Colombia
Country Report

Economic Research, **Corficolombiana**

I. Economic Activity

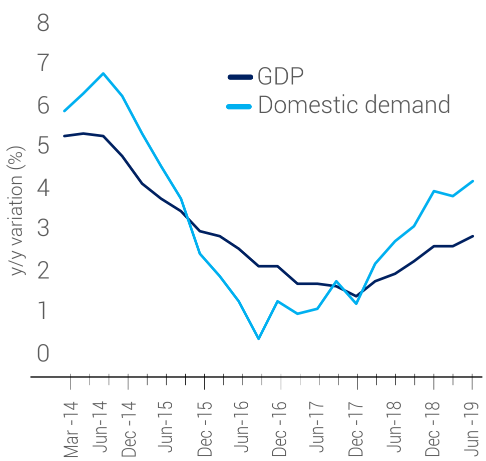
Content:

Swimming upstream

Growth accelerated from 2.6% y/y in 2018 to 3.0% in 1H2019, led-by domestic demand (Figure 1) despite weaker activity in LatAm. We continue to forecast a growth rate of 3.2% for 2019 and in consistence with this view, we expect activity to gain momentum reaching a growth rate of 3.4% during the second half of the year.

Private Domestic Consumption grew at an annual rate of 4.6% during 1H2019 backed by a minimum wage real increase of 2.7% -the highest in 25 years- and a stronger growth of consumer credit. Private investment continues to recover, growing 4.3% y/y during 1H2019, almost twice as large as the 2.6% recorded during the same period last year. The better momentum of capital expenditure plans reflects: i) the pro-investment measures included in the Financing Law approved at the end of last year —such as the reduction in corporate taxes (from 37% in 2018 to 34% in 2019 and a gradual downward reduction of 30% by 2022) and the tax credits for the VAT paid in the acquisition of fixed assets.

Figure 1.
GDP and domestic demand in Colombia
(quarterly data)

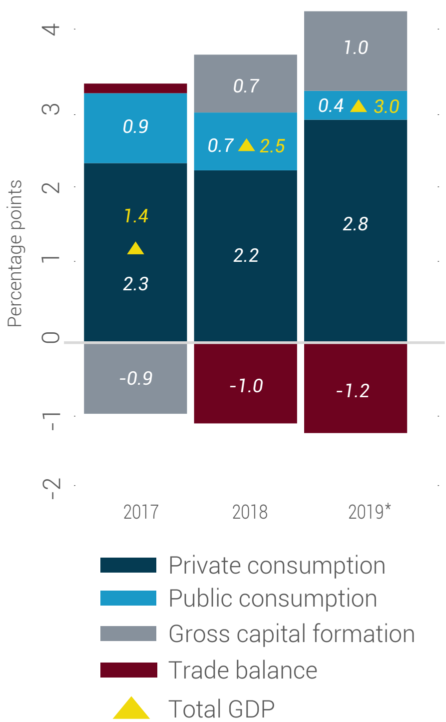


Source: DANE

Public spending, on the contrary, has slowed down and only grew 2.7% y/y in 1H2019, less than a half of the 5.6% growth registered in 2018, as a result of the ongoing fiscal consolidation and the sluggish execution of spending during the fiscal year. Spending at the subnational level, which is driven by the electoral cycle at the regional level, has been surprisingly modest and the ministers appointed by president Duque (some of them without prior experience in the executive) are still in the process

Low interest rates and the pro-investment of the Financing Law explain the better momentum of investment plans

Figure 2.
Contribution to economic growth - Demand side



* First Half
Source: DANE, Corficolombiana

Colombian economy has been resilient to a broad-based slowdown of economic growth worldwide

of designing new policies and programs. All the above explains the slow pace of execution by the Central Government.

Net exports continue to drag economic growth and subtracted 1.2 percentage points to the 3.0% y/y in 1H2019 (Figure 2). Colombia continues to struggle on its effort to diversify its exports from Oil and Coal and find a substitute market for Venezuela, which used to be Colombia's most important trade partner before its economic collapse. In consequence, the current account deficit is widening and it is expected to reach 4.2% of GDP by the end of 2019.

Against this backdrop, we are skeptical about the capacity of the economy to pick up momentum onwards, particularly in 2020, given lower growth prospects world-wide, regionally and some internal issues, such as: i) the large current account deficit, which despite being mostly financed by foreign direct investment (FDI), leaves the economy vulnerable to short-term portfolio outflows; ii) the uncertainty related to fiscal framework in 2020 and beyond, after Colombia's Constitutional Court sentence which revoked the Financing Law, claiming procedural errors during the approval stages of the Law, although the decision is not retroactive and allows the Government to seek a new approval in Congress before the end of this year. Our forecast for growth in 2020 is 3.1%, primarily reflecting weaker domestic demand growth, especially in household income due to a lower rise in minimum wage and a moderation in consumer credit.

Consumption and Investment

A story of private growth

As mentioned earlier, activity has been resilient to a worldwide broad-base synchronized economic-growth slowdown, mainly thanks to stronger private consumption and investment. Household spending is growing close to an annual rate of 6% supported by higher wages in the formal sector and rapid growth in consumer credit. Wages in the formal sector have benefited from the hike in the statutory wage (minimum wage) of 6% (2.8% in real terms), and a shortage of skilled workers, which has led to the increase in wages for well trained-experienced workers. In addition, consumer credit is growing at a strong pace, partly fueled by a stronger competition in the segment as banks try to diversify from commercial credit, which remains flat despite stronger economic growth.

Commercial credit has been hit hard by a serious of large non-performing loans associated to public transportation systems in some cities (Massive Transportation projects) and the contingencies related to infrastructure projects. Some domestic banks have pursued an active strategy of replacing commercial credit with consumer credit, looking for larger credit spreads and faster revenue growth. The availability of consumer credit combined with faster wage growth explains the better outlook for private consumption in 2019, but at the same time justifies our less optimistic forecast for GDP growth in 2020.

Consumer credit recovery combined with faster wage growth explain the good figures of private consumption in 2019

On its turn, private investment continues to recover and it is expected to grow 4.0% in 2019. Investment on machinery and equipment grew 12.0% y/y in 2Q19, after reaching a peak growth of 18.4% in 1Q2019. This stronger pace primarily reflects lower interest rates and lower corporate income taxes, reduced by the Financing Law from 37% to 33%, as well as the tax credits for the VAT paid in the acquisition of fixed assets, which can be deduced against income taxes.

The stronger growth of non-residential investment contrasts with the sluggish investment on housing. Real estate activity has remained subdued since the economic slowdown brought by lower oil prices in 2014. The contraction of the housing sector has been particularly strong on the high-end segment in which inventories remain large as a result of oversupply during the booming years. On the contrary, low-end homes have benefitted from subsidies and other public programs such as interest rate and down payment subsidies. Altogether, value-added in the construction sector, excluding structures, fell 7.2% y/y in 1H2019. For the rest of the year we expect a smaller decline in value added and forecast a contraction of 6.3% in an annual basis as a result of a recent pick up on cement dispatch, a leading indicator of activity in the sector.

II. Inflation and Monetary Policy

No room for monetary stimulus

Once the shock generated by the 2016 tax reform vanished by early 2018, annual inflation quickly converged into the target range set by Colombia's Central Bank (BanRep's) (2.0%-4.0%). In the first half of 2019, annual inflation remained relatively stable at around 3.3%, but during the last few months it trended up, moving closer to the upper limit of the target range. Inflation rose to 3.82% in September from a bottom low of 3.02% in February (Figure 3).

Recent pickup in consumer prices has been driven by food prices, affected by adverse climate conditions

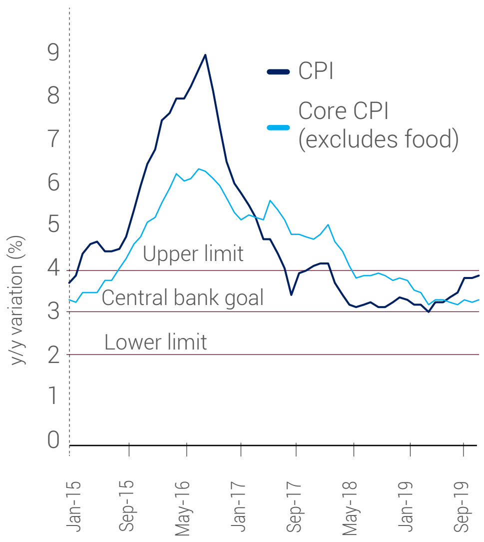
This pickup in consumer prices is primarily explained by food prices, affected by adverse climate conditions such as El Niño Phenomenon on 1Q2019 and heavy rainfall on 2Q2019, as well as road closures caused by blockades and landslides. These shocks brought annual food inflation up to 5.6% in September, a figure not seen since the beginning of 2017. Tradable prices are also adding some pressure since they are gradually incorporating the exchange rate devaluation from late 2018. Even though, the FX pass-through remains low and tradable annual inflation stood at 1.7% in September, we expect it will inch up in the next few months.

Central bank is expected to maintain stable its monetary policy rate in 4.25% (slightly expansive) throughout 2019 and 2020

Non-tradable prices remain on a downward trend since the beginning of 2018 —moving around 3.5% in 2019— because of lower price indexation and a negative (but closing) output gap. In the same way, regulated annual inflation eased from 6.4% in December 2018 to 4.7% in September, driven by a marked reduction in fuel and energy prices; however, regulated prices remain significantly above BanRep's target.

We expect the transitory shocks affecting food prices to moderate in the upcoming months leading to a total inflation of 3.6% by the end of 2019 and 3.4% by 2020. Nevertheless, we estimate that the recent exchange rate devaluation will drive tradable prices back to the target range throughout 2020, adding upward pressures and preventing total inflation from reaching a lower level.

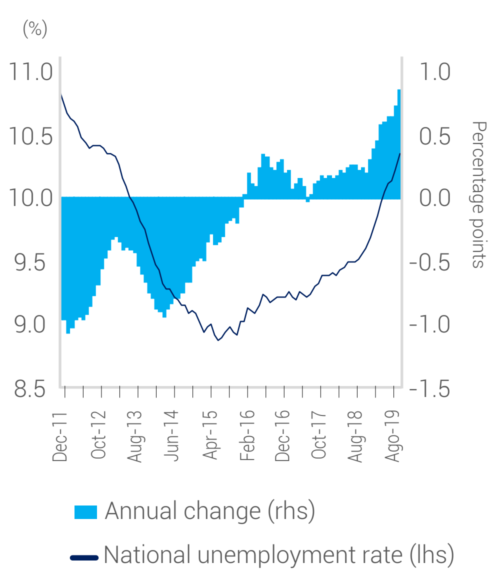
Figure 3.
CPI and Core CPI



Source: DANE

Employment and labor force participation figures remain puzzling given the pickup in economic activity

Figure 4.
National unemployment rate in Colombia (12 month average)



Source: DANE

In this context, and considering that the economy is still recovering at a moderate pace and remains below its long-term capacity, we estimate that BanRep will maintain the monetary policy rate at its current level of 4.25% (slightly expansive) throughout 2019 and 2020, accounting for a stability cycle of thirty-two months, the longest since the inflation target scheme was implemented in 2000.

III. Labor Markets

Notwithstanding better growth numbers, the domestic labor market remains weak. The unemployment rate reached a new peak of 10.8% in August, 1.6 percentage points higher than that of the same period of the previous year (Figure 4). This upsurge in unemployment is mostly explained by sluggish job creation and not by an increase in the participation rate, which is surprisingly declining despite the large inflow of immigrants from Venezuela. Employment and labor force participation figures remain puzzling, given the pickup in economic activity and the fact that the increase of migration in the last years seems to be not fully captured by official statistics.

The weaker pace of job creation could be explained by three factors: i) the large increase in the statutory minimum wage approved by the Government for this year; ii) substitution of labor by capital because of the incentives to machinery and equipment investment included in the Financing Law; and iii) a tighter labor markets for skilled labor that prevents firms to hire workers in the largest cities in the country to expand in the middle of some technological reconversion. The government has adduced that the slowdown in the construction sector is also a key factor behind the lethargic labor market, but employment growth in the construction sector remains on positive territory given that activity in the low-end housing segment is labor-intensive. The agricultural sector stands out as the worst in terms of job creation during the last year. One possible explanation is that formal jobs on agriculture, are now being taken by immigrants and not officially reported.

IV. Fiscal Policy

Stronger tax revenue, uncertain outlook and blurry numbers

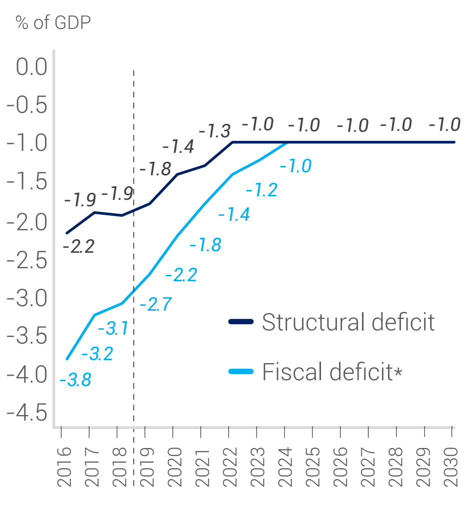
Tax revenues and Fiscal Deficit

Fiscal numbers have surprised on the positive side so far, this year as tax revenues have surpassed expectations and public spending is not being executed at the usual pace as part of the adaptation process of new government officials in charge of many of the social programs. Up until August, the fiscal balance of the Central Government reached a deficit of 1.5% of GDP, an improvement upon the same figure over the last couple of years of 2.2% and 2.5%, respectively. Consistent with this better number, the Government expects to have a primary fiscal surplus by the end of the year and a fiscal deficit of 2.4% of GDP, surpassing the Fiscal Rule target (Figure 5).

Government expects to have a primary fiscal surplus and a total fiscal deficit of 2.4% of GDP by the end of the year

It is worth remembering that the Fiscal Rule was modified in April to accommodate for additional spending related to immigration and under the assumption that the short-term costs on health and education to attend Venezuelan immigrants will translate into a higher potential output growth because of a larger labor force in the future. As a result, the Committee for the Fiscal Rule decided to ease the fiscal target of 2019 to 2.7% of GDP from the previous 2.4% of GDP and adopted changes in the same direction for the fiscal deficits for the next two years. A month after this decision, the government announced its intention to meet the initial target of 2.4% of GDP by selling its participation in some public companies.

Figure 5.
Fiscal deficit of Central Government



* From 2020 to 2030, it refers to fiscal deficit allowed by Fiscal Rule

Source: Ministry of Finance

The announcement of the lower deficit target was welcomed by markets, but there was some criticism as the official numbers showed the proceeds from the eventual asset sale program as revenues (above the line) and not as a financing source (below the line). At the end, this controversy was not relevant for 2019, given that the government is reaching the 2.4% fiscal deficit target without relying on privatizations. However, this issue is likely to resurface in 2020. The government has restated its intention to sell ISA – an electric power company which is worth about US$3.3 billion.

In addition, recent decision by the Constitutional Court to revoke Financing Law from January 2020 increases the uncertainty on next year's fiscal adjustment and undermines the economic policy credibility. On the one hand, corporate tax reduction and incentives to investment included in the Financing Law would have had a negative impact on the tax revenues for the government: we estimate a fiscal revenue reduction of 0.2% of GDP in 2020, 0.3% in 2021 and 0.5% in 2022. Nevertheless, this administration supported its economic and social plans –included in National Development Plan 2018-2022– in boosting growth and investment through tax cuts to firms, so legal instability associated to Court rulings could modify private investment plans. Our base scenario assumes that the government will present again the Financing Law to Congress, using an important amount of its political capital to get it approved, thus reducing the chances to propose other important reforms (Pensions, Labor market, capital market).

There is some criticism as the official numbers showed the proceeds from the eventual asset sale program as revenues (above the line) and not as a financing source (below the line)

As we mentioned above, even before the Court ruled against the Financing Law it was unclear how the government would make up for the lower corporate tax revenue going forward, given the reduction in the corporate income tax from 32% to 30% over the next three years, and the end of the presumptive income tax by 2021, as approved by the Financing Law in 2018, that would imply a larger deficit of 0.2%, 0.3% and 0.5% of GDP for 2020, 2021 and 2022, respectively.

Moreover, although the Minister of Finance, Mr. Carrasquilla, seems to be determined to continue with the process of selling ISA, it remains to be seen whether he can count on the political support from the government's party. Former president, Mr. Uribe, leader of Centro Democratico Party, has opposed several times in the past to selling public companies in strategic sectors. Mr. Uribe vocally contested the sale of Isagen –also in the electric sector- during the previous administration. Mr. Duque, the current President, also opposed to this sale during the time he was Congressman, a political position that could be used today by the opposition to try to block the privatization.

Now, the option of selling an additional participation in the state oil company, Ecopetrol, seems out of the table. Nevertheless, if the plan of the Finance Minister to sell their control of Interconexión Electrica S.A. – ISA (the main energy distribution company in the country) fails, this could be the most likely alternative.

Debt for Obligations

The Ministry of Finance was granted a new authority by the National Development Plan approved in May, to issue local peso bonds (TES) to replace non-explicit public debt such as obligations with healthcare providers and delinquent debt related to lawsuits against the Nation. A recent amendment to the 2020 budget also authorizes the government to issue local debt to pay for gas and electricity subsidies.

A recent amendment to the 2020 budget authorizes the government to issue local debt to pay for gas and electricity subsidies

These operations make sense from a financing point of view as they replace expensive obligations – in some cases bearing an interest rate above 30%- for local issued bonds that pay 6% at most. However, none of these costs will be accounted as expenses, so while increasing public debt, they do not record as part of the government's deficit. If this type of operations become the new practice, the outright link between fiscal deficit and debt would disappear, rendering obsolete the Fiscal Rule. The government has faced strong criticism because of this type of operations and we expect the Fiscal Rule Committee to pronounce itself against it next year. For the time being, the government expects to issue new TES for a total amount of US$3.2 billion (COP 11 trillion) to replace US$ 2 billion (COP 7 trillion) of delinquent debt associated to lawsuits against the nation and US$ 1.2 billion (COP 4 trillion) of healthcare debt. We think that by year's end this number will be close to US$1.4 billion (COP 5 trillion) as the government is underestimating the time it takes to settle these obligations.

Healthcare System Deficit

The fresh resources being injected into the healthcare system have been welcomed by hospitals and clinics that are under financial stress because of the unpaid debts of the government and the EPS (the health insurance firms that affiliate patients and collect premiums from the Solidarity and Guarantee Funds). According to the financing plan for this year, the government is expecting to issue TES and transfer funds to the healthcare by US$1.16 billion (COP 4 trillion), on its effort to reduce a deficit that can amount to US$ 2.90 billion (COP 10 trillion). In addition to this operation, the government has announced changes to the healthcare system (Ley de Punto Final) that not only include the payment of the delinquent obligations, but also a cap to the maximum amount that the EPS can charge the government for medical procedures outside the basic medical coverage.

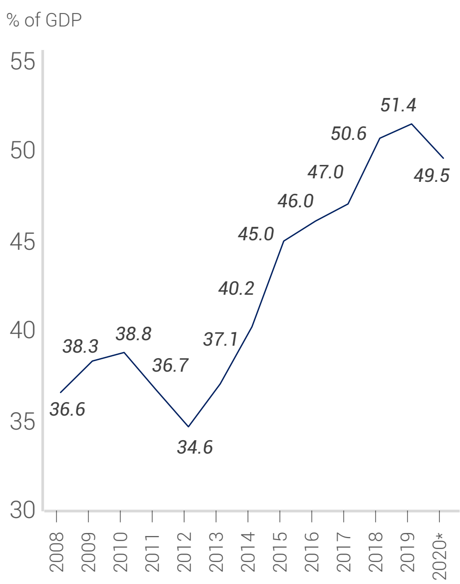
We expect the Central Government debt to increase by 1.7 percentage points by the end of the year, rising to 52.3% of GDP in 2020 from 50.6% this year

Rising Debt despite Lower Deficit

As result of the issuance of new TES to replace existing obligations and the depreciation of the peso, we expect the Central Government's debt to increase by 1.7 percentage points by the end of the year, rising to 52.3% of GDP in 2020 from 50.6% this year. The fiscal plan for 2019 assumed an exchange rate of COP/USD 3,209 by year's end. Each percentage point of depreciation of the peso additional to the fiscal plan increases debt by 0.17 percentage points of GDP. This effect is partially offset by greater tax revenue coming from oil exports and international reserves. Taking all this into account, an exchange rate of COP/USD 3,450 by the end of the year should translate into a 1.2 percentage point of GDP increase in the government's debt.

The government expects debt-to-GDP to stabilize around 51% due to strong growth (Figure 6). As we mentioned earlier, we are skeptical about the capacity of the economy to continue with its positive momentum and estimate that the economy's growth rate will hover around 3% over the next few years, well below the 4% assumed by the government. In that case, debt-to-GDP will remain above 52% and the government will need to rethink its fiscal policy strategy, which is now mostly based on stronger activity and improved tax collection efficiency.

Figure 6.
Gross debt of Central Government



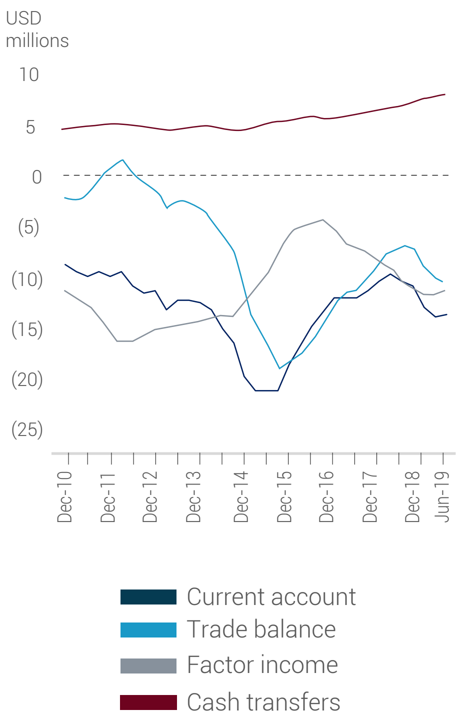
* Government estimation

Source: Ministry of Finance

For the time being, credit agencies, with some differences, seem to be willing to wait and see whether the current fiscal strategy works. Moody's decided to remove Colombia's sovereign negative outlook in April, based on the better growth prospects for this year. Fitch Ratings, on the contrary, switched the outlook to negative from stable, highlighting the need for a fiscal structural adjustment that cannot be replaced by a one-off revenue policy, such as the asset sale program. Although Fitch could announce a downgrade decision any time before year's end, we do not rule out that it could postpone the review of the outlook to 1Q2020 in order to have more information about revenue growth and public spending during the second half of this year.

V. External sector

Figure 7.
Current Account by components (four mobile quarters)



Source: DANE

Current account deficit continues as one of the major vulnerabilities of Colombian economy

A widening deficit that adds to fragility

Colombia's Current Account deficit widened to 4.4% of GDP in 1H19, from 3.7% of GDP during the same period last year. The wide deficit is primarily explained by the increase in the trade deficit of goods and services (Figure 7). The increase in imports, especially capital goods and transportation equipment, along with smaller oil and coal exports, explain most of the increase of the trade deficit in the first half of the year. The trade deficit has been offset by a decrease in the factor payments and larger remittances sent by Colombian citizens living abroad.

The fall in oil exports respond entirely to a reduction in oil prices that declined to $66 dollars per barrel (dbp) in 1H2019 from 71 dbp during the same period last year (Brent reference). Meanwhile, coal exports have declined in volume terms by an average of 15% during the first eight months of this year because of lower oil production and weaker demand by Colombia's main importer, Turkey, and a more sluggish demand worldwide in general.

Going forward, we expect oil prices to inch down to 65 dbp for the rest of the year, which is consistent with the broad-based economic slowdown and the OPEC's effort to offset bearish risk with cuts on supply. Regarding prospects for coal, we estimate a challenging environment due to a decrease in the global demand and a decline in domestic production associated to regulation.

Given this backdrop, the external front, as well as fiscal side, continues as one of the major vulnerabilities of Colombia's economy. Despite the large increase of 24% in FDI inflows in 1H19, the resilient growth of imports in the context of large peso depreciation (close to 12% during the last year) implies that Colombia will continue to rely on capital inflows, which eventually could become harder to attract given the elevated uncertainty and the precarious outlook of the global economy.

The central bank is fully aware of this risk, and early in the year committed to accumulate international reserves using PUT options. The international reserves accumulation program worked relative well at the beginning of this year (Banrep bought US$ 1 billion during the first four months) but once the peso started to depreciate, the program faced strong criticism and the monetary authority put it on hold. The room for further intervention in the FX market has greatly diminished given the upward pressure on tradable goods coming from a weakened peso. On this front, we think that Banrep fell short at accumulating reserves and that it could try to secure an extension of the Flexible Credit Line arrangement with the International Monetary Fund (IMF).

VI. A review of the Corporate Sector

Upside opportunity despite gloomy past

Besides price considerations that have boosted the certification of new reserves in 2017 and 2018, the enhanced recovery program is the most important factor for adding reserves

Despite stronger economic activity relative to previous years and the Latam region, Colombian equity markets have not really delivered in the recent past. The gains of 18% this year, although positive, just compensate for the losses of 12% in 2018. Despite this gloomy picture, there are some sectors and specific companies that stand out as an investment option, particularly when compared to the rest of Latam and with an important upside, if risk aversion rescinds.

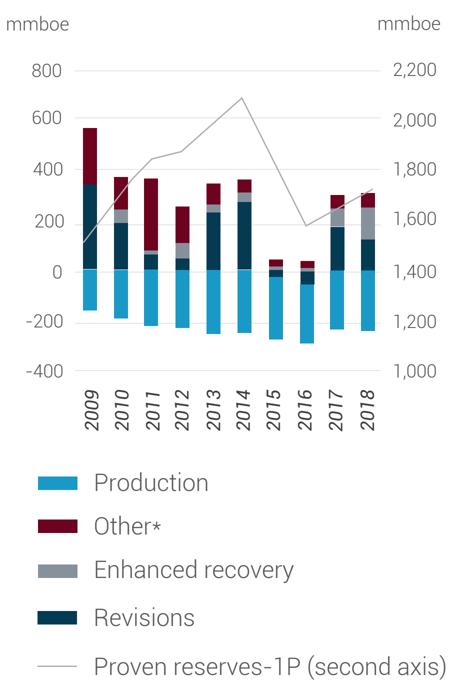
Oil and gas

Oil and Gas companies weight 14.7% of the local market index (Colcap - a capitalization index composed by the most traded stocks). The Oil industry, although only weights 6% of the country's GDP, is at the center of Colombia's economy activity given its importance in terms of exports and fiscal revenues. The government has an 88.5% stake in **Ecopetrol**, the most important local player, with around 67% of the country's total oil production, and 88% of oil equivalent proved reserves.

Ecopetrol's production since 2016 is on average 718 kboed (thousand barrels of oil equivalent per day), with a small variation of less than 1% per year. The stable production of the company has been enabled by enhanced recovery programs that currently explain around 30% of the company's production. Besides price considerations that have boosted the certification of new reserves in 2017 and 2018, the enhanced recovery program is the most important factor for adding reserves, making it the key variable for Ecopetrol and the country's oil industry.

Given that there are plenty of oil fields where the recovery program can be implemented- as long as the price of oil remains around US$ 60, we expect the company to continue delivering positive results in terms of both production and fiscal revenues. Going forward it remains to be determined whether the company will be able to undertake Hydraulic Fracking projects to increase its production and extend Colombia's oil self-sufficiency. Recently, Colombia's Council of State, an administrative court, granted permission to oil companies to carry out pilot fracking projects with the goal of getting more information about the effects of fracking. This authorization, although opens the door to the use of this technology, shows that it will be a long and bumpy road ahead before Ecopetrol, or any other company, can use Hydraulic Fracking at large scale.

Figure 8.
Ecopetrol's proven oil reserves (1P)



Source: Ecopetrol. Extensions, discoveries and acquisitions. mmboe: Millions of barrels of oil equivalent

Just as in the case of oil, Colombia's self-sufficiency in natural gas is limited to a couple of years, but this could be less worrisome given the relative easiness there is to construct regasification plants near Colombian ports, as well as the current and expected low gas prices in international markets. Ecopetrol is the most important player in gas E&P. Another important player in this market is **Canacol**, which despite being a small company in terms of market capitalization, has an active pipeline projects, and an excellent track record of finding gas reserves. We expect Canacol's margins to increase because of the recently opened **Promigas** pipeline. In addition to regulated (households) and industry consumption growth, we expect an increase in the gas share in thermic electricity generation relative to carbon, and an increase in gas consumption relative to gasoline, because of environmental considerations.

Utilities

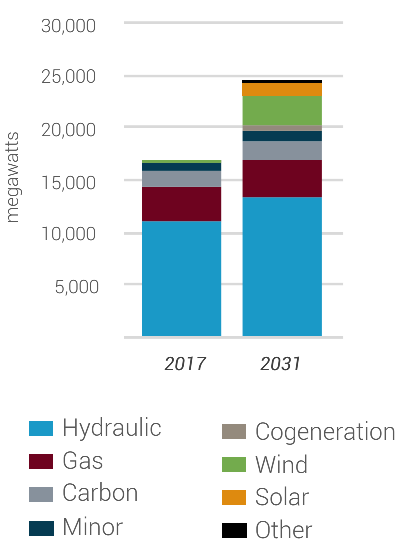
While this sector weighs only around 3.3% of GDP, its listed companies represent 16% of the Colcap (excluding the share of holdings that invest both in energy and infrastructure). These companies belong to the whole power industry chain (generation, transmission, distribution and commercialization of electricity), and the gas transportation activities (transportation and distribution) of the gas industry. The premise of an outright connection between energy consumption and economic growth holds in Colombia, as well as a secular growth trend, explained by the

The long term goal of the country in this front is to increase the share of unconventional renewable generation (wind, solar, biomass, etc.) with respect the total generation matrix from less than 1% (2017) to around 18% in 2031 (4,349 MW)

increasing share of the population accessing basic public services. Environmental awareness is not expected to have a negative effect on energy consumption, but rather to alter the energy generation matrix towards renewables (as opposed to thermal electricity generation). The country's long-term goal in this front, is to increase the share of unconventional renewable generation (eolic, solar, biomass, etc.) with respect to the total generation matrix from less than 1% (2017) to around 18% by 2031 (4,349 MW). **Celsia,** is becoming the most important player in nonconventional electricity generation.

Among the important issues for the sector's outlook are: i) the uncertainty surrounding EPM's Hidroituango and when it will become operational. Hidroituango will be the largest hydroelectric power plant of the country when finished, and its planned capacity would increase Colombia's capacity by around 14%. ii) The bid for **Electricaribe** (around 16% of the country's distribution); and iii) the eventual privatization of **ISA,** the country's largest transmitter (around 48% of local market share), with a remarkable international presence, focused in Brasil, Chile and Perú.

Figure 9.
Colombia's long term power generation matrix goal



In relation to the sector which carries out natural gas distribution and transportation activities, the key aspects to follow are: i) the construction of a regasification plant near a port in the pacific coast; ii) the construction that enables bidirectionality in the country's central gas pipelines to transport between the Atlantic region and the Central region of the country), iii) volatility on the demand of gas from the thermal power generation plants, in line with the el Niño, and iv) the construction of the transmission line that will enable the connection of the nonconventional renewable generation of the far north of the country (Guajira) with the interconnected national system (Sistema Interconectado Nacional).

Given that **Grupo Energía Bogotá (GEB)** is present in the whole energy chain (generation, transmission, distribution and commercialization of electricity); as well as transportation, distribution and commercialization of natural gas), we highlight this company as the one whose results will capture the mentioned factors; maintaining its growing revenue base.

Not surprisingly, the performance of this sector is related to the country's economy, so the better economic outlook is having a positive effect on valuations on this sector

Financial Services

The 4.3% share in GDP from financial and insurance activities obscures the fact that the financial sector is the most important in the Colombian stock market, given its share in the capitalization index of 43.5% (31.6% if we only include banks and a bank holding). Not surprisingly, the performance of this sector is related to the country's economy, so the better economic outlook is having a positive effect on valuations on this sector. It is also worth mentioning that beyond considerations of domestic activity, banks are increasingly affected by economic activity in Central America, where the three largest banks have significant investments.

Retail

Commerce represents around 18% of Colombia's PIB, and it is represented in the stock market by retail and processed food companies. The retail industry's share in the Colcap is around 10%, and the companies listed in Colcap exemplify the weakeness of Latam growth for the second half of the current decade.

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Given the forecasts we have for the country's consumption growth, which although positive but far from the large numbers we observed during the booming years, and the stronger competition from hard discount retail, we expect stable numbers for **Nutresa's** revenue, and recommend selling the position in **Grupo Éxito,** given the ongoing corporate reorganization by the parent company **Casino Group.** On the most optimist scenario, we expect a stable single digit growth in revenue from defensive stocks.

Construction

Without adding the share of holdings that invest both in energy and infrastructure, the construction sector's share is around 9% of the Colcap (including infrastructure, construction and cement, with Cement doing most of the work) and 7% of GDP. Investing in construction and infrastructure might be taken as a sure bet, given the room the country has to grow in urban development, roads and infrastructure, and housing for the poor. The fact of the matter is that this sector has underperformed in recent years, in part because of regulation problems and environmental considerations.

Out forecasts are far from optimistic, yet include a timid recovery of the construction sector as a whole, and a spike in infrastructure construction as a function of the public-private partnerships

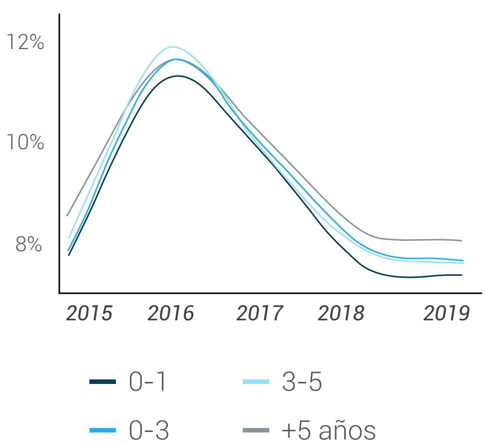
If we add regional prospects for the cement market, the outlook turns even gloomier. Our forecasts are far from optimistic, yet include a timid recovery of the construction sector as a whole, and a spike in infrastructure construction as a function of the public-private partnerships. If the Colombian peso remains relatively weak against the dollar, our top pick is **Cementos Argos,** given its market presence in the US, a further reduction in operational costs, and a strong position in the domestic market with a market share of 60% in concrete and cement.

Other sectors / companies

Finally, a couple of individual remarks to cover the full spectrum of the Colombian equity market: The insurance, asset management and pension sectors are represented in **Grupo Sura.** We do not expect an upside for the company, given the subdued growth in the region.

Avianca Holdings, the largest airline in the country, could have a bright future, if it manages to overcome next year's debt settlements. Prices shares are attractive, yet they reflect the inherent risk of the current financial fragility.

Figure 10.
Cost of debt



VII. Corporate Finance - local view

Lower corporate spreads and equity costs

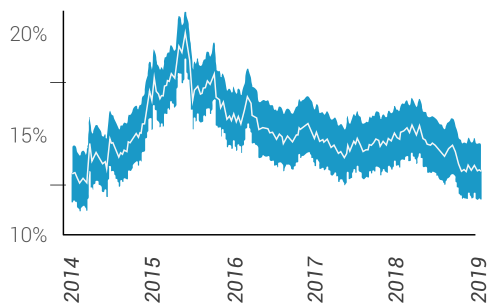
Cost of debt

During the period that covers the last 8 years, Colombia went through two episodes of high corporate rates. The first event came through between 2010 and 2012, related to a reduction of the monetary stimulus by the central bank. The second episode occurred shortly after the collapse of oil prices in 2014 that ultimately and negatively affected the Colombian credit markets. Yet, that is all in the past now. Interest rates of both credit institutions and securities market debt securities are lower than those observed in the last 4 years and represent a great opportunity for companies that wish to reduce their borrowing expenses, refinance their obligations, or carry out long-term investment plans, financed with debt. Today, corporate spreads price in a low probability of default, showcasing an improvement in the country's economic conditions.

7% - 8%

Is the range of the interest rates for corporate credit

Figure 11.
Cost of equity



13.1%
Is our CAPM based estimation of the cost of equity

Cost of equity

The profitability required for buying equity in Colombian companies decreased in the last 4 years. Our CAPM based estimation of 13.1% in COP (9% in USD) denotes a 7.1% margin above the 10-year COP denominated government bond yields. This value, in conjunction with other variables including the cost of debt and WACC, is one of the tools that companies use to tackle investment decisions. A drop in both long-term US treasury yields and the risk premium for Colombia explained the reduction in the cost of equity in the last 3 years. We believe that a low cost of equity is a necessary condition for companies to increase CapEx in the next couple of years.

A word on capital structure and taxes:

Some of the companies we study responded to credit market opportunities and did not necessarily sought after a target capital structure. Several companies in the country do not optimize their capital structure as the modern corporate finance theory advises, but on the contrary, move in harmony with interest rates, as the theory known as "market timing" suggests. Moreover, the changing conditions on the corporate tax rates and the equity tax, makes it difficult to plan for long-term debt tax shields. It is reasonable to chase low interest rates no matter how their current capital structure is.

4 key numbers *(under the assumption that the Financial Law gets approved by Congress)*

Current Cost of Equity with a Beta of 1	**12% - 15% in COP** (7.5%-10.5% in USD)
Current Cost of Debt in COP (long-term AAA rated)	**7% - 8%**
Corporate Tax Rate: 2019	**2019 = 33% · 2020 = 32%** **2021 = 31% · 2022 = 30%**
Weighted Average Cost of Capital in COP (for a 50% equity financed company)	**8.3% - 10.2%**

Forecasts Table

	2018	2019p	2020p
Economic activity			
Growth rates (year-over-year, %)			
GDP	2.6	3.2	3.1
Private Consumption	3.6	4.1	3.8
Government Spending	5.6	3.8	2.4
Investment (Gross Capital Formation)	1.5	4.2	4.6
Exports	3.9	3.2	2.8
Imports	7.9	7.7	5.0
Contribution to GDP growth (percentage points)			
Private Consumption	2.5	2.8	2.6
Government Spending	0.8	0.6	0.4
Investment (Gross Capital Formation)	0.3	0.9	1.0
Exports	0.6	0.5	0.4
Imports	-1.7	-1.7	-1.1
Inflation			
End of the year (y/y,%)	3.2	3.6	3.3
Average (y/y, %)	3.2	3.5	3.3
Interest rates			
Repo rate set by the Central Bank (end of the year, %)	4.25	4.25	4.25
Time Deposits (end of the year, %)	4.54	4.50	5.00
Fiscal accounts			
Fiscal Balance of Central Government (% GDP)	-3.1	-2.7	-2.2
Primary Fiscal Balance of Central Government (% of GDP)	-0.2	0.5	-0.3
Net Public Debt (% of GDP)	50.6	51.5	49.9
Nonfinancial Public Sector Gross Debt (% of GDP)	54.5	NA	NA
Fiscal Balance of Nonfinancial Public Sector (% of GDP)	-2.4	-1.7	-1.0
External accounts			
Exchange rate (end of the year, COP/USD)	3.250	3.275	3.350
Exchange rate (average, COP/USD)	2.957	3.240	3.325
Current Account (% of GDP)	-3.9	-4.2	-3.9
FDI (% of GDP)	1.9	4.3	2.8

Source: BanRep, DANE, Ministry of Finance and Corficolombiana

Economic Research Team

Jose Ignacio López
Executive Managing Director and Head of Economic Research
(+57-1) 3538787 Ext. 6165
jose.lopez@corficolombiana.com

Macroeconomics and Financial Markets

Julio César Romero
Chief Economist
(+57-1) 3538787 Ext. 6105
julio.romero@corficolombiana.com

Ana Vera Nieto
Senior Economist | Fixed Income
(+57-1) 3538787 Ext. 6138
ana.vera@corficolombiana.com

Maria Paula Contreras
Senior Economist | Colombian Economy
(+57-1) 3538787 Ext. 6164
maria.contreras@corficolombiana.com

Cristhian Alejandro Cruz Moreno
Senior Economist | FX and Commodities
(+57-1) 3538787 Ext. 6120
cristhian.cruz@corficolombiana.com

Laura Daniela Parra
International Economy Analyst
(+57-1) 3538787 Ext. 6196
laura.parra@corficolombiana.com

José Luis Mojica
Local industries Analyst
(+57-1) 3538787 Ext. 6107
jose.mojica@corficolombiana.com

Nicolás García Díaz
Intern
(+57-1) 3538787 Ext. 6112
nicolas.diaz@corficolombiana.com

Equity Markets

Andrés Duarte Pérez
Director
(+57-1) 3538787 Ext. 6163
andres.duarte@corficolombiana.com

Roberto Carlos Paniagua Cardona
Analyst
(+57-1) 3538787 Ext. 6193
roberto.paniagua@corficolombiana.com

Daniel Felipe Duarte Muñoz
Analyst
(+57-1) 3538787 Ext. 6194
daniel.duarte@corficolombiana.com

Corporate Finance

Rafael España Amador
Director
(+57-1) 3538787 Ext. 6195
rafael.espana@corficolombiana.com

Sergio Andrés Consuegra
Business Intelligence Analyst
(+57-1) 3538787 Ext. 6197
sergio.consuegra@corficolombiana.com

Daniel Espinosa Castro
Corporate Finance Analyst
(+57-1) 3538787 Ext. 6191
daniel.espinosa@corficolombiana.com

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