Equity market development in Latin America. International Bulletin of June 2020.

The OECD has published a document called *"Equity market development in Latin America: Enhancing Access to Corporate Finance"*, in which it provides an overview of the problems and particular situation of the equity markets in six Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru).

The report includes recommendations to support development of equity markets and access to finance for corporations in the region.
It draws on the study of the regulatory and institutional framework as well as on dialogue with the main actors (investment firms, experts, regulators and investors). The work of the group in charge of drafting the report reflects the importance of developing equity markets to strengthen economic growth and access to the region's capital markets.

The report describes the limitations of excessive dependence on bank financing and highlights the importance of increasing financing through capital markets.

It also points out that an institutional framework and macroeconomic stability are essential to support the development of capital markets. It expressly mentions that non-listed firms perceive entry fees to be extremely high. The report addresses the various obstacles identified, such as high fee costs, investment bank fees, as well as the high fees paid in Initial Public Offerings (IPOs).

The cost of meeting compliance requirements is a further obstacle to strengthening capital markets.

Another identified deficiency is low liquidity caused by the following factors:

) High ownership concentration and the dominant presence of company groups.
b) The availability of other sources of funding, such as state-sponsored programmes and/or subsidised lending.
c) Banks playing a conflicting dual role (both as direct lenders and underwriters of bonds and equity), which gives financial institutions a position of quasi-monopolistic dominance.

The report points out that one of the rationales for the integration of markets (like the Integrated Latin American Market, MILA) is to spur liquidity. However, this has not yet been consolidated and the expected results have not been obtained.

Issuers in the region prefer to continue trading and operating in their domestic markets as they do not see any further advantages to trading on the MILA.

The report identifies the following measures to improve equity market operations:

– Develop a better understanding of the regional financial market structure and its main actors (investment banks, law firms, etc.).
– Ensure a better supervision of corporate governance requirements.
– Implement a scale of transparency requirements to balance investor confidence with the costs of meeting transparency requirements.
– Reduce dependence on bank financing and increase financing through capital markets.

The report also identifies the relationship between equity finance and innovation and productivity. Small and medium-sized companies have identified special difficulties in obtaining financing through bank loans. Particularly, start-ups and e-commerce firms encounter significant difficulties in accessing financing.

Another significant point is that companies that have launched initial public offerings (IPOs) have less difficulty obtaining funding, through the subsequent issuance of corporate bonds and their placement in the markets, than those that have not followed the same roadmap.

Another problem identified is the existence of large foreign investors who are reluctant to invest in this region.

The Committee of Experts *(Round Table*), which has monitored the writing of this report, suggests that the increase in corporate governance standards may at least partially solve the problem relating to the fair valuation of companies, as well as the growing appeal for investors of companies in the region.

The OECD Principles of Corporate Governance of 2015 established the importance of developing an effective corporate governance system to continuously support a balanced development of capital markets.

The MILA, formed by Chile, Colombia, Mexico and Peru, is developing a common trading platform. Argentina and Brazil are also showing an interest in actively collaborating, especially in relation to the "*fund passport*" for cross-border mutual funds. This mechanism is very similar to the EU community passport.

As seen above, the Latin American markets are characterised by a high level of ownership concentration and the existence of large financial conglomerates. This results in low levels of free float. Low liquidity can have negative consequences in terms of price formation. Latin American markets are currently seeing a slight improvement in liquidity levels.

Another factor causing low liquidity in the region is that many companies' shares are traded simultaneously in different markets, such as Europe and North America.

Trading in domestic markets ranges between 55% and 70%, while in Argentina, trading in domestic stocks represents only 18% of the total volume traded.
The capital raised through corporate transactions in secondary markets (public offerings) is three times more than the capital obtained through IPOs from 2000 to the present date. Since 2017, this trend has been downward and the gap between the two sources of financing has narrowed appreciably.

The low liquidity in most of these countries is also due to the high concentration of ownership in the hands of few investors. The number of companies included in local indices is limited. In the US and the UK, ownership concentration also exists, especially in the hands of large institutional investors.

In Chile, 70% of listed non-financial companies are part of groups of companies that have a controlling shareholder, in Argentina eight of the ten largest companies have a controlling shareholder and in Colombia, controlling shareholders hold more than two thirds of the shares of large companies.

The report repeatedly stresses that financial markets play a key role in allowing investors (insurance companies, investment banks and portfolio managers) to allocate their resources through financial intermediaries (investment banks and portfolio managers). The search for financing for specific projects is the final goal.

The report stresses that there is a correlation between growth and finance. Financial markets can be a source of instability and systemic risk. Ensuring a proper balance between market makers and supervisory and regulatory actions is one of the greatest challenges, not only in this geographical area but in all developed markets.

Apart from the above, three additional factors have been identified for the development of the region's financial markets:

a) The institutional framework to protect investors and creditors' rights.
b) Macroeconomic stability.
c) Market infrastructure to ensure transparent, efficient, secure and timely execution of transactions.

The report identifies the following obstacles to achieving the aforementioned goal:

– Foreign exchange controls, especially for foreign investors in Argentina.
– The reluctance of many companies to list, especially in smaller markets, with low trading volumes.
– Excessive disclosure requirements, which could put them at a competitive disadvantage vis-à-vis their non-listed competitors.
– Problems affecting family businesses, as founders may have concerns about loss of control of the company.
– Problems relating to the size of smaller companies which make it hard for them to attract investors.

The impact of cryptocurrencies and blockchain remains to be quantified, but a more competitive environment for traditional market intermediaries is always advisable.

The report also recommends the implementation or development of the following issues:

– The institutional framework and macroeconomic stability are critical elements in facilitating the development of equity markets.
– Capital raising should be supplemented with others forms of fund raising, such as crowd funding and investors should play a more active role, through venture capital and private placements.
– Development of a financial culture, especially a “capital market culture”.
– The need to improve qualitative elements such as professionalisation, market discipline, credibility and reputation.
– Non-listed firms may underestimate the pre-conditions required for going public; therefore transparency must be reinforced.
– Companies may have to overcome certain cultural barriers to access capital markets.
– De-listing has been a market feature in this geographic area and must be analysed.
– Non-listed firms perceive entry fees (IPO one-time costs) as very high, while investment banks´ and legal firms´ fees are regarded as high by listed and non-listed firms alike. This is a feature seen in all countries in the region, except for Chile. In Colombia, special attention is being paid to the matter. A proportional and flexible approach would be advisable. Company size must be taken into consideration.
– Market participants generally rate corporate governance as good or acceptable but supervision should not be relaxed.
– Low liquidity remains a problem, especially for Argentine companies. Dual listing accentuates the problem. As does the high ownership concentration and the dominant presence of company groups throughout the region.
– Improve the handling of potential conflicts of interest for financial institutions, where banks play a conflicting dual role (both as direct lenders and underwriters of bonds and equity).
– Raise the appeal of the MILA integrated market and work towards regulatory harmonisation among the various member countries, as well as incentives to attract new investors.
– The role of institutional investors in medium- and long-term investments should be highlighted.
– Build a better understanding of the business models of stock exchanges and other secondary markets. Stock exchanges play a key role in providing liquidity (trading), clearance and settlement services, as well as in the supervision of stock market transactions.
– Ensure the proper development of derivatives markets for ETF and IT services.
– The issues affecting the supervision of cross-border activities must be addressed and developed.

Lastly, the report points out the close correlation between transparency and investor confidence.

Useful link:

Equity Market Development in Latin America. Enhancing Access to Corporate Finance