Assessing Corporate Risk in Mexico

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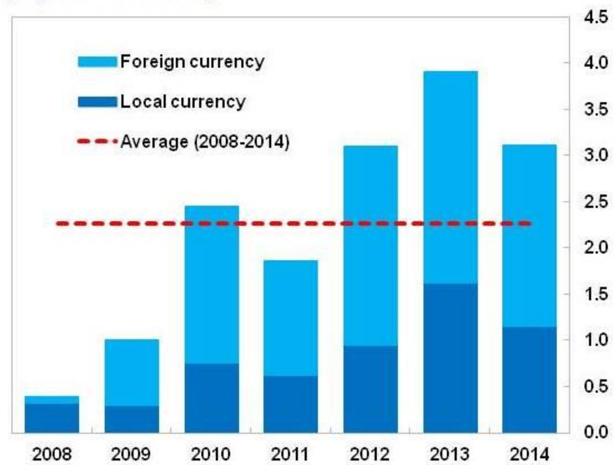
As the United States approaches its first interest rate increase in nearly a decade, many emerging markets have seen the value of their currencies plummet, and financial markets in general have become more volatile. A particular concern is the impact on emerging market firms, which increased borrowing significantly since the crisis, often in foreign currency, spurred by easy access to global capital markets.

In our recent paper, we test the financial strength of Mexican firms to less favorable financial conditions. The sharp depreciation of the peso vis-à-vis the U.S. dollar over the past 12 months and higher spreads are already a test, which they have passed with flying colors. But we take one step further and conduct stress tests on corporate balance sheets to a further deterioration in financial conditions. Here, the results are that the financial sector would remain resilient.

Taking advantage of global liquidity

Mexican corporations took advantage of easier access to global capital markets in the years after the 2008 global financial crisis by issuing a substantial amount of bonds (see Chart 1). Mexico is the second largest corporate bond issuer in Latin America, with total corporate debt—including state-owned enterprises and foreign subsidiaries of Mexican firms—reaching 32 percent of GDP in 2014 (up from 28 percent of GDP in 2010).

Chart 1
Net Issuance of Corporate Bonds by Mexican Firms
(in percent of GDP)



Source: IMF staff calculations.

The rise in bond issuance has been largely used to reduce borrowing costs (refinancing at lower rates) and increase the maturity structure of debt. Only 10 percent of total corporate bonds mature in 2015 and 2016, with the bulk of bonds maturing in 2020 or later. This should strengthen the financial position of Mexican firms and increase its resilience to shocks. However, around two thirds of the net issuance was denominated in foreign currency, which could increase vulnerability to a depreciation of the peso.

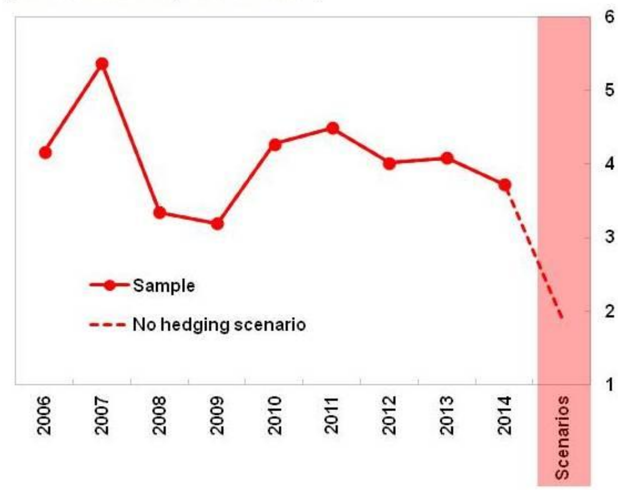
Corporate balance sheets

To gauge the strength of firms, we analyze the sensitivity of Mexican corporations to financial stress, using data for 121 publicly listed nonfinancial corporations. Our study assumes the following combination of shocks: a 30 percent increase in borrowing costs, a 20 percent decline in earnings, and a depreciation of the Mexican peso by 30 percent against the U.S. dollar and 15 percent against the euro.

To put the severity of these shocks in perspective, during the global financial crisis, the median increase in borrowing costs among Mexican firms was 10 percent, the median decline in earnings was 20 percent, and the depreciation of the peso against the U.S. dollar was 30 percent during the first six months of the crisis.

Our analysis shows that these combined shocks would weaken firms' debt servicing capacity, as captured by a decline in the interest coverage ratio—defined as earnings before interest and taxes to interest expense (see Chart 2). But the corporate sector would remain resilient, with very few firms at risk of facing repayment difficulties. In other words, corporate earnings would remain sufficiently large to service debt under the stress tests. This conclusion holds even when we assume no hedging (or insulation) against the depreciation of the currency. In reality some of the exchange rate risk is hedged either naturally (as some firms have earnings denominated in U.S. dollars) or through financial instruments.

Chart 2
Interest Coverage Ratio
(EBIT/interest expense, median)



Source: IMF staff calculations.

Impact on the real economy

Even if firms continue to repay their debts in the stress scenario, some may choose to reduce investment as they seek to rebuild buffers and strengthen debt-servicing capacity. We also did an empirical assessment of the likely growth consequences of greater financial stress. Two channels were considered: a fall in investment by affected firms and a reduction in credit supply by banks.

Our results suggest that the assumed severe shocks are likely to have a modest impact on real GDP growth (between 0.2–0.4 percent) through these two channels.

Monitoring risks

Mexico has made important advances in monitoring corporate risks. For instance, listed firms are required to disclose detailed information on their derivative positions on a quarterly basis.

Continuing to improve the monitoring and analysis of corporate balance sheets should help with the early identification and mitigating of risks that could threaten financial stability.

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