January 10, 2023

Corporate Finance: 2024 strategy manual

A kilometer of resistance for entrepreneurs

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Since 2022, we warned about the challenges that the Colombian economy would face in 2023. Now, with a look in the rearview mirror, we see that some of the risk scenarios materialized.

On the local front, 2023 was a year of persistent inflation, high financial costs, a volatile exchange rate and a marked slowdown in the economy. Fortunately, the external environment turned out to be more favorable than anticipated, as concerns about a recession in the United States dissipated during the year, as labor market data showed a more robust economy.

Lower inflation in developed and some emerging countries also helped to improve investor confidence and the overall climate in international financial markets. The almost magical coincidence of lower inflation and more robust growth made sentiment towards emerging countries such as Colombia favorable for much of this year.

In this context, we experienced an appreciation of the Colombian peso and a reduction in our country's sovereign risk premium. The cost of equity calculations, which we discuss in detail in this report, showed a correction from the levels observed at the end of last year.

As can be seen, the outlook in 2023 was mixed, and business decisions took place in a context of macroeconomic adjustment. In our Annual Economic Projections Report we discuss the forecast outlook for 2024, where we expect the final phase of the ongoing adjustment to occur. We project a decline in inflation that will allow the central bank to continue with the interest rate cutting cycle. In this context, consumers and businessmen will benefit from the relief in financial costs, but well into 2024.

The final phase of the economic adjustment will begin in 2024, but the last stretch will be the most difficult. With this challenge in mind, we present a new edition of the Strategy Manual, where we cover the traditional topics in Corporate Finance: Cost of equity (*Ke*), cost of debt (*Kd*), *WACC* and risk management, among others.

At the current juncture, prudent risk management, under the shadow of an eventual global recession in 2024, a cooling local economy and a more persistent high rate and inflation outlook, will be particularly relevant. We hope that the summary of this report will be a useful road map to face this last kilometer, with a mountain prize: of adjustment of the Colombian economy.

We hope that in addition to finding this report relevant, our readers will frequently visit the Corporate Finance page, where we will update the content here in a timely manner.

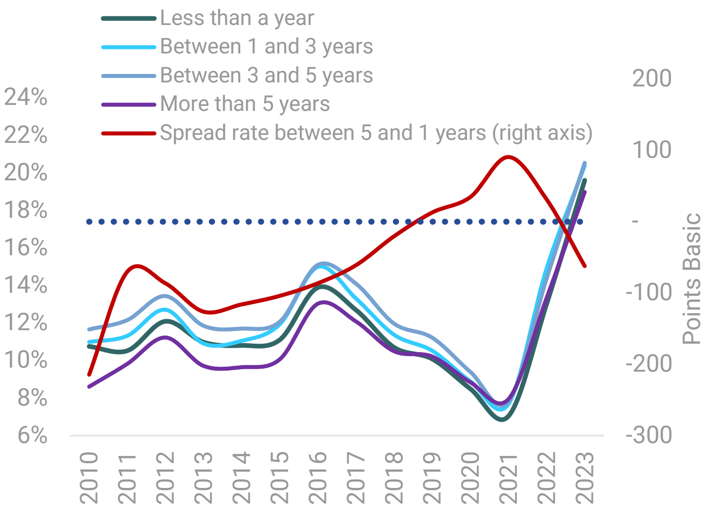
January 10, 2023

Investment decisions and profitability

The current economic situation in Colombia presents a challenging scenario marked by financial uncertainty and volatility in global financial markets. Throughout 2023, several factors, such as the economic strength of the United States and the decrease in global liquidity, have left their mark on the country.

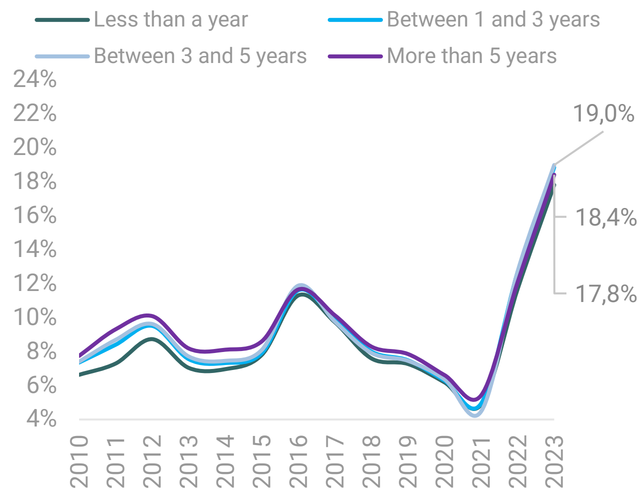
One of the main challenges facing Colombia is inflation, which has led to the implementation of a restrictive monetary policy. Which has led to an increase in interest rates in the economy, affecting both capital markets and access to business financing.

Graph 1. Interest rates for commercial loans (ordinary)



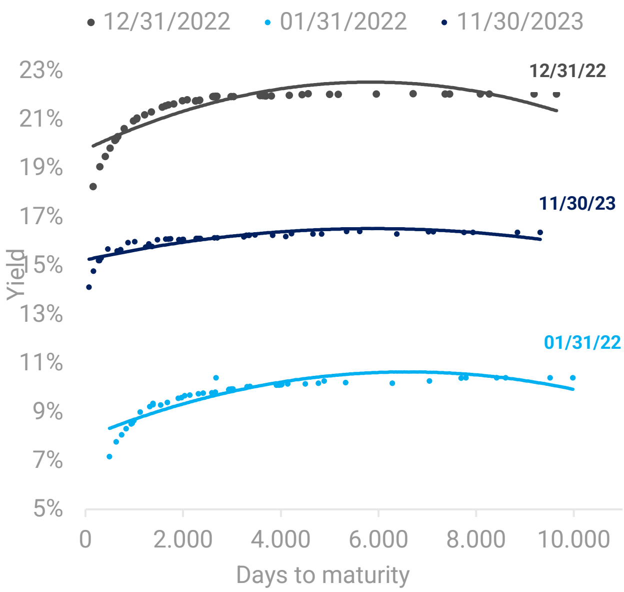
Interest rates are a cumulative weighted average for the year. October 31, 2023.
Source: Banco de la República. Corficolombiana.

Graph 2. Interest rates for commercial loans (preferential)



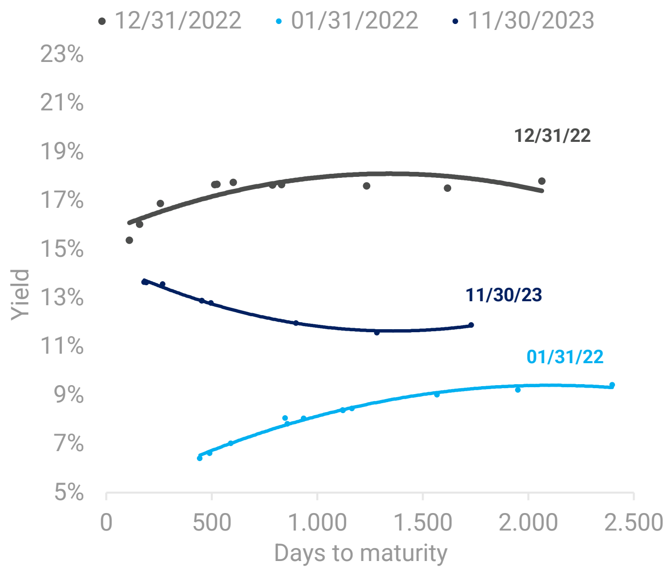
Interest rates are a cumulative weighted average for the year. October 31, 2023.
Source: Banco de la República. Corficolombiana.

Graph 3. Cost of corporate debt real economy (CPI AAA) at different dates



Source: Precia Pricing Provider. Corficolombiana

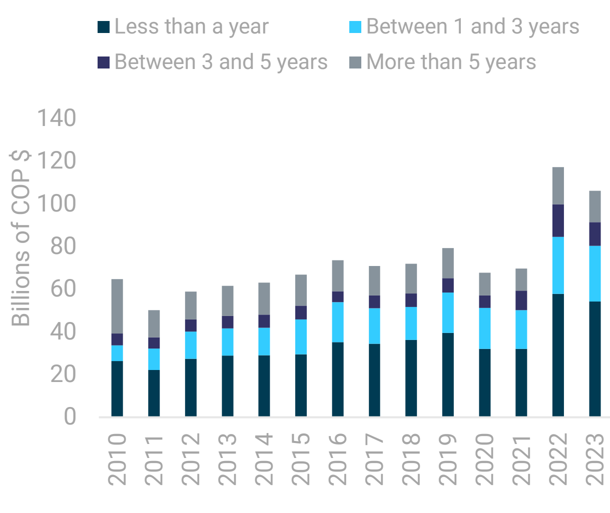
Graph 4. Cost of corporate debt real economy (Fixed rate AAA) at different dates



Source: Precia Pricing Provider. Corficolombiana

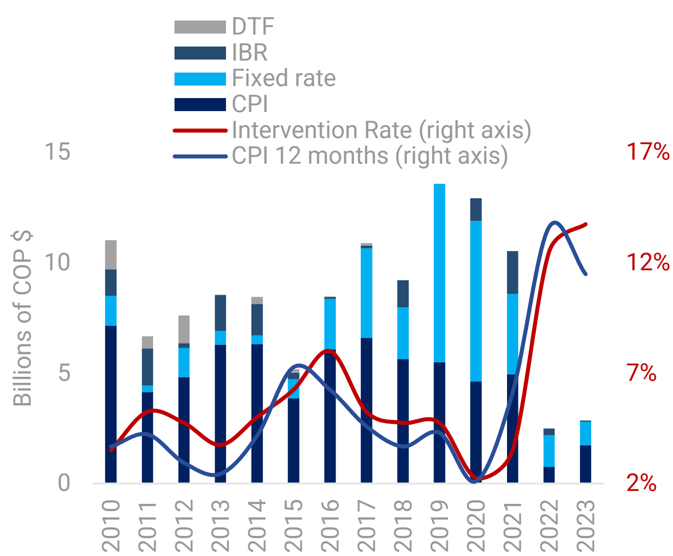
This increase in interest rates has impacted financing costs, both in bank loans and corporate bond issues. Although rates are high, commercial credit has experienced an increase in disbursed amounts, while corporate bond issues have decreased in 2022 and 2023, because of higher credit and liquidity risks, as well as uncertainty regarding the return of inflation to its target range.

Graph 5. Amount disbursed for commercial loans (ordinary) by term



Source: Banco de la República. Corficolombiana. October 31, 2023.

Graph 6. Corporate debt issuance by indicator



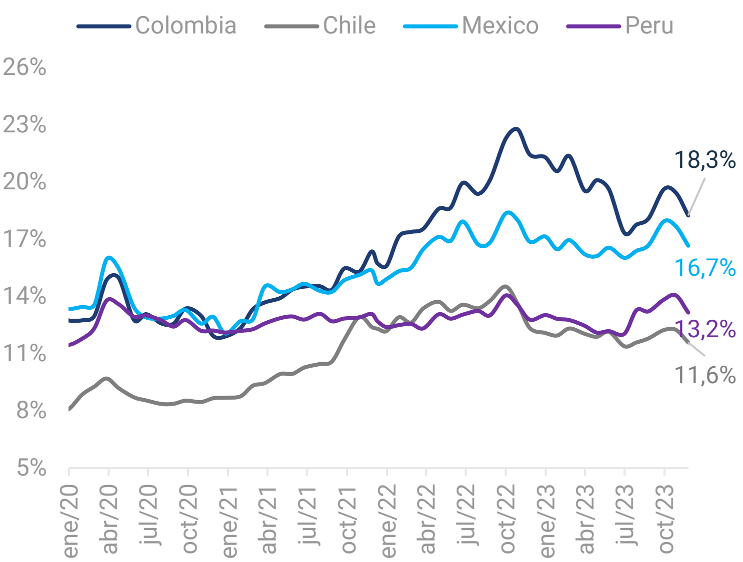
Source: Colombian Stock Exchange. Corficolombiana. October 31, 2023.

In this context, companies are at a crossroads when making investment decisions in search of profitability. The choice between debt and equity financing has become more complex, as not only the cost of debt financing has become more expensive, but also the cost of financing through equity.

The cost of financing with own resources for the country is at high levels in comparison with peer countries in the region, such as Mexico, Chile, and Peru, which complicates financial decisions for Colombian companies. Factors such as the behavior of U.S. Treasury interest rates (*risk-free rates*), the exchange risk premium and country risk are determining factors for the cost of equity capital (*Ke*). Fortunately, even though Colombia has the highest *Ke* compared to its peers in the region, lower risk aversion and a lower country risk premium have contributed to lower the required return to invest equity capital in 2023 compared to the second half of 2022.

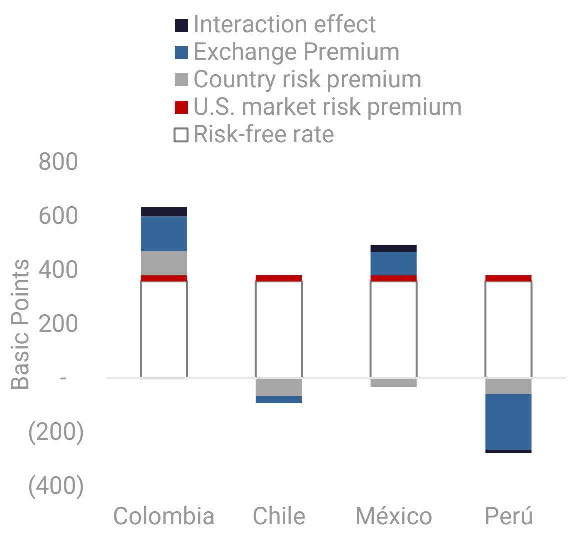
On the other hand, 10-year CDS (*Credit Default Swaps*)[1] on bonds have experienced a decrease in 2023, helped in part by the Carry Trade[2].

Graph 7. Cost of equity in local currency for Colombia, Chile, Mexico, and Peru



Source: Refinitiv Eikon. Corficolombiana. November 24, 2023

Graph 8. Ke Components and their performance (Dec 2020 – Nov 2023)



The interaction effect is the result of compounding rates. Remember that the formula for the expected return in local currency is equal to ((1 + Ke USD) x (1 + Exchange Premium)) - 1. is equal to ((1 + Ke USD) x (1 + Exchange Premium)) - 1
Source: Refinitiv Eikon. Corficolombiana.

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[1] CDS is a premium that hedges the risk of default on a fixed-income asset, in this case a country´s sovereign bonds.

[2] Carry Trade is a strategy that involves taking long (buying) positions in currencies with high interest rates, such as COP, CLP, PEN, and MXN, while taking short (selling) positions in currencies with lower interest rates, such as USD, JPY. This strategy is based on the gradual accumulation of the interest rate differential as a source of profits, regardless of exchange rate volatility. Generally, in periods of low volatility, investors tend to feel more confident that exchange rate fluctuations will not compromise the steady accumulation of the interest rate differential. This is done in fixed income securities with high credit quality (sovereign bonds). Historical evidence shows that carry trade strategies have generated positive returns over long periods.

Cost of equity is influenced by monetary policy and the general economic situation. Persistent political and economic uncertainty adds complexity to financial decisions, forcing companies to adopt cautious and flexible approaches to overcome uncertain times.

As a fundamental premise, despite high financial costs, companies must ensure the necessary liquidity for their continued operation. The current strategy focuses on working with current and known interest rates, assessing payment, and borrowing capacity, and selecting the right financial tools, rather than postponing investment decisions just because interest rates are high compared to previous years.

Financing strategies may vary according to the economic cycle, adapting to changing conditions to generate shareholder value. Even though interest rates are high compared to the recent past, companies can still secure liquidity, especially through commercial credit or the issuance of corporate bonds depending on the size and access to capital markets of the firm.

On one hand, commercial credits are the least affected in terms of quality compared to consumer credits and microcredits, providing room for the banking sector to grant loans. In addition, interest rates on commercial loans with terms longer than 5 years are lower than those for shorter terms. And, on the other hand, there is the possibility of reactivating financing through the issuance of corporate bonds, and a point of equilibrium is reached between investors and issuers for some specific indicator (fixed rate or variable rate - CPI and IBR-) at certain terms.

Financing decisions

A company's financial management is a fundamental pillar for its long-term success. While product and service decisions are crucial, financing decisions, specifically the choice of capital structure, are equally significant, as they have a direct impact on the value of the firm. This section will address the complexities of financing decisions during a challenging economic context, focusing on the search for balance between debt and equity, liquidity management and adaptability to market conditions.

The capital structure, which represents the combination of debt and equity used to finance operations, varies throughout a company's life cycle. **The objective is minimizing the weighted average cost of capital (*WACC*), depending on its life cycle.**

In the complex economic environment of 2022 and in 2023, companies have faced significant challenges, including uncertainty, limited liquidity, and high interest rates. While risks may diminish in the coming years, the market remains vulnerable to potential dangers. It highlights the importance of companies not neglecting their liquidity and adopting a prudent approach to dealing with periods of uncertainty. In this regard, liquidity plays a crucial role, as prudent management is essential to avoid operational and credit risks, especially in times of stress and uncertainty.

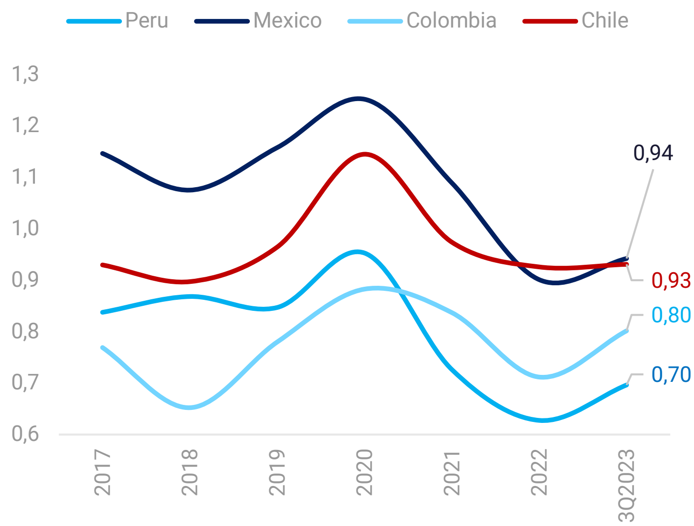
The main objective is to find the combination that will not only ensure liquidity but also favor the generation of value to the company in the long term, in accordance with the company's life cycle.

Financial decision-making is often influenced by the behavior of interest rates. Currently, there is a preference for short-term borrowing due to fluctuations in interest rates. However, it is emphasized that companies should not blindly follow this behavior and should consider more diverse and strategic financial options.

The choice between short-term or long-term debt is a key point. Although short-term debt can provide immediate liquidity, it carries significant risks related to refinancing. That contrasts with long-term debt, which can not only reduce liquidity risk, but also facilitate access to resources for long-term investments, freeing up resources for less liquid and more profitable projects.

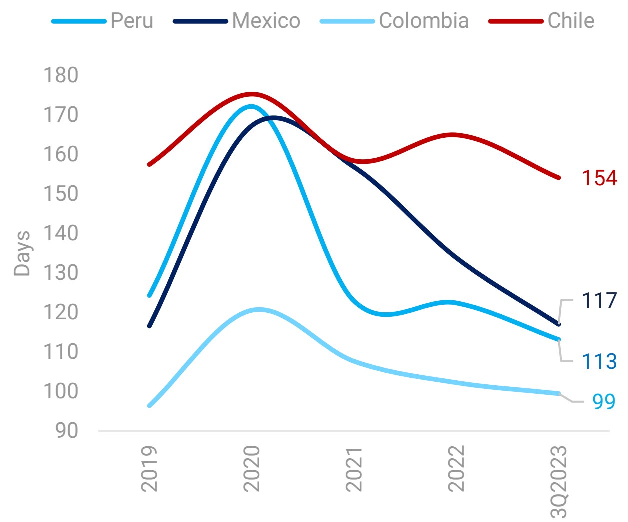
Capital structure and financial strength analysis of some Latin American companies reveals similar trends of increasing indebtedness, rising interest expenses, minimal changes in payment capacity and declining liquidity. These findings underscore the importance of finding the right balance in an economic environment that presents common challenges despite macroeconomic differences between countries.

Graph 9. Evolution of liquidity (Quick ratio)



Corresponds to the median of the companies' indicators by country. We took 132 companies from different sectors, excluding the financial sector that has some instrument in the capital market.
Quick ratio corresponds to (current assets - inventory)/current liabilities.
Source: Capital IQ. Corficolombiana.

Graph 10. Days the company survives without revenue (Basic Defense Interval)



Source: Capital IQ. Corficolombiana. September 30, 2023.
Basis Defensive Interval = (Total cash + short term investments + accounts receivable) / (Operating expenses + interest expense + taxes)

In conclusion, making financial decisions in a challenging economic environment requires a strategic and balanced approach. Companies must maintain liquidity, minimize risks, and be prepared to overcome obstacles on the road to business success. Adaptability and informed decision making are key in finding the optimal balance between debt and equity to maximize enterprise value.

In retrospect, the years 2022 and in 2023 were exceptionally challenging economically, marked by uncertainty, high interest rates and inflationary pressures. As we move into the home stretch, it is recognized that it may longer than initially anticipated. The importance of perseverance and determination to overcome the remaining obstacles and reach the goal are emphasized.

In this order of ideas, CFOs will have to play a crucial role in this scenario, focusing on maintaining business performance, preserving liquidity, and minimizing weighted average cost of capital (*WACC*). Flexibility and adaptability in financial decisions are fundamental skills to face changing economic conditions, without neglecting the long-term perspectives of value generation.

Short-Term Foreign Exchange Risk Management

In the last Corporate Finance Annual Report published at the end of 2022 under an environment of rising interest rates, inflationary pressures, reduced liquidity in global markets, and an economy with strong economic growth. In it, we argued that, given the impossibility of anticipating the duration of a tight monetary policy and a downturn cycle that was just beginning, it was necessary for companies to increase and preserve the stability of working capital using different financial products available.

Currently, in the economic slowdown part of the cycle, inflation that remains high compared to its target range and interest rates not seen in the recent past, it is important to remember which are the instruments and strategies that will allow companies to be sustainable and contribute to the country´s growth.

This year, the reader will notice that both the chapters on 1). Investment Decisions and 2). Profitability and Financing Decisions focus indirectly on liquidity management. These chapters emphasize the need to ensure liquidity for working capital in the coming years, preferably through medium or long-term financing, seeking to take advantage of the term premium on bank loans (the difference between long-term and short-term rates), the resources offered by issuing bonds at fixed or variable rates, depending on their term, as well as financing with multilateral entities and issuing debt denominated in dollars, the tax deduction granted by the debt given the interest expense, and the optimization of the capital structure by reducing the average cost of capital (*WACC*).

For the purposes of this summary, we focus on short-term foreign exchange risk. For working capital management derived from foreign currency operations, in an environment of high interest rates, global liquidity constraints, a robust U.S. economy, lower levels of risk aversion and the uncertainty of how long the economic downturn cycle will last.

We believe that financial risks related to changing scenarios such as the one we are currently experiencing affect the behavior of the exchange rate, which should be managed under a risk management scheme framed by the definition of a foreign exchange hedging policy.

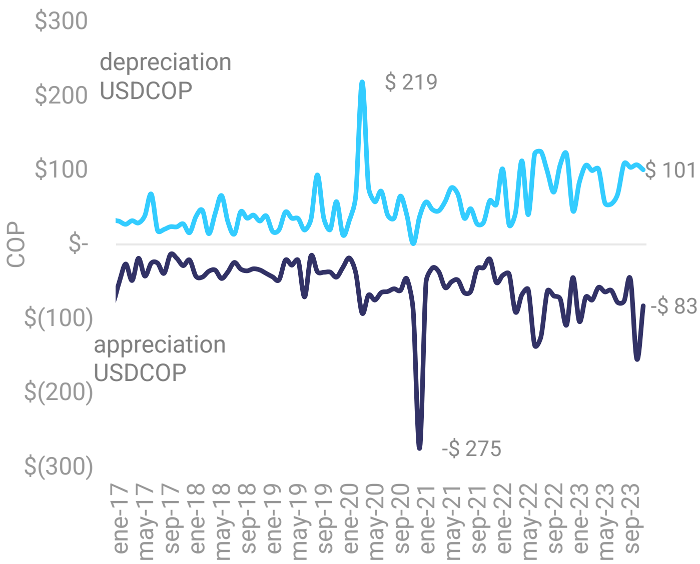
Market Bipolarity: Weakness versus strength heading into 2024.

2023 has been a period of great volatility reminiscent of the movements of a roller coaster. For example, by the beginning of the year in the US, there was already significant uncertainty about whether the rise in inflation seen in 2022 would persist, as well as whether the economy was headed straight into a recession. In the first half of the year, we had positive surprises on different fronts for the U.S. economy, on the one hand, inflation fell faster than expected and, on the other hand, the economy remained resilient. Despite that recovery, uncertainty about inflation and the economy remained. However, that uncertainty became part of the market story for the second half of 2023 given market consensus on a soft landing, with no recession and inflation under control.

Alternatively, in this same year, other countries suffered in some way the effects of inflation and Colombia was no exception. After reporting one of the lowest inflation rates for a 12-month period (1.49% November 2020), in March 2023 inflation reached 13.34%. In effect, this caused Banco de la República to respond by increasing the intervention rate to 13.25% from 1.75%.

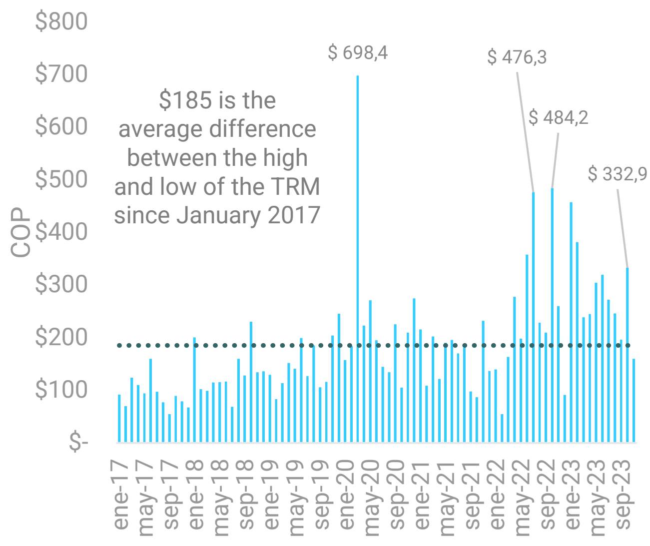
After a year characterized by different local and international events, the USD/COP exchange rate has presented a notable variation, ending with an appreciation of the Colombian peso. In the period between January and October 2023, the USD/COP exchange rate has shown an appreciation of around 18.4% A.E. The TRM has fallen from its historical maximum recorded in early November 2022 ($5,061.21) to $4. 060.83 at the end of October 2023. The lower risk aversion, a lower country risk premium and the search for higher yields by investors through strategies such as carry trade, the Colombian peso has managed to recover value lost in previous years, by reducing the USD/COP gap against its regional peers.

Graph 11. For one month, what was the maximum appreciation/depreciation in one day



Source: Banco de la República. Corficolombiana.

Graph 12. In 2023, TRM presented daily variations of magnitudes lower than those observed in 2022



Source: Banco de la República. Corficolombiana.

For 2024, a challenging outlook for the USD/COP exchange rate is foreseen, since in the medium term there are still risk factors that will keep its volatility high. Both external factors, such as the perception of a possible significant recession in the United States, the loss of carry trade attractiveness in emerging economies to the extent that interest rates start to be cut before the Federal Reserve does so, and the persistence of high commodity prices; and internal factors, which include the decrease in inflation in Colombia and the correction of the current account deficit, will be determining in the behavior of the TRM in the coming months.

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The importance of hedging transactions and the forward analysis

In international trade, companies often carry out transactions in foreign currencies, which exposes them to exchange rate volatility. Unfortunately, anticipating the direction of these changes is extremely complex. In the face of uncertainty, Colombian businessmen are well advised to carry out hedging operations that help them mitigate the exchange risk associated with their international transactions so as not to affect their cash flows and improve their financial position in the long term.

Financial products such as forwards and depreciation from them[3], allow to implicitly estimate the value at which the purchase and sale of dollars will be made in the future and the market expectations regarding exchange rates.

When analyzing the cost of implementing an exchange hedge in the country, by means of forward contracts, it is observed that the practice of protecting cash flow against exchange rate variations[4] has increased in recent years, for different maturities. This increase is mainly attributable to the interest rate differential between Colombia and the U.S., a primary determinant of such hedging.

By using forward contracts, it is not only possible to calculate the costs associated with the acquisition and sale of dollars in the future, as well as the expectations related to the exchange rate. They also provide the ability to identify the maturities most used by real sector companies, as well as the months in which they tend to carry out more net purchase or sale transactions.

When examining the volume of forward transactions through net purchases made by the real sector over several years, it can be affirmed that the first three months and the last month of the year stand out as the months in which, on average, the real sector makes the largest net purchases in the forward market, and the months of August and October as the months with the largest net sales on average.

A challenging outlook for the USD/COP exchange rate is projected for 2024, influenced by external and internal factors. In view of this, the importance of foreign exchange hedges to stabilize short-term obligations is highlighted. Financial derivatives such as forwards, futures and currency options are effective tools to mitigate transactional risk, especially relevant for exporting and importing companies with debt denominated in foreign currency.

Emphasis is placed on the need to establish a foreign exchange risk policy, a fundamental step to manage exposure to exchange rate fluctuations. The policy should define clear objectives, hedging strategies, specific responsibilities, and a control and monitoring system.

In conclusion, short-term foreign exchange risk management is essential in a challenging economic context. The implementation of foreign exchange hedges, supported by a well-structured policy, is a key tool to preserve financial stability and contribute to business growth in a changing and volatile environment.

[3] Forward points are the basis points that are deducted from or added to the current (spot) exchange rate to determine the exact exchange rate at which the contract will be settled.

[4] The costs of making a forward are obtained from the implicit devaluation, which corresponds to the percentage variation in effective annual terms between today´s price and the future price of the USDCOP exchange rate in each term.