Investigaciones Económicas

March 2025

FINANCIAL ANALYSIS

Cost of Equity (Ke): LAC 5 January Update

LAC5 Cost of Equity (Ke):

January 2025 Update

Cost of Equity (K_e): January 2025 Update

Largely unchanged costs amid a promising Latin America medium-term outlook

- The midpoint of Ke for Colombia is 15.0% in USD and 21.9% in COP per our results.
- As regards to the other target countries of this study, our Ke values in USD are 19.8%, 15.3%, 12.8%, and 13.6% for Brazil, Mexico, Chile, and Peru, respectively.
- Long-term downward trend for CDSs in the region, with Colombia still holding the highest figure among peers.
- Non-idiosyncratic factors such as the US-risk-free rate and market-risk premium exerted upward pressure on all countries in 2024.
- Balancing domestic and external factors, opposing trends evened out, resulting in a sideways trend in Ke for regional peers.
- We see a link between the downward trend in Investment/GDP in Colombia and its high Ke as the spread versus regional peers in investment ratios continues to grow.

Daniel Monroy
Corporate Finance Analyst
danielf.monroy@corfi.com

Andrés Duarte Pérez
Financial Analysis Manager
andres.duarte@corfi.com

This report is a follow-up to the October 2024 edition, with revisions to the previous estimates explained in the annex. This edition includes Brazil; thus, the cost of equity was calculated for the 5 Latin American countries with updated macro data. The complete explanation of the models employed is found in the Methodology appendix, detailing our method so our readers can take better decisions for their own models.

We noticed a sideways trend in the cost of capital (Ke) for selected Latin American countries in 2024. Downward pressures were mostly due to country risk premiums, while upward ones where partly driven by US-based rates, with both directions balancing each other out, ending up with just a slightly higher required return on equity in most of the Latin American countries studied as of January 2025.

LAC5 Recovery in Domestic Macroeconomic Signals but Facing Risks from Incoming Changes in US Foreign and Economic Policy

In the foreword of our previous Ke update, we anticipated a scenario where the higher-for-longer rates in Latin America would come to an end. However, rate cuts slowed down in Latin America after the US elections creating a path of a more moderate reduction than had been previously forecast by us and other analysts.

Since 3Q2024, reference rates have risen in Brazil and Mexico, and both are likely to stay on this trend in 2025. In contrast, domestic variables in the other regional peers selected for this study (Colombia, Peru, and Chile) suggest more favorable rate expectations into the new year. In addition to regional country-specific macroeconomics, there are non-economic factors to consider in the near term.

Such is the new US administration and the way its relations with Latin America pan out in the first quarters of 2025 will set the tone for the next four years. For now, we observe a wide tariff position with goods from Latin America facing trade restrictions that could lead to the scaling back or renegotiation of trade agreements such as the NAFTA with Mexico and Canada. Nonetheless, their decision-making so far shows bargaining over political issues can help level down tariff decisions —except for China— and many Latin America could remain unaffected by these restrictions.

The latter perspective aligns with Dan Restrepo, expert in US-Latin America relations, who claims migration and drug trafficking will be prioritized over the strictly economic[1]. Thus, the risk of disadvantageous measures directly targeting Latin American countries might shrink. However, the deportation of migrants could deepen tensions and lead to substantial drawbacks in bilateral relations with countries such as Venezuela, Colombia, Guatemala, and Mexico, who are the most affected by this issue. On the other hand, countries such as Panama and Costa Rica can profit from opportunities related to nearshoring and investment.

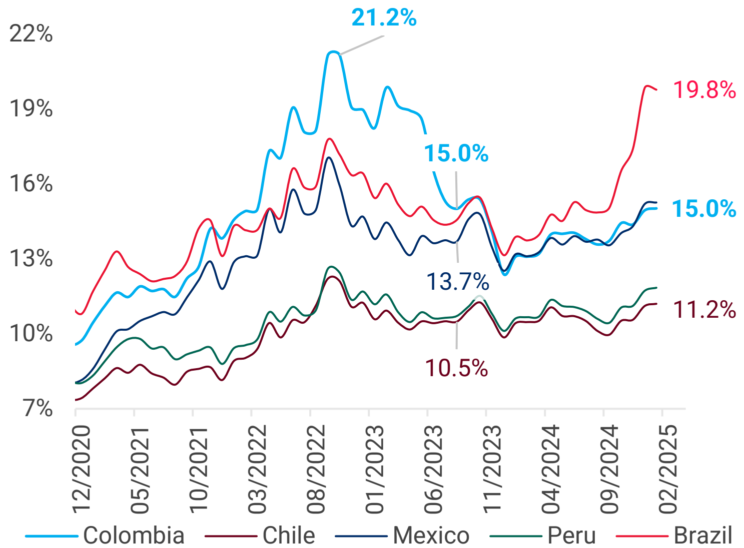
Finally, a stronger dollar is expected due to policies aimed to protect the U.S. currency. The aggregate impact on LAC5 exchange rates, foreign exchange hedging and thus on the exchange rate component within Ke, should be heterogeneous and highly unpredictable for the time being.

[1] Presentation by Dan Restrepo, former White House advisor on the outlook of US relations with Latin America, from the latest Annual Corficolombiana Forum held on December 3rd, 2024 (Spanish): https://www.corfi.com/documents/20123/0/presentacion-dan-restrepo-foro-corfi-dic2024.pdf

Evolution of Ke and Return Components: Focus on LAC5[2]

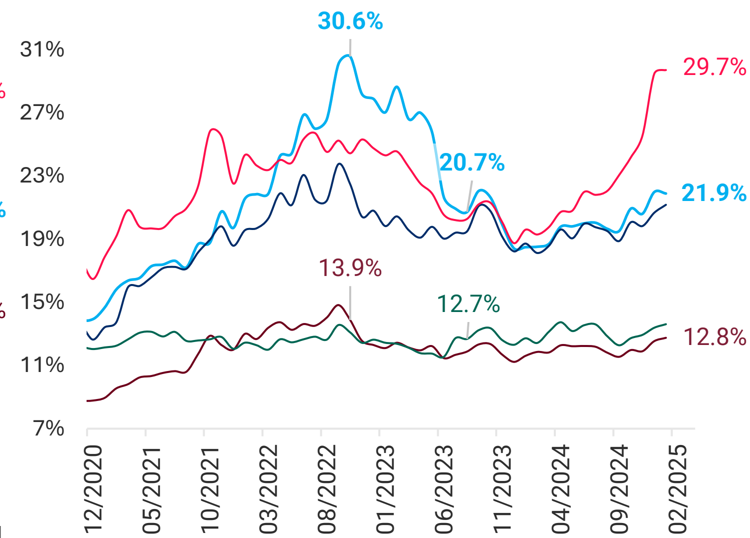
The falling long-term trend in cost of equity from the regional highs of 3Q2022 did not extend into 2024 in studied countries. Brazil, particularly, faced harsh upward pressures in the second half of 2024. Compared to the results from December 2023, **Ke in USD remained stable for most of the year (Graph 1), with remarkable increases for Colombia (+264 bps), Mexico (+273 bps), and Brazil, with a sharp rise of 663 bps**.

Graph 1: Cost of Equity in USD



Source: Refinitiv Eikon, Corficolombiana.

Graph 2: Cost of Equity in Local Currency



Source: Refinitiv Eikon, Corficolombiana.

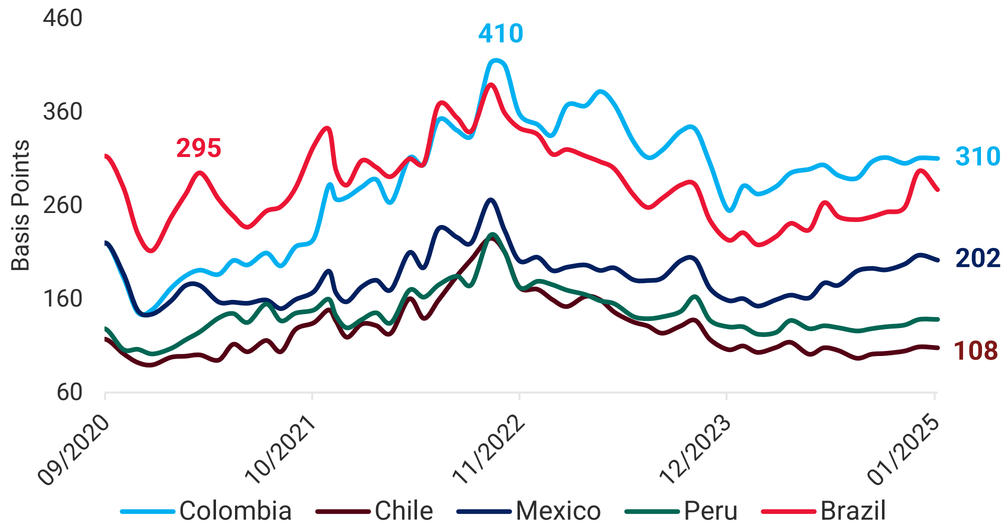
Ke spreads between countries have been maintained, and thus, a diversified investor will continue to ask for higher returns when investing in Brazil or Colombia relative to Peru and Chile, safer investment destinations according to their Ke levels.

Keep in mind that the difference between USD and local currency Ke is explained by the foreign exchange hedging cost (a step-by-step breakdown is found ahead in the Results Summary). This impact is more noticeable in Colombia and Mexico than Peru and Chile, **as their currencies depreciated more in 2024, 15% for Colombia and 22% for Mexico.**

[2] LAC5 is a broadly defined group containing the largest economies in Latin America. In the context of this report, it stands for the grouping of Brazil, Mexico, Colombia, Peru, and Chile.

Graph 2 shows the historical impact of implied devaluation (derived from forward curves) used to convert their USD Ke in USD. Brazil once again stands out as an outlier in this respect with a region-high exchange rate premium of 8,3% as of January 2025 in line with a 27% BRL devaluation in 2024.

Graph 3: Evolution of Ten-Year Credit Default Swaps (CDS)



Source: Refinitiv Eikon. Corficolombiana.

Graph 3 shows the changes in ten-year CDS in LAC5 countries, explained by country idiosyncratic and regional risk factors. There is long-term, region-wide downward momentum in this parameter for all LAC5 countries, even Colombia, Mexico, and Brazil.

Brazil does not have highest CDS compared to peers, despite it facing the steepest country risk premium increase. This is explained by the incorporation of a scaling factor between the bond and stock markets, where market exchange volatility is divided by sovereign bonds volatility. In Brazil there have been inflation upticks above consensus, monetary policy rate hikes, and added pressure to fiscal imbalances. Forecasts are currently less optimistic following recently announced budget packages for 2025, as announced allocations are unlikely to fix imbalances before 2026 (Bloomberg, 2025[3]).

Thus, we see an uneven impact on the bond and stock markets causing bond returns and volatility to decrease sharply since mid-2024, while its stock market volatility remained unchanged in that period.

[3] Source: https://www.bloomberglinea.com/economia/los-analistas-de-brasil-elevan-las-previsiones-de-tasas-de-interes-e-inflacion-para-2025/

Find ahead a collection of recent key events and factors to consider in LAC5 from 2025 onwards.

Table 1: Key Country-Specific Events and Risk Factors (ordered from left to right from highest to lowest 10Y CDS)

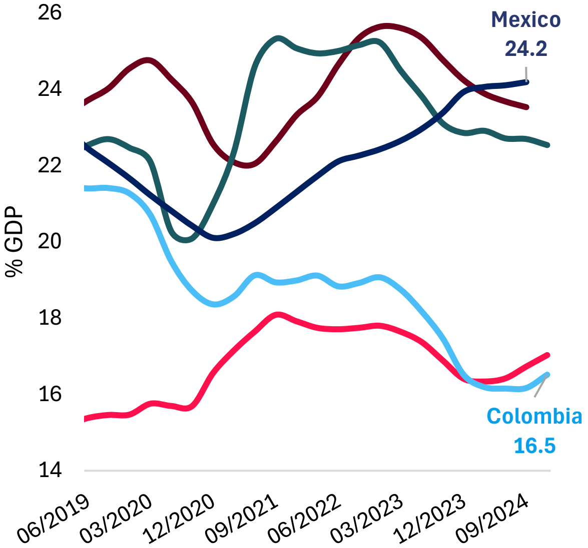
	Colombia	Brazil	Mexico	Peru	Chile
Key Events	▪ Fin. Ministry: proposal for higher fiscal rule flexibility (May/2024) ▪ Public spending budget cut (Jun/2024) ▪ Moody's: Outlook→negative (Jun/2024) ▪ Approval of reform to the Regional Participation System (Dec/2024) ▪ Fitch: Outlook→negative (Mar/2025)	▪ S&P: Rating upgrade→BB (Dec/2023) ▪ Large-scale floods in the South-east region (May/2024) ▪ Rebound of Selic rate kickstarting new hike cycle (Oct/2024)	▪ Sheinbaum kick-off: follow-through in investment seen positively, in spite of a riskier perception of their institutionality (Jun/2024) ▪ Proven bargaining power with new US administration during aggressive unfolding of tariffs (Mar/2025)	▪ S&P: Rating downgrade→BBB- (Apr/2024) ▪ Fitch: confirmed BBB rating with a stable outlook (Nov/2024)	▪ S&P: Outlook→ negative (Oct/2023) ▪ Inflation spike and deceleration in monetary policy rate (TPM) cuts (Apr/2024)
Risk Factors	▪ Changes in fiscal rule management amid a challenging horizon ▪ Long-term investment downtrend when GDP recovery is most needed ▪ Reforms, and Constitutional Assembly proposal by the Government	▪ Steady exchange rate devaluation, and impact on debt premiums further increasing the cost of debt ▪ Rising inflation constantly above analyst forecasts and regional peers	▪ Government position on fiscal deficit ▪ Debt profile of key publicly owned companies: PEMEX & CFE whose debt not guaranteed by the government ▪ Likely USMCA renegotiation given changed US trade terms	▪ Unlikely advancement in reforms until next presidential election. ▪ Uncertainty regarding the recovery of fiscal leeway. ▪ Protests and political instability, and impact on investment flows ▪ Exposure to copper price changes	▪ Roadblocks in the reaching of political consensus for reforms despite some progress in labor laws. ▪ Fiscal rule vulnerability mixed with high external debt, yet to be counteracted with GDP growth consistently

Sources: Rating agencies, IMF. regional and country-specific news, Corficolombiana.

The Relation of Ke Evolution on Investment/GDP and Stock Market Returns

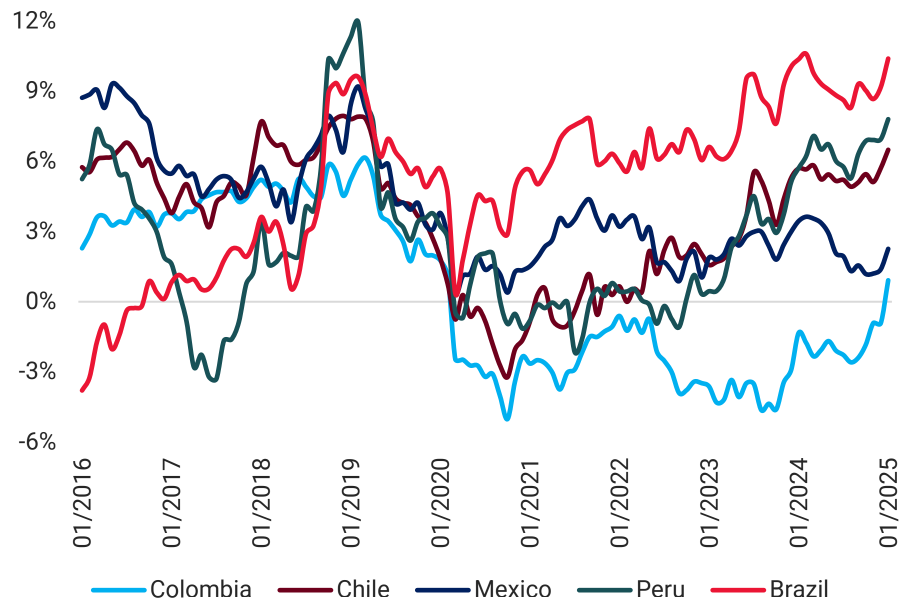
On Graph 3, the Investment/GDP ratio shows Colombia standing out due to

Graph 4: Investment/GDP



Source: Refinitiv Eikon, Corficolombiana.

Graph 5: Ten-Year Stock Index Returns



Source: Refinitiv Eikon, Corficolombiana.

its negative trend in this ratio, which we believe follows similar variables to that of Ke, emphasizing the perception of Colombian investments being riskier. The opposite goes for Mexico, whose investment levels have remained stable, despite their elevated Ke.

Since late 2023, the Ke of both Mexico and Colombia has been similar with high values and trending upwards. However, the return on the Colombian market per the COLCAP 10Y returns has been the lowest, keeping a spread with Mexico and other regional markets studied. This behavior may be explained by the expectations on future cash flows of index members that should be lower in the Colombian case. Besides, Brazil is the only one that shows a positive relation between Ke and stock market performance in the last four years.

Profitability and Expectations: Overcoming Hurdles on the Path to Recovery

Over the past year, the macroeconomic environment in the region has been improving steadily due to internal factors and the waning of external inflationary forces. However, international factors like commodity prices are key to further strengthen growth dynamics, allowing selected Latin America countries to gradually become more secure investment destinations in the long term. A gradual improvement in region-wide country ratings by S&P reflects this upward trend.

Nonetheless, we see a rocky road ahead for Colombia, whose investment and growth numbers are yet to fully recover. This challenging pathway is embodied by 2Q2024 credit warnings issued by Fitch Ratings, and an outlook downgrades by Moody's and Fitch in June 2024 and March 2025, citing the fiscal landscape and institutional dependability as critical factors to monitor closely.

We estimate a required rate of return on equity (Ke) for Colombian firms between 20.5% and 23.3% in COP, with a midpoint of 21.9% (15.0% in USD), from the viewpoint of an international, diversified investor. Bear in mind that implicit devaluation is calculated with 10-year USD/COP forward curve nodes to determine the exchange rate premium in our model.

Results summary

Table 2: Breakdown of the Cost of Equity by Component

Factor	Colombia	Chile	Mexico	Peru	Brazil	Variable Information
Risk-free Rate	4.59%	4.59%	4.59%	4.59%	4.59%	(A)
10Y US Treasuries	4.59%	4.59%	4.59%	4.59%	4.59%	US Government 10-Year Treasury Bonds
US Market Premium	5.47%	5.47%	5.47%	5.47%	5.47%	(B) = (F) × Average (G;H)
Leveraged Beta	1	1	1	1	1	(F) Market-leveraged Beta
Arithmetic Avg, Return (1928-2017)	5.50%	5.50%	5.50%	5.50%	5.50%	(G) Returns estimated by A, Damodaran updated annually and adjusted for survival bias
Geometric Avg, Return (1928-2017)	5.44%	5.44%	5.44%	5.44%	5.44%	(H) Returns estimated by A, Damodaran updated annually
Country Risk Premium	**4.96%**	**1.14%**	**5.20%**	**1.78%**	**7.92%**	**(C) = (I) × (L)**
Sovereign Default Risk Factor	2.75%	0.72%	1.66%	1.03%	2.41%	(I) = (J) - (K)
Target Country 10Y CDS	3.10%	1.08%	2.02%	1.38%	2.77%	(J) Negotiated rate for issuer risk insurance for the 10Y Sov, Bond of the Target Country
US 10Y CDS	0.35%	0.35%	0.35%	0.35%	0.35%	(K) Negotiated rate for issuer risk insurance for the 10Y Sov, Bond of the Target Country
Stock Market/Bond Scaler	1.80	1.58	3.13	1.74	4.03	(L) = (M) / (N)
Market Index St, Deviation	17.70%	17.00%	15.24%	17.33%	17.08%	(M) St, deviation of Stock Market Index total returns (5-year moving average)
Sovereign Bond Index in USD St, Deviation	9.81%	10.79%	4.87%	9.98%	4.24%	(N) St, deviation of inflation-linked S&P Sovereign Bond Index total returns (5-year moving average)
Required Return on Equity (USD)	**15.02%**	**11.20%**	**15.26%**	**11.85%**	**19.78%**	**(D) = (A) + (B) + (C)**
Exchange rate premium	5.97%	1.40%	5.14%	1.58%	8.30%	(E) Devaluation calculated with 10Y Forward Curve Nodes in USD-Local Currency, Source: Precia
Required Return on Equity (Domestic Currency)	**21.90%**	**12.76%**	**21.18%**	**13.62%**	**29.72%**	**Ke = (1 + D) × (1 + E) -1**

Sources: Precia, Refinitiv Eikon, and Aswath Damodaran data, Corficolombiana.
Percentages displayed in annualized terms and rounded to two decimals.

Methodology

At this stage we present a summary of sources and methodologies employed for the construction of the figures in this report. The cut-off date for most figures is the last Friday of the last month of data, in this case, January 31st, 2025.
The cost of equity is calculated using the following formulas:

$$\begin{aligned}\text{Cost of Equity}_{USD} &= \text{Risk-free Rate}_{EE.\ UU.} + (\beta \times \text{Market Premium}_{EE.\ UU.}) \\ &+ \left((CDS_{COL,CHL,MEX,PER,BRL} - CDS_{EE.\ UU.}) \times \frac{\sigma \text{Stock Market}_{COL,CHL,MEX,PER,BRZ}}{\sigma \text{SovereignBonds}_{COL,CHL,MEX,PER,BRZ}} \right)\end{aligned}$$

$$\begin{aligned}\text{Required Return on Equity}_{COP,CLP,MXN,PEN,BRL} \\ = (1 + \text{Return on Equity}_{USD}) \times (1 + \text{Forward Curve Implit Devaluation}) - 1\end{aligned}$$

- The risk-free rate chosen for our model is the 10-year US Treasuries. Source: Refinitiv Eikon.
- The Market Premium is drawn from the historical (1928-2024) average returns of the S&P 500 while subtracting the annual average of the 10Y Treasuries. The yearly difference is averaged and subtracting a factor of survival bias (-1.5% every year) adjusting for bankrupt companies and those exiting the index.

  For reference: Brown, Goetzmann, & Ross (1995), Damodaran, *Investment Valuation* (p.161-162), and Damodaran Online Database (www.stern.nyu.edu/~adamodar/).

- The Country Risk Premium has two components:
  - The first component is the CDS differential between the 10-year value for the target country and the US figure because it works as a proxy embedding the relative default likelihood for each of the analyzed sovereign issuers.
  - After that, a scaling factor is used in which stock market risk where the volatility (standard deviation) of the total returns of the national benchmark index is divided by the volatility of the total returns of a sovereign bond index in the same currency. When compared to earlier editions of this report, this approach considers total returns instead of regular ones, and factors are in the same currency trying to reach a more robust scaling factor. Sources: Refinitiv Eikon and S&P Dow Jones Indices.

The computation of these factors results in a Ke in domestic currency. At this point, the USD rate is converted into the matching local currencies for target countries. This is performed by using the 10-year implied devaluation from the respective forward curve factoring in the cost of an exchange rate hedge. After finding the matching figure, the following formula is used:

$$\text{Implicit Devaluation} = \left(\frac{\text{Spot FX Rate} + \text{FX Rate in X days}}{\text{Spot FX Rate}}\right)^{\frac{365}{X\ days}} - 1$$

Where **X days** refers to the date difference per chosen forward curve node. Source: Precia, local forward curve data provider for LAC5.

Equipo de investigaciones económicas

César Pabón Camacho
Director Ejecutivo de Investigaciones Económicas
(+57-601) 3538787 Ext. 70009
cesar.pabon@corfi.com

Macroeconomía y Mercados

Julio César Romero
Economista Jefe
(+57-601) 3538787 Ext. 70231
julio.romero@corfi.com

Gabriela Bautista
Analista Contexto Externo
(+57-601) 3538787 Ext. 70496
gabriela.bautista@corfi.com

Nicolás Cruz Walteros
Analista Economía Local
(+57-601) 3538787 Ext. 69973
nicolas.cruz@corfi.com

Felipe Espitia
Analista Senior Renta Fija
(+57-601) 3538787 Ext. 70495
felipe.espitia@corfi.com

Alejandra Gacha
Analista economías Sudamérica
(+57-601) 3538787 Ext. 69964
alejandra.gacha@corfi.com

Mateo Pardo
Analista economías Centroamérica
(+57-601) 3538787 Ext. 69628
mateo.pardo@corfi.com

Mariapaula Castañeda
Estudiante en práctica
(+57-601) 3538787 Ext. 70495
maria.castaneda@corfi.com

Análisis Financiero

Andrés Duarte
Gerente de análisis financiero
(+57-601) 3538787 Ext. 70007
andres.duarte@corfi.com

Jaime Cárdenas
Analista sector financiero
(+57-601) 3538787 Ext. 69798
jaime.cardenas@corfi.com

Daniel Monroy
Analista de finanzas corporativas
(+57-601) 3538787 Ext. 69798
danielf.monroy@corfi.com

Catalina Figueroa
Analista de renta variable
(+57-601) 3538787 Ext. 70495
ayde.figueroa@corfi.com

Análisis Sectorial y Sostenibilidad

Fabián Osorio Quintero
Director de Sectores y Sostenibilidad
(+57-601) 3538787 ext. 70497
cristhian.osorio@corfi.com

Andrés Gallego
Analista de Sectores y Sostenibilidad
(+57-601) 3538787 Ext. 69973
andres.gallego@corfi.com

Dino Francisco Córdoba
Analista de Sectores y Sostenibilidac
(+57-601) 3538787 Ext. 70495
dino.cordoba@corfi.com

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