistics allow us to clearly identify the country of investment and the type of investor, as well as the investor's country of origin. This makes it possible to identify the amount of investment by a specific investor in his country and in other countries. The consolidated information allows us to identify investments in and from specific countries and regions, thus providing evidence on the intensity and changing patterns of capital flows.

The second source of information, Morgan Stanley Capital Investment (MSCI Barra Incorporated), provides index performance indicators of the capital markets by region and country.³ The historical information about returns makes it possible to present evidence on the higher returns received by investors in EMDEs, especially when compared to their investment opportunities in DEs and other markets. Higher sustained returns serve as pull factors that attract the attention of portfolio investors.

The third source of information is related to indicators of operational, financial risk indicators of companies participating in capital markets worldwide. This information is drawn from a database developed by Dr. Aswath Damodaran⁴ of New York University's Stern

School of Business. Dr. Damodaran compiles and makes publicly available financial information and indicators of public companies participating in capital markets. He processes the information by regions, markets, countries, industries, and specific companies. The database allows for consistency in the definition and calculation of indicators.

1.4. Sources of value and a company's potential as an investment

Identifying the factors that promote the profitability and improve the risk profile of companies and projects is essential to investors. This study uses the Global Capital Asset Pricing Model (GCAPM)⁵ to try to identify companies' and projects' sources of value. The GCAPM is favored because of the greater information it makes available on publicly traded companies in EMDEs. This information allows for the estimation of specific parameters that capture the impact of the economic environment and changes in the industry on both the market's and a company's performance—thus eliminating the need to make explicit adjustments for country risk.

The GCAPM allows us to measure both the potential yield $P(R_k)$ and the minimum expected performance required by investors, according to the market $E(R_k)$. The difference between these two returns—the excess return—is the best way to measure the creation of value for shareholders. In general, the potential return can be appropriated by direct and venture capital investors, while the minimum requirement is associated with portfolio investors since they bear lower levels of risk. Investors search for opportunities for which the potential yield exceeds the minimum required return, as indicated in Eq. (1):

$$P(R_k) > E(R_k). \quad (1)$$

The potential return is obtained by estimating the Asset or Security Characteristic Line (SCL). According to the SCL, the potential return is a function of: 1) the excess (deficit) return generated by the company with respect to the market, captured by the alpha coefficient (α) of SCL; 2) the index of performance of the specific market analyzed (R_{mg}); and 3) the levered beta (β_a) of the company, which captures the factors associated with systemic nondiversifiable market risk.

According to the SCL, the potential return of a company is the result of specific factors such as the efficiency and quality of the operation, captured by the alpha coefficient, and can be explained as indicated in Eq. (2):

$$P(R_k) = \alpha + \beta_l R_m. \quad (2)$$

Once the alpha and beta of a company are estimated, the minimum return required by investors can be determined to make sure that it covers:

- the opportunity cost that could be obtained in an alternative risk-free investment (Rf), usually associated with the yields of government bonds;
- the premium obtained in the market when investing and taking the risk of capital, measured as the average historical difference between market return (R_m) and the risk-free return ($R_m - R_f$); and
- an adjustment to reflect the characteristics and company-specific risks, captured by a company's levered beta (β_a).

² The "Coordinated Portfolio Investment Survey" (CPIS) is provided by the International Monetary Fund (IMF) and is a voluntary data collection exercise conducted under the auspices of the IMF that collects an economy's data on its holdings of portfolio investment securities (data are separately requested for equity and investment fund shares, long-term debt instruments, and short-term debt instruments). www.imf.org.

³ MSCI Barra Inc., is an independent provider of research-driven insights and tools for institutional investors. www.msci.com.

⁴ The data come from http://people.stern.nyu.edu/adamodar/New_Home_Page/data.html, a widely cited source of information for both academic research and investment analysis. The data, as indicated by Prof. Damodaran, are gathered mainly from Bloomberg, Morningstar, Capital IQ and Compustat.

⁵ The CAPM is used to determine a theoretically appropriate required rate of return of an asset. The model was introduced by Jack Treynor, William Sharpe, John Lintner, and Jan Mossin independently, building on Harry Markowitz's earlier work on diversification and modern portfolio theory (Markowitz, 1999).

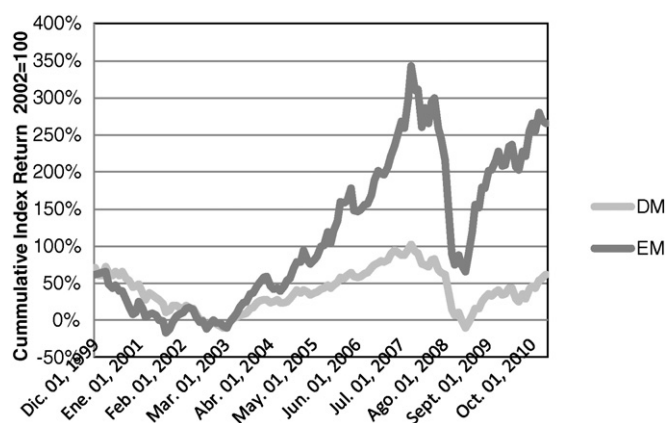


Fig. 1. Developed and emerging capital markets. Market index, 2002 = 100.
Source: elaborated by the author.

The minimum required return is determined more by the beta coefficient, which tends to be the result of the quality and effectiveness of risk management and can be established as indicated in Eq. (3):

$$E(R_k) = R_f + \beta a^*(R_m - R_f). \quad (3)$$

As a result, two alternative strategies can be developed for investors in EMDEs. First, Alpha strategies seek to identify high-potential companies and projects, as well as the appropriate time to make the investment. The best opportunities for investors are with companies that have yet to develop their operational potential but that could achieve it in the short or medium term. Second, Beta investment strategies are best for companies that have already optimized operations and defined their risk profile. Typical investments are associated with undervalued companies or those that might benefit from market growth and access to global markets.

2. Assessing the impact of regional and country risk factors

2.1. Changing patterns of capital flows and portfolio investments

The improved investment climate has led to the increase in portfolio investment, which was favored and, at the same time, promoted the activation of these economies' Capital Markets. As Fig. 1 shows, portfolio investors in EMs have obtained significantly higher cumulative returns than those investing in DMs. However, while flourishing portfolio investments have had a significant impact on economic growth, Camacho (2001) indicates that when the investments result from macroeconomic distortions or wrong incentives, a sudden reversal of conditions may have devastating effects on macroeconomic stability and the soundness of the financial system.

Fig. 2⁶ The information was obtained from the Coordinated Portfolio Investment Survey website of the IMF, at www.imf.org, compares the composition of portfolios of investors from emerging markets and investors in emerging markets. The figure shows that investors in emerging markets focus on equity, while investors from emerging markets maintain a larger proportion of debt instruments in their portfolios. While this may be the result of their risk preferences, some studies suggest that the limited availability of corporate bonds and securitization markets hinder their ability to participate in capital markets and leads them to search for investment opportunities in developed markets. This, in turn, limits the depth of these countries' financial markets and the investment opportunities open to local investors (Andrade, Farrell, & Lund, 2007). Nevertheless, even though the recent crisis affected the performance of financial and capital markets worldwide, investments in EMDEs by investors from other markets have not only significantly recovered, but also appear to be more stable than the flows to developed countries (Roxburgh, Susan, & John, 2011).

2.2. Methodology to assess of the impact of country risk factors

Country factors play a major role in top-down strategies, in which the search for opportunities focuses on the conditions of the economic and political environment. Multivariate discriminant analysis is used in this study to determine the extent to which regional and country considerations could affect the preferences of potential investors. A large number of financial studies use discriminant analysis. Altman (1968), for example, develops the Z score to predict the bankruptcy probabilities in US firms, while Taffler (1982) uses it to predict bankruptcies in the UK. Camacho (1996) develops a model to serve as an early warning in identifying troubled banks, while Gumparthi and Manickavasagam (2010) generate a model of risk classification for small and medium-sized enterprises in India.

The analysis in this study focuses on the ability to correctly classify a company in a region or market, based on the set of financial indicators used to evaluate its performance. The estimation is conducted at two different levels. First, a pre-classification of 12,994 sample companies is based on those financial indicators, and, next, it is determined whether or not companies can be correctly classified. In addition, discriminant analysis is performed to determine whether there are significant differences in companies' performance that can be attributed to the region or the country. At the regional level, 12,994 companies are separated into seven regions (Africa and the Middle East; China; Eastern Europe and Russia; emerging countries of the European Union; Latin America and the Caribbean; India; and Small Asian Economies), while at the country level, 518 companies operating in five Latin American countries (Argentina, Brazil, Chile, Mexico and Peru) area the focus of the analysis.

2.3. Analysis of regional and country risk factors

As Exhibit 1 indicates, at the global level, there appear to be significant differences in the average level of performance indicators according to the region of origin. In fact, most of the companies considered seem to fit one of two profiles: 1) companies operating in EMDEs in Africa and the Middle East, characterized, on average, by high returns on investment, high levels of liquidity and low debt levels; or 2) companies in emerging countries of the European Union, operating with higher debt levels but significantly lower returns on investment. The better performance of the first type of companies could be attributed to the fact that they are more driven by the domestic market's potential and/or its internal conditions. These companies are already participating in capital markets and seem to be very attractive to potential investors who want to create value for themselves by optimizing

⁶ The information was obtained from the Coordinated Portfolio Investment Survey website of the IMF, at www.imf.org.

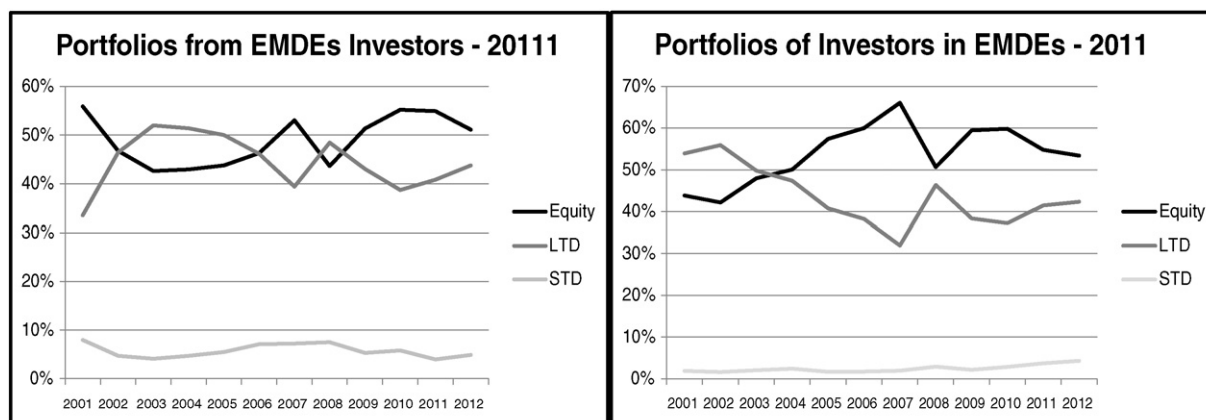


Fig. 2. Portfolio composition of investors (by origin of investor and type of investment).
Source: Coordinated Portfolio Investment Survey, IMF.

the companies' financial structure—in terms of both liquidity and use of debt—and potential for growth and internationalization. For the second type of companies, their weaker indicators may result from the fact that they have more linkages and/or greater exposure to the economic conditions in industrialized economies. These companies may have stronger financial and economic relationships with industrialized markets and companies that have been most affected by the global financial economic crisis (U.S. and Europe).

Exhibit 1. Key performance indicators and Classification Matrix of Firms in EMDEs – 2011.

Country	# Observations	Average					
		Cash/ Value of Firma	Debt/ Capitalization	Beta Levered	Return on Equity	Return on Investment	% Correct Classification
África y Medio Oriente	1.312	18,9%	10,8	0,79	28,9%	30,0%	37,7%
China	3.234	15,2%	17,17	0,82	12,5%	18,9%	15,0%
Europa del Este y Rusia	426	15,6%	12,66	0,82	10,2%	17,0%	0,9%
Unión Europea	599	16,7%	46,84	0,83	7,3%	-0,2%	39,2%
India	1.536	17,1%	369,59	0,8	11,3%	17,7%	3,5%
América Latina y Caribe	630	17,2%	3,28	0,82	10,5%	20,1%	0,5%
Economías Pequeñas Asia	5.257	19,1%	50,05	0,81	22,8%	23,2%	0,4%
Total	12.994						
Clasificación Matrix	Africa and Middle East	China	East Europe and Rusia	European Union	India	Latin America and Caribbean	Small Economies
Africa and Middle East	49,8%	12,5%	0,6%	35,4%	1,0%	0,5%	0,2%
China	50,9%	15,0%	0,7%	32,3%	0,5%	0,2%	0,4%
Eastern Europe and Rusia	50,0%	10,6%	0,9%	36,2%	1,2%	0,2%	0,9%
Europe	43,4%	12,5%	1,8%	39,2%	2,5%	0,0%	0,5%
India	48,3%	13,3%	0,5%	34,0%	3,5%	0,2%	0,2%
Latin America and Caribbean	48,6%	13,3%	1,1%	36,2%	0,2%	0,5%	0,2%
Small Economies Asia	49,5%	13,0%	0,8%	34,7%	1,4%	0,2%	0,4%

Source: elaborated by the author.

A beta strategy would lead to search opportunities outside of countries most affected by the crisis, while an alpha strategy would focus on companies with stronger profiles. Thus, an alpha strategy would focus on companies with less influence in or dependence on these regions and with greater capacity and potential to manage risk exposure and the conditions of the environment. However, for companies to respond better in this type of environment and position themselves more competitively with investors, they would need a combination of factors associated with the quality of management—or alpha of the company—and the ability to anticipate a crisis and adjust for risks—associated with the beta.

2.4. The role of country factors in the case of Latin American companies

Exhibit 2 presents the analysis results with regard to Latin American firms. As the exhibit shows, there appear to be significant differences in the level of capitalization and indebtedness of companies in different countries. In particular, these differences seem to indicate that:

1) companies in Colombia, Brazil and Peru require higher levels of liquidity, which could be the result of higher volatility of their cash flows or the reduced availability of market instruments to manage liquidity; 2) companies in Colombia and Peru are characterized by lower levels of debt, which could be a result of the preference for lower financial exposure, but also of the limited demand for debt products in their capital markets; 3) companies in Argentina and Brazil appear to experience greater exposure to market risks, while those in Chile are the least exposed to those risks; and 4) companies in Peru and Mexico seem to have generated better returns in the post-crisis era, from both the operational and financial perspectives.

With respect to the probability of correct classification, the results suggest that close to 40% of companies from Argentina, Chile and Colombia can be correctly classified in terms of country of origin. A significant proportion of companies from other countries seem to fit the profile of Chilean companies, which are, perhaps, more consolidated and stable than those of other countries. In contrast, only 25% of companies from Brazil and Peru can be correctly classified, while the Mexican companies are the most difficult to relate to their country of origin. As a result, more than 60%—and, in some cases, up to 85%—of Latin American companies exhibit characteristics similar to those operating in other countries. This finding indicates that performance and results have more to do with the quality of operations and management than with the location of the operation. This result favors alpha investment strategies, for which investors focus on the companies' profiles rather than on their country of origin. These companies should explore their growth potential, taking advantage of their country's improved economic fundamentals and of the ongoing internationalization of businesses.

Exhibit 2. Key performance indicators and Classification Matrix of Firms in Latin America – 2011.

Country	# Observations	Cash/ Value of Firma	Debt/ Capitalization	Beta Levered	Return on Equity	Return on Investment	% Correct Classification
Argentina	61	7,5%	74,0%	0,986	13,0%	20,3%	37,7%
Brazil	145	11,2%	88,8%	0,985	10,2%	17,8%	24,8%
Chile	129	8,0%	76,4%	0,496	13,2%	11,2%	39,5%
Colombia	32	9,1%	33,6%	0,609	8,2%	2,8%	37,5%
Mexico	82	3,3%	75,1%	0,67	17,6%	16,6%	15,9%
Peru	69	11,5%	37,7%	0,693	17,3%	30,6%	24,6%
Total	518						
Clasificación Matrix	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Total
Argentina	37,7%	18,0%	16,4%	13,1%	3,3%	11,50%	100,0%
Brazil	33,1%	24,8%	17,9%	6,2%	4,1%	13,80%	100,0%
Chile	13,2%	4,7%	39,5%	13,2%	20,2%	9,30%	100,0%
Colombia	9,4%	3,1%	37,5%	37,5%	6,3%	6,30%	100,0%
Mexico	23,2%	8,5%	37,8%	11,0%	15,9%	3,70%	100,0%
Peru	18,8%	10,1%	24,6%	11,6%	10,1%	24,60%	100,0%

Source: elaborated by the author.

3. Classification criteria to determine a firm's potential

In order to match the investor's profile with a company's potential, a three-stage process is implemented: 1) investors are profiled based upon their investment horizon and risk appetite; 2) classification criteria are developed based on the operational, financial, return and risk characteristics of firms; and, 3) the investors' profiles and the companies' characteristics are compared to determine the best possible pairings, focusing on the sources of value and risk–return combinations.

3.1. Investors' profiles and companies' characteristics

Investors in EMDEs fall into three different categories: traditional direct investors, venture capital investors, and portfolio investors. Traditional direct investors control the business and have a long-term perspective; they focus on the company's expected cash flows and on the risk–return combination of the results. Venture capital investors take a medium-term perspective, have a significant share in the business, and focus on capital gains coming from a buy-back of its shares or the initial public offering of the company. Finally, portfolio investors take a short-term perspective and conduct an active management strategy, focusing on the quality of cash flows and the ability of the company to pay dividends or of the market to appreciate the value of the company in terms of the price of stocks.

For the purpose of this study, in order to match investors' strategies with companies' potential and profiles, their behavior is characterized as follows:

- Direct equity investors aim to beat the market returns and follow an alpha investment strategy. They favor investment opportunities in which the quality of operations and the risk management practices lead to superior results. The returns are measured in terms of the internal rate of returns of the investment. They are also likely to apply a bottom-up approach, focusing on the quality of the investment.
- Venture capital investors focus on investment opportunities in which value is created by improving the efficiency of operations and by optimizing the financial structure of a company. They use an alpha investment strategy, but they look for companies in their early stages of development or for the value creation that comes from restructuring inefficient or troubled companies. Venture capital investors apply mainly a bottom-up strategy for investment selection. They usually seek an additional risk premium on the return expected by traditional investors and require an exit strategy.
- Portfolio investors look for stable companies and predictable returns, thus implementing beta investment strategies. They focus either on mature companies or on “ripe fruits” with potential capital gains and/or stable dividend flows. They conduct an active portfolio management strategy and are more likely to apply a top-down strategy for investment selection, paying significant attention to the country and the industry conditions that the company faces.

3.2. Companies' profiles and potential for value creation

The high levels of uncertainty that characterize the current business environment make it even more important for advisors and investors to identify the most suitable opportunities, based on their profiles. They look not only for good risk–return combinations, but also for companies and projects that have a greater ability to adapt to changing conditions and that offer greater opportunities to create value. Based on theoretical foundations and key performance indicators, this study proposes criteria for placing businesses into three different categories: companies with operational potential; companies with financial potential; and companies with capital market potential.

Companies with *operational potential* may be able to improve their productivity and make better use of their installed capacity. These companies are characterized by low ROI, so they would be attractive to strategic partners willing to contribute technology and management skills, or to venture capital investors willing to wait for the development and consolidation of the business to improve their profitability.

On the other hand, companies with *financial potential* have already achieved good operational conditions, resulting in good ROI. However, they may exhibit relatively low ROE, thus offering the potential to increase profitability through changes to their debt structure and financial condition. These companies, which have not yet developed their financial potential, may be attractive to direct capital investors for mergers and acquisitions, with partners that might allow access to capital markets to issue debt in better conditions and to improve the management of risks in order to stabilize returns.

Finally, companies with *capital market potential* would be consolidated firms with high ROI and ROE compared to similar companies, which may allow investors to seize value by accessing markets to raise equity. These companies have optimized operations and capital structure, can access markets and are ready to attract portfolio investors.

3.3. Measuring the competitiveness and assessing the potential of firms

The competitiveness of a firm and its potential as an investment opportunity depend on the strength and stability of the returns that characterize its operations (ROE). From a financial analysis perspective, a firm's sustainability is based, first, on the quality of its operation, associated with superior returns on investment (ROI), and, second, on its increased profitability from taking advantage of leverage. Firms can maximize the contribution of leverage by accessing capital markets to improve the company's financial structure, which should lead [?] to better conditions in terms of the structure and cost of debt. Improving both operational efficiency and financial structure leads to the maximization of the alpha of the company. From a financial perspective, good liquidity and risk management practices can reduce the variability in returns and optimize the beta of the company. Combined, a maximized alpha and an optimized beta can improve the company's performance indicators and risk profile, leading to the creation of value for the investor.

Improved productivity and the reduction in costs allow companies to increase their debt level, thus increasing leverage and reducing their dependence on their own equity to take advantage of growth opportunities. Better support from suppliers can also increase the quality of a business and lead to higher returns on investment (ROI), while higher leverage and increased debt capacity can lead to higher returns on equity (ROE), as indicated by the following equation:

$$ROE = ROI + (ROI - i \cdot (1 - t)) D/E, \quad (4)$$

where i cost of debt

t tax rate

D/E debt to equity ratio.

As Fig. 3 shows, companies in EMDEs outperformed those in other parts of the world after the crisis. It is important to note that the companies not only achieved better operational efficiency indicators, but also exhibited a significant profitability advantage.

Exhibit 3. Latin American Companies Investment Profile – 2011.

Country	Potential			
	Operational	Financial	Capital	Total
Argentina	5	38	18	61
Brazil	13	91	41	145
Chile	11	58	60	129
Colombia	4	16	12	32
Mexico	3	53	26	82
Peru	5	44	20	69
Total	41	300	177	518

% Distribution				
	Operational	Financial	Capital	Total
Argentina	8,2%	62,3%	29,5%	100,0%
Brazil	9,0%	62,8%	28,3%	100,0%
Chile	8,5%	45,0%	46,5%	100,0%
Colombia	12,5%	50,0%	37,5%	100,0%
Mexico	3,7%	64,6%	31,7%	100,0%
Peru	7,2%	63,8%	29,0%	100,0%
Total	7,9%	57,9%	34,2%	100,0%
Profile	Direct Investment or Venture Capital	Direct Investment, Corporate Debt	Raise Equity, Access Global Markets	

Source: elaborated by the author.

3.4. The potential of Latin American companies as investment opportunities

The classification criteria were applied to the sample of 518 Latin American companies already active in capital markets in the region. The procedure was first used to determine how many of the firms could be assigned to the predefined profiles. Next, the companies were matched with the most suitable type of investors, according to the preferences and strategies associated with each type.

The results, presented in Exhibit 3, indicate that approximately 92% of Latin American companies exhibit high levels of operational efficiency, which may be the key to their ability to face the adverse economic environment of recent years. In addition, 34.2% of the listed public firms of the most active capital markets in Latin America have operational and financial conditions that make them attractive candidates to raise equity or to be targets of mergers and acquisitions. Finally, 57.9% of the firms present opportunities to create value for investors by improving their financial structure.

These results indicate that most Latin American companies participating in capital markets have already achieved high levels of operational efficiency. Nevertheless, they can still create value by improving

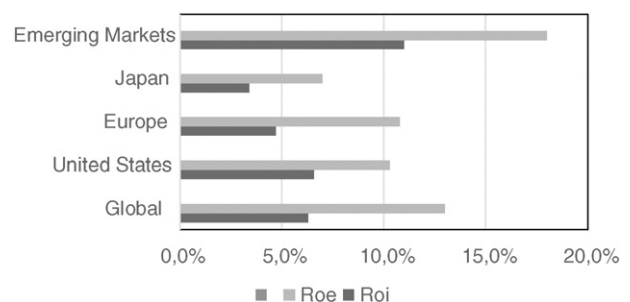


Fig. 3. Average ROI and ROE – 2011.
Source: elaborated by the author.

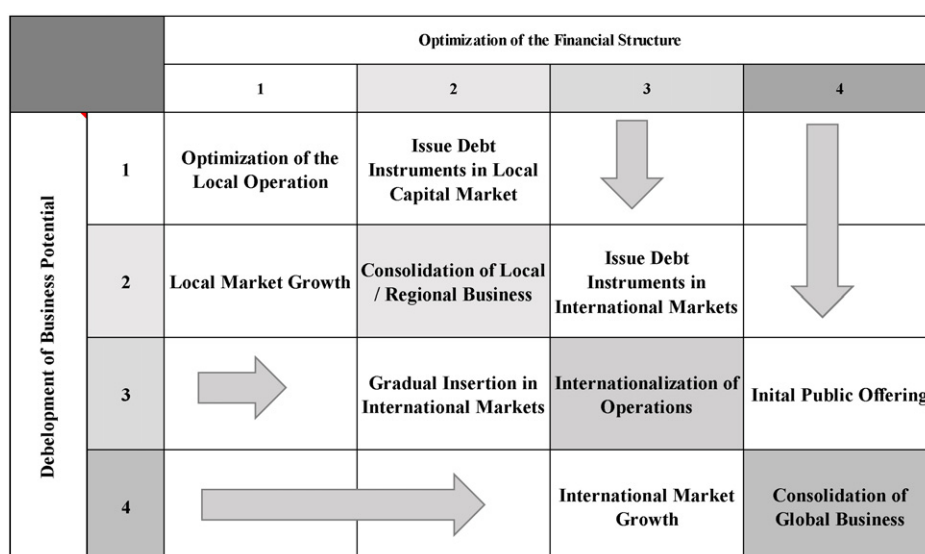


Fig. 4. Strategy to consolidate operations and access global capital markets.
Source: proposed by the author.

their financial condition. Since investors from emerging markets seem to prefer a balanced portfolio, one possibility is to issue debt in the local capital market as a means to improve conditions and reduce costs. Once these companies optimize their financial structure, they will be in a better position to raise equity. There appears to be an opportunity to raise debt, given the preferences of portfolio investors, and the increased availability of corporate debt should favor the development of the local capital market. The results could also encourage firms that have not achieved operational efficiency to position themselves as attractive opportunities for venture capital investors or strategic partners, while those with good operational and financial indicators should consider entering both the debt and equity markets.

4. A strategy for Latin American firms to access capital markets

4.1. Open opportunities to create value

This study suggests that companies' potential, rather than country risk considerations, may be an increasingly relevant factor in attracting investors in EMDEs. This finding is consistent with important changes at the country level, including a significant improvement in macroeconomic fundamentals and the reduction in the perception of country risk. It also is consistent with company-level changes, such as the increased competitiveness of businesses associated with the improvement in their operational and financial management. Companies in EMDEs seem to be better prepared to take advantage of the growing globalization of economies to internationalize their operations.

The study also reveals the great potential for Latin American companies to attract potential investors into EMDEs. Particularly encouraging is that a large percentage of companies already present in capital markets exhibit superior results, thus positioning themselves to attract foreign direct investment, as well as inducing additional companies to enter those markets. In particular, a high percentage of companies have achieved operational efficiency, but have yet to exploit their financial potential, which they can achieve by accessing debt markets.

Companies can also benefit at the macroeconomic level, as an increase in the number of participants in capital markets may give depth to the market, and improved performance can contribute to the diversification of investment portfolios. Troubled companies may also benefit, as restructuring their debt and operations may offer significant opportunities for venture capital investors.

4.2. A strategy to consolidate operations and access capital markets

For a firm to develop its competitive potential and successfully participate in the global economy, it must optimize its financial structure and identify unexploited opportunities to increase productivity. Fig. 4 presents the optimal path for a company's internationalization and consolidation of global operations. According to this path, the optimization of local operations eases the consolidation of local or regional business, thus exploiting the growth potential of the market and accessing local debt markets. This consolidated business should be the platform for the internationalization of operations by gradually inserting the company in the broader international market, while accessing international debt markets. To exploit international market growth and consolidate the global operations, the company can rely on both the local and international equity markets, going public through an Initial Public Offering (IPO), to guarantee access to the necessary resources to expand its operations.

This suggested strategy to develop a company's competitive potential could allow the firm to benefit from the wave of investment into emerging and developing markets. Depending on how much a company develops its potential, its long-term goals and strategic actions should focus on creating value for the investors by:

1. Strengthening the business by adjusting operations to close the competitive gaps with other market players.
2. Capturing the local market potential by maximizing the use of non-traditional debt to generate higher margins and capture a large share of the market.
3. Accessing local debt markets in order to reduce costs and increase the company's debt capacity, improving performance and solvency indicators and, thus, improving the company's risk profile.
4. Gradually accessing international markets in order to gather the required resources to expand local/regional operations.
5. Proceeding with an IPO in both the local and international markets to raise the equity needed to consolidate the global business.
6. Relying on competitive advantage and sustainable profitability as the basis of superior potential returns to attract portfolio investors.

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