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Uruguay Strategy Flash

Uruguay announces the retap of the 2034 SSLB USD bond.

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Today Uruguay announced a retap of the 2034 SSLB, issued last year, with the guidance indicating a 120bp spread over the UST, with the bond trading 70bp over its benchmark. The operation takes place today and looks to fulfill the administration's financing needs for the year. The bond was first issued in Oct-22 at 150bp over its reference UST (08/15/2032) and has since compressed its spread significantly, currently posting a 70bp difference with the bond currently yields around 5.5%. The current security is a very particular issuance, as it has a coupon payment structure tied to environmental KPIs embedded in the Paris Agreements and Uruguay's sustainability commitments. The tracked indicators are CO_2 emissions (with 1990 as a baseline) and the surface area of native forests in the country (with 2012 as a baseline). Failure to comply with these benchmarks will result in a 15bp coupon step-up per KPI (meaning, failure to achieve both will result in a 30bp coupon increase), while compliance will guarantee a stable coupon. However, further overperformance would also be rewarded, as achieving a second tier of benchmarks would qualify the bond for a 15bp coupon step-down per KPI. For further details, please check our detailed description of the bond structure here.

Figure 1: 2023 GFNs total USD5.3bn, with USD4.7bn in bond issuances

USDmn	2022	2023	2024	2025	2026	2027
Financing Needs	**5,137**	**5,287**	**4,455**	**4,827**	**4,190**	**4,704**
Primary Deficit	730	590	243	-26	-60	-16
Interest Payments	1,667	1,935	2,048	2,086	2,096	2,135
Principal Payments	2,594	2,685	2,140	2,800	2,189	2,608
Use of Assets	147	78	23	-34	-35	-24
Secure Financing Sources	**5,137**	**5,287**	**4,455**	**4,827**	**4,190**	**4,704**
IFIs	571	450	350	250	250	250
Bond Issuance	4,028	4,682	3,995	4,464	3,826	4,336
Other (net)	537	155	110	113	114	118
Net Indebtness	1,860	2,860	2,300	-	-	-

Source: TPCG Research based on MEF

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In a hostile international scenario, the administration had to opt for a hard currency re-tap in a context where its financing strategy required an additional USD1.5bn in bond issuances. The government GFNs contemplated the issuance of nearly USD4.7bn in new bonds to meet its principal and interest payments for the year. Of these, the finance ministry tapped local markets for nearly USD2bn, with the UYU33 issuance adding another USD1.25bn in financing. This means that, with two months to go, the administration still needed to raise around USD1.5bn to comply with its financing strategy. While the finance ministry's instrument of choice probably would have been a local currency-denominated international bond, the current international conditions did not favor said issuance, shifting the administration's choice into the SSLB, especially as the local market was also tapped to capacity. In addition, the improved performance of the Treasury benchmark in the last week gave the Finance Ministry a solid window to perform the issuance. Therefore, the government plans to raise the remainder of its financing sources with the retap of its 2034 SSLB, which is expected to amount to around USD1.5bn.

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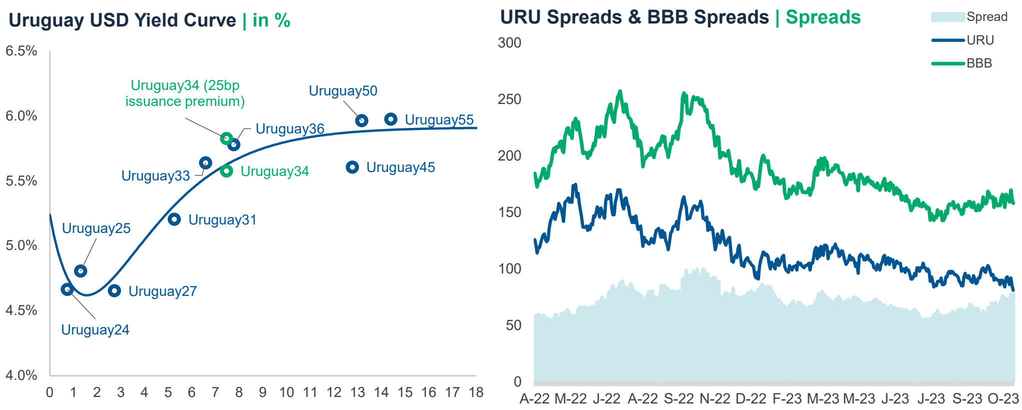
We expect the issuance to pay around 20-30 bps over the market price as an issuance premium, coming in at 90bp to 100bp over the UST. Regarding the pricing of the bond, we find the bond's options are valued at basically the same price, with the SSLB yielding in line with the general URUGUA USD curve, meaning the market is skeptical about how compliance with the KPIs will go. With this in mind, we find the pricing of the retap should closely follow the market price, in addition to an issuance premium, which, in the case of Uruguay, usually hovers around the 20-30bp mark. In this scenario, the rate of the retap should hover around the 5.8% mark, possibly closing at 5.75%, the original coupon payment. This would mean a spread against the treasury of around 90-100bp, 20-30bp tighter than the initial guideline (T+120bp), which usually tends to be somewhat wide. In addition, with the administration needing to issue roughly USD1.5bn, the initial size of the 2034s, the premium could experience some pressures to the upside.

Figure 2: We estimate the retap to come close to the 90bp + UST mark,



Source: TPCG Research based on TPCG Trading Desk

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Even if we expect the operation to be a success for the administration, in the medium run, we find the international situation paints a somewhat bleak picture for Uruguay. In recent years, Uruguay has experienced major policy transformations that have significantly improved macroprudential conditions, positioning it as a very robust credit in the EM space. This resulted in a major spread compression against the UST, with the country reducing its financing costs since 2020. However, with the widening of the Treasury curve, even the compression in the country's idiosyncratic risk has not been enough to compensate for the hike in US rates. We believe that, in a context where the US curve normalizes, responding to a new monetary policy cycle, then, with the compression of the benchmark, the duration play in Uruguay's hard currency curve makes significant sense. However, suppose the US curve responds to a normalizing monetary policy and to increased fiscal risks, compressing the short end of the curve while widening the long end. In that case, Uruguay's dollar debt does not look so attractive. In addition, the country's debt levels are significant, and the widening in the benchmark will hit financing costs significantly, a process that could eventually derail Uruguay's debt sustainability path.

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