

August 13th, 2018

Province of Mendoza: Ongoing Solid Fiscal Consolidation Effort

Notes from Our Call with Mendoza's Economic Team

In the wake of Argentine sovereign debt's return to its old distressed neighborhood due to a challenging macro backdrop, our friends in the distressed community have been making inquiries about the country's sub-sovereign credits. (See *Balanz 230* for our latest analysis of Argentina's material challenges). Earlier this month, we had an opportunity to speak with senior members of the Province of Mendoza economic team, and while we are encouraged by Governor Alfredo Cornejo's ongoing fiscal discipline and the solid economic activity in the midst of a wider recession in the country, the tipping (*inflection*) point in Mendoza's risk/reward investment decision (besides the sovereign macro backdrop) hinges on the analysis of the province's political future. Pending constitutional reform in the Mendoza's constitution, Alfredo Cornejo cannot run for re-election in 2019. In the following pages, we will highlight some of the key points we discussed with Mendoza's Director of Public Debt, Víctor Fayad, who provided us with insight on the province's fiscal and economic health along with some very nascent feelers on the province's the political future.

Since late 2015, we have promoted the Province of Mendoza as our sub-sovereign credit risk dark horse, grounded on the thesis that should Alfredo Cornejo (PRO-UCR alliance) defeat FVP loyalists for governorship in the territory, a new age of fiscal discipline was poised to take hold. Under the reins of the fiscal hawk Cornejo, an early retirement plan was implemented, reducing administrative personnel from 575 to 330 and the number of ministries from 14 to 5. These aggressive fiscal efforts led to a small primary surplus of P\$150m in 2016. The 2018 bonds rode the coattails of this fiscal consolidation wave ushered in by Cambiemos' Cornejo as they compressed to an impressive YTM of 3.60% at the beginning of December of 2017. Mendoza was also able to issue a US\$500m 2024 bond below par at U\$98.71 in May of 2016 with a coupon of 8.375%, which also saw significant yield compression, bottoming out at a YTM of 5.80% in January 2018 vs. its prior peak of 8.80% in May 2016. With the sovereign curve searching for a new normal for valuations, sub-sovereign credits have been hit quite hard. Both of these bonds now trade at wides, with the September 2018 at a YTM of 8.45% and the 2024 sitting near the 2018 bond's 2015 levels — a YTM of 11.65% with a duration of 3.7 years.

Mendoza 2024 (PMY24): Technical Data

Technical Data: MENDOZA 2024 (PMY24)		YTM	Nominal Yield (Sem.)	Clean Price	Dirty Price	Variation % in Price
Issue Currency	US\$	8.65%	8.47%	99.59	101.59	11.19%
Date of Issue	19-May-16	9.15%	8.95%	97.78	99.78	9.21%
Maturity	19-May-24	9.65%	9.43%	96.01	98.01	7.27%
Amount Outstanding (MM)	USD 500	10.15%	9.91%	94.28	96.28	5.38%
Coupon	8.375%	10.65%	10.38%	92.60	94.60	3.54%
Freq. Coupon. payment	Sem.	11.15%	10.86%	90.96	92.96	1.75%
Amortization	Sinkable	11.65%	11.33%	89.36	91.36	0.00%
Next Payment	19-Nov-2018	12.15%	11.80%	87.80	89.80	-1.71%
Clean Price	89.36	12.65%	12.28%	86.28	88.28	-3.37%
Acc. Interest	2.00	13.15%	12.75%	84.80	86.80	-5.00%
Mod. Dur	3.70	13.65%	13.22%	83.35	85.35	-6.59%
YTM	11.65%					
Nominal Rate	11.33%					
Law	NY					
ISIN	USP6480JAG24					

Specified Denominations: U.S.\$150,000 and integral multiples of U.S.\$1,000 in excess thereof

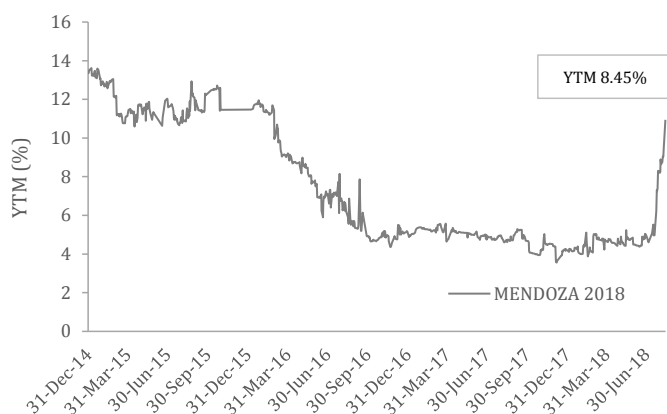
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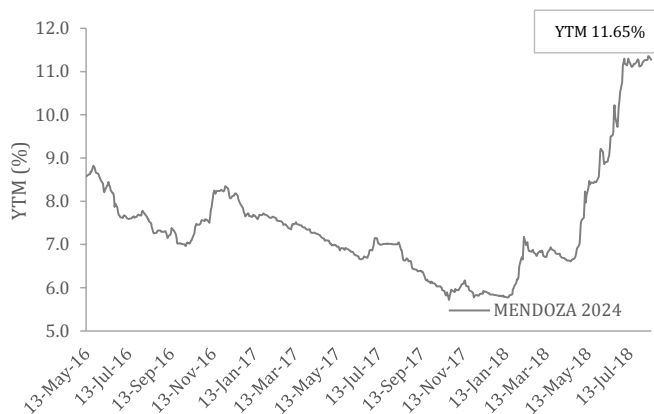
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Mendoza's September 2018 (BARX1) YTM



Mendoza's 2024 (PMY24) YTM



Economic & Demographic Overview

The Province of Mendoza is the seventh largest of Argentina's 23 provinces & CABA, and its territory covers 5.3% of the nation's land mass. According to the 2015 census, there are 1.88m inhabitants, accounting for 4.4% of the total population of Argentina. Roughly 63.7% of the inhabitants live in the metropolitan area surrounding the capital city Mendoza. In Mendoza, the population is split between 48.7% men and 51.3% women, and the residents have a median age of 29.5 years. Overall, the population grew by 10.25% or 162k people from the 2001 census to the 2010 survey which is a tad bit slower than the 10.6% absolute expansion in Argentina's populace over this period. It expanded by another 6.4% in the last five years due in large part to the oil and gas sector's rapid expansion. Mendoza's provincial economic output represents almost 3.5% of Argentina's overall GDP.

Provincial Tax Collection Has Been Firm Despite Tax Alleviation Push

Provincial tax collection grew +28.2% yoy in 1H18 while the provincial revenues expanded 25% yoy, both below inflation in the same period (29.5% yoy). In signing the Fiscal Responsibility Law (*Pacto Fiscal*) in December of 2017, the provincial government not only recognized the excessively high revenue tax (*ingresos brutos*) burden on the private sector which in turn affects economic activity, but also agreed to a gradual reduction until elimination. Revenue tax is a large component of the provincial tax structure, so much so that in some of the poorest territories it makes up more than 80% of the tax take. In 2016, *ingresos brutos* made up 75.17% of Mendoza's tax base, declining to 73.32% in 2018. Year-to-date Mendoza has reduced the revenue tax to 68.88%, which in part explains the slowing tax collection growth in 1H2018. A nation-wide recession has led to a significant decline in consumption. While the province assumes the decline in consumption will continue at least for the next few months, they highlight certain parts of the service sector (tourism in particular) and the O&G economy as new engines to bolster tax collection.

Being the wine capital and with its border close to Chile, Mendoza is a popular tourist destination. In general, Mendoza is one of the most developed provinces in the country lending itself to being a popular destination for tourism. The province has over 2,000km of national road networks, 77.4% percent of which is paved, and almost 14,000km of provincial roads, 22.8% of which are paved. The territory also has an extensive rail network of approximately 1,500km and three airport terminals, one international, Mendoza International Airport, and two domestic airports, San Rafael Airport and Malargue Airport. The recent devaluation of the ARS has made vacation for Chileans and other foreign travelers cheaper.

Other Initiatives that Could Boost Mendoza: Uber

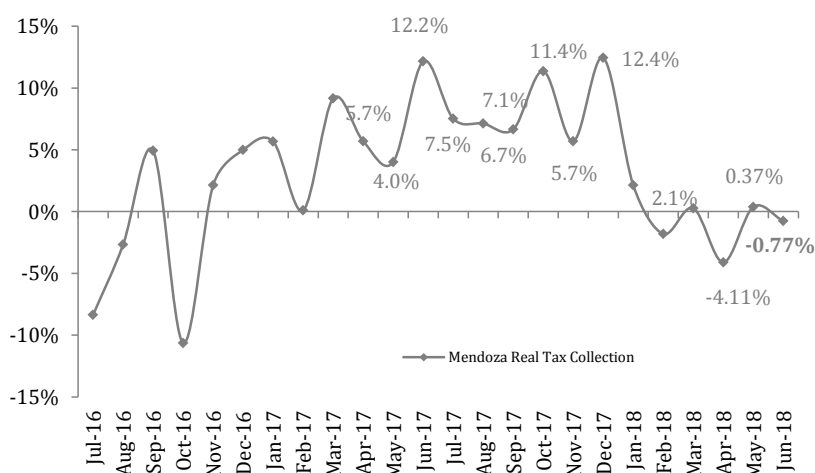
Mendoza became the first province in Argentina to legalize Uber. In domestic flights, Mendoza's airports are the fourth busiest after Aeroparque (Buenos Aires), Cordoba and Bariloche (Río Negro). Excluding Ezeiza and Aeroparque, Mendoza's international airport also has the highest arrival of foreigners after Cordoba, showing a growth of 22% yoy in 7M2018.

<https://www.nytimes.com/reuters/2018/07/31/technology/31reuters-argentina-uber.html>

Vaca Muerta Helping

In the first five months of 2018, 1.8m3 of oil was extracted, a 12% increase in the same period of 2017 (+1.65% yoy). According to the newly appointed Minister of Energy, Javier Iguacel, Mendoza registered an 8% increase in wells drilled in 5M2018, from 86 in 2017 to 93. An increase in O&G activity should translate into an increase in royalties to the provincial coffers. While the Macri administration has paused its oil price liberation system to control inflation, the government looks to teach import price parity by year-end. Gasoline prices have increased 31% this year, above inflation (5%-7% in the last few days) and additional 7% increases are coming in October, November and December. This is all to say that at a moment of a general economic cooling, and a declining revenue tax structure, Mendoza proves to have alternatives to finance its fiscal demands.

Mendoza Tax Collection In Real Terms (YoY)



Mendoza's Tax Administration, which monitors provincial CPI through its statistics branch, reported a June inflation print of +3.2% and a LTM figure of around 33% yoy. This compares to the national +3.7% June mom print and a LTM of 29.5%.

Fiscal Analysis: Province of Mendoza

Since the tenure of Alfredo Cornejo began at the end of 2015, Mendoza has gone from a primary deficit 2.2% of PBG to a break-even level in 2017. The state's 2017 numbers showed a negligible P\$44m primary deficit that represents a tiny 0.02% of provincial GDP (PBG). The 2017 fiscal deficit clocked in at 1.5% of PBG (P\$4.07bn) and can be explained by an increase in infrastructure spending (P\$5.1bn), which would have been more than enough to cover the P\$4.02bn in interest paid in 2017. In 2Q2018, Mendoza registered a balanced budget, with a current income of P\$39.06bn and a current expenditure of P\$33.78bn. This is an extraordinary performance in the first six months, and underlines the quality of Cornejo's fiscal execution.

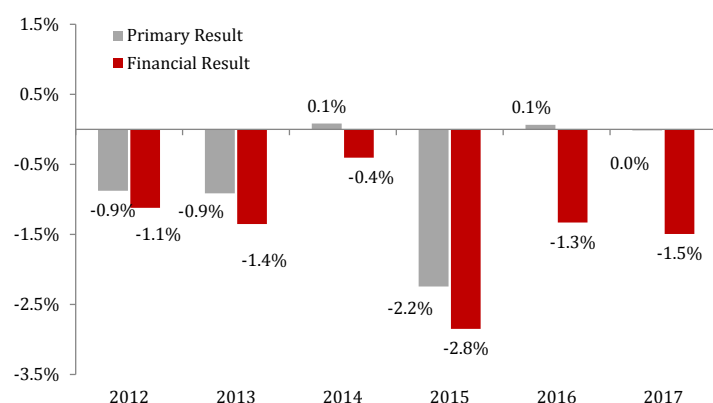
Revenue Sources & Expenditures

	Million P\$				YoY % Change				YoY % Change			
	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
Current Income	35,906	48,643	65,697	39,059	29.9%	35.5%	35.1%	30.0%	98.1%	98.0%	98.0%	98.7%
Tax Revenue	31,643	41,331	55,517	32,921	32.4%	30.6%	34.3%	28.3%	86.5%	83.3%	82.8%	83.2%
- Provinces	12,398	16,682	22,336	13,416	27.0%	34.6%	33.9%	27.7%	33.9%	33.6%	33.3%	33.9%
-- Property	499	667	918	791	29.1%	33.6%	37.6%	42.1%	1.4%	1.3%	1.4%	2.0%
-- Vehicles	816	1,165	1,721	1,413	42.1%	42.8%	47.7%	31.5%	2.2%	2.3%	2.6%	3.6%
-- Gross Income	9,772	12,926	16,662	9,520	24.8%	32.3%	28.9%	25.1%	26.7%	26.0%	24.9%	24.1%
-- Stamp	1,282	1,874	2,949	1,647	35.4%	46.2%	57.3%	32.9%	3.5%	3.8%	4.4%	4.2%
-- Others	29	50	86	46	9.1%	69.5%	73.9%	57.6%	0.1%	0.1%	0.1%	0.1%
- National	19,245	24,649	33,181	19,505	36.1%	28.1%	34.6%	28.7%	52.6%	49.7%	49.5%	49.3%
-- Automatic transfers	10,757	14,086	19,707	11,736	21.8%	30.9%	39.9%	35.5%	29.4%	28.4%	29.4%	29.7%
Non-Tax Fees	4,263	7,312	10,180	6,138	13.9%	71.5%	39.2%	40.6%	11.6%	14.7%	15.2%	15.5%
-- Royalties	2,397	3,360	3,299	2,492	10.1%	40.2%	-1.8%	62.1%	6.5%	6.8%	4.9%	6.3%
Capital Income	696	979	1,343	516	-5.0%	40.7%	37.3%	14.9%	1.9%	2.0%	2.0%	1.3%
TOTAL	36,602	49,621	67,040	39,575	29.0%	35.6%	35.1%	29.8%	100.0%	100.0%	100.0%	100.0%

	Million P\$				YoY % Change				YoY % Change			
	2015	2016	2017	2Q18	2015	2016	2017	2Q18	2015	2016	2017	2Q18
Current Expenditure	38,382	49,726	65,994	33,777	40.7%	29.6%	32.7%	24.9%	92.5%	94.5%	92.8%	92.6%
- Wages	23,373	28,674	36,622	18,939	43.6%	22.7%	27.7%	17.8%	56.3%	54.5%	51.5%	51.9%
- Goods and Services	4,442	5,580	8,093	3,426	40.6%	25.6%	45.0%	27.6%	10.7%	10.6%	11.4%	9.4%
- Interest	1,040	3,174	4,021	2,548	54.3%	205.3%	26.7%	112.1%	2.5%	6.0%	5.7%	7.0%
- Current Transfers	9,527	12,298	16,523	8,594	33.0%	29.1%	34.4%	28.4%	23.0%	23.4%	23.2%	23.6%
- Others	-	9	734	266	-	-	-	-28.9%	-	0.0%	1.0%	0.7%
Capital Expenditure	3,128	2,919	5,111	2,683	88.0%	-6.7%	75.1%	56.7%	7.5%	5.5%	7.2%	7.4%
TOTAL	41,510	52,646	71,105	36,459	43.4%	26.8%	35.1%	26.8%	100.0%	100.0%	100.0%	100.0%

Million P\$	2015	2016	2017	LTM 2Q18
Primary Result	-3,868	150	-44	2,680
Financial Result	-4,908	-3,024	-4,065	-2,688

As % of GDP*	2015	2016	2017
Primary Result	-2.2%	0.1%	0.0%
Financial Result	-2.8%	-1.3%	-1.5%

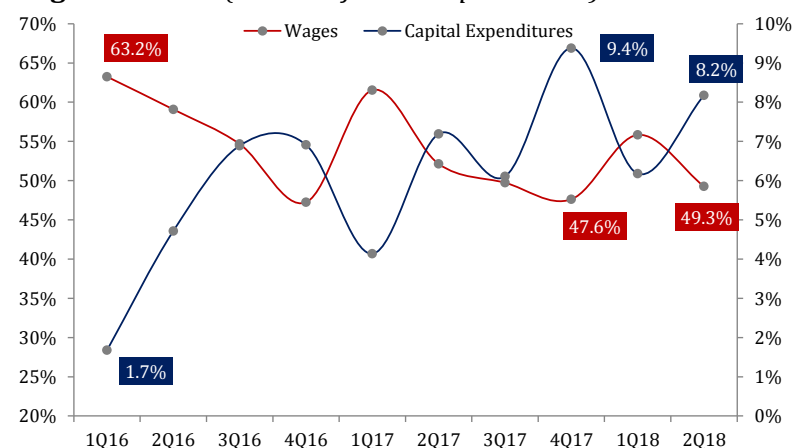


Continuing Deceleration in Public Sector Payrolls (In Real Terms)

Governor Cornejo and his team came into office with an aggressive fiscal consolidation plan designed to control the relentless expansion of public sector payrolls. They implemented a voluntary retirement scheme and froze new hires in public administration. Only the education and health sectors have been allowed to add personnel. Strict absenteeism penalties for teachers were also implemented to cut down on excessive costs for substitutes. In 2016 and 2017, wages grew well below inflation at +22.7% and +27.7% respectively. The figure continues to expand below yoy inflation in 1H2018 at +17.7% (P\$18.94bn) vs. 1H2017. The P\$18.94bn represents 56% of the P\$33.78bn current expenditure figure (excluding CAPEX).

These figures demonstrate the governor's firm commitment to the Fiscal Responsibility Pact signed by the province with the federal government. We expect Mendoza to continue to hold the line on current expenditures as Governor Cornejo is one of Argentina's most vocal proponents of Fiscal Responsibility plan for the provincial governments.

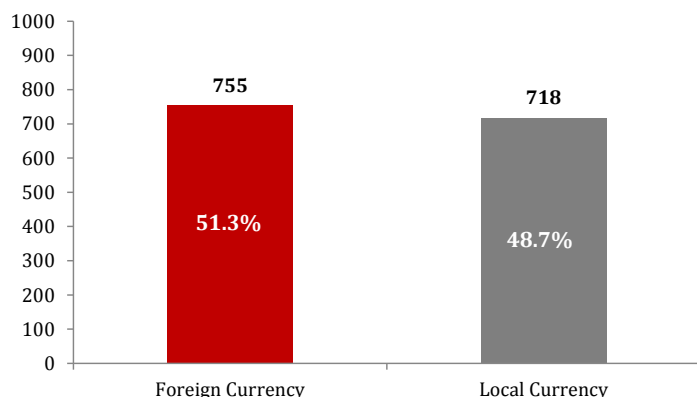
Wages & CAPEX (As A % Of Total Expenditures)



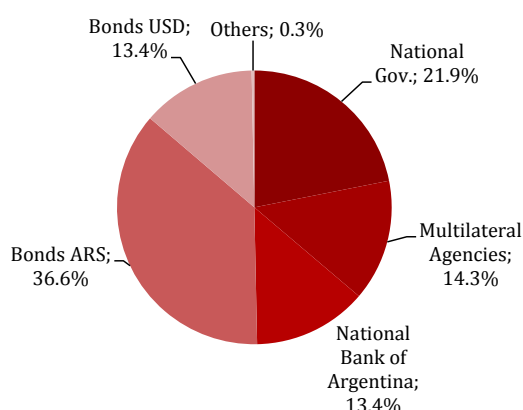
The Mendoza government is undertaking a moderately aggressive infrastructure plan. CAPEX has increased from 5.5% of total expenditure in 2016 to 7.4% in 1H2018, a nominal amount of P\$36.5bn. The team has been making needed repairs on public facilities such as schools, hospitals, health care centers and other government buildings along with the repaving of roads and two big projects. The first is a P\$1.5bn investment toward the construction of the Cuyo Federal Penitentiary Center in Cacheuta. The other major project is a P\$164m investment towards the construction of a Criminal Justice Center in the City of Mendoza.

Debt Profile

Debt Breakdown By Currency (Mill. US\$)



Debt Breakdown By Type

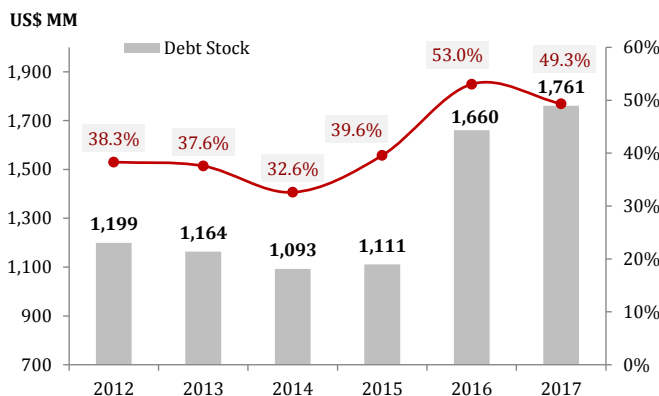


High Proportion of Debt In Local Currency Aided By Devaluation

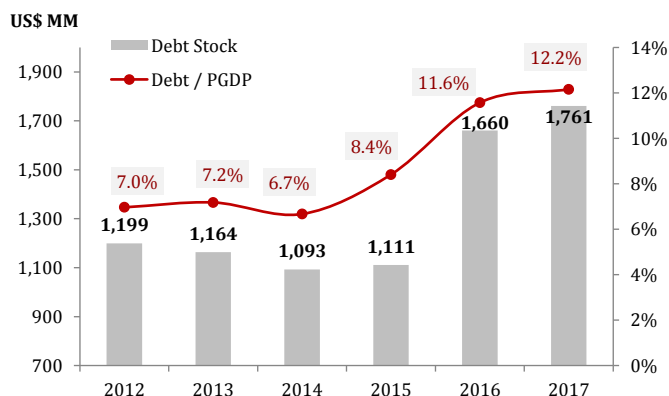
As we can see in the charts above, Mendoza's debt profile reached a total of US\$1.47bn (P\$42.5bn) in 2Q2018. Of this debt stock, 51.3% is denominated in USD and 33.6% in ARS Badlar and the remaining 15.1% in ARS fixed-income securities. The provincial debt/PBG ratio went from 8.4% to 12.2% at the end of 2017, reflecting a 3.8pp expansion due to the US\$500m 2024 dollar bond issue in May 2016 and the P\$5.2b in Badlar+ bonds sold a year later. The only other debt in hard currency the province has is the US\$12.2m float in the September 2018 bonds. The PMY2024 does not make any principal payments until May 2022 (1/3) followed by two additional principal payments in May 2023 and in May 2024.

Mendoza faced interest payments of P\$4.02bn during 2017. In 1H18, they have spent P\$2.55bn on interest obligations. Even though this represent a whopping a 112% spike yoy vs. 1H2017, it is a mere 7.0% of the provinces expenditure line. Going forward, it will be an important line item to monitor.

Debt Stock vs Gov. Revenues



Debt Stock vs GDP



During 2017, debt-to-total-revenues fell to 49.4% from 53.0% yoy due in large part to an improvement in income growing +35.1%, more than 8pp above inflation. This +35.1% growth contemplates automatic transfers from the national government; however, if we look at revenue growth excluding said transfers (the provincial line item under Current Revenues) tax collection in this category grew +33.9%. This distinguished

Mendoza as one of few provinces that is not heavily dependent on government transfers. In 1H2018 tax revenue expanded 30% yoy and even maintained a 5pp gap over current expenses.

In our conversation with Mendoza's economic team, the province informed us that they were contemplating issuing a bond to cushion some of the debt amortizations and maturities they face in the remainder of 2018. They were discouraged from taking action in the face of the present macroeconomic challenges and subsequent market rates. They would like to analyze the possibility of a local currency issue if and when the markets normalize. Until then, they are in conversation with the national government for a loan through Banco Nación to finance 2018's debt amortization. In 1Q2018, they had capital maturities of P\$3.9bn (U\$136m at said period). This figure has certainly declined in 1H2018 given the May-July ARS volatility.

Conclusion: Mendoza is A Good House In A Complicated Neighborhood

To reiterate our view, Mendoza's risk/reward investment inflection point hinges on an analysis of the province's political future. However, the political backdrop is unclear at this early stage to make any credible conjectures as the primary candidates have not been decided yet. Per the statutes of province's constitution, Cornejo cannot run for re-election. Recently he's been splitting his time in Buenos Aires and Mendoza, leading many to believe he will run for a congressional spot in 2019 if there is no amendment made to the provincial constitution. The only credible rumor we can point to is that the Economy Minister, Lisandro Nieri, would run as vice governor in the event Cornejo gets an opportunity for a second term. In our call with Victor Fayad, the public official was confident Cambiemos would win out in 2019. Fifteen of the 18 municipalities in Mendoza were won by Cornejo. Moreover, there have yet to appear credible threats in the opposition party. <https://radiomitre.cienradios.com/cornejo-mendoza-baires/>

We continue to like what we see in Mendoza. Nevertheless, political continuity is needed to perpetuate the exceptional work done by Cornejo and his government, and this is in question given the shifting political sands ahead of the 2019 elections. Argentina is already facing a challenging macro backdrop, and we caution widows and orphans to be careful. Meanwhile, we invite our distressed friends to consider Mendoza as an interesting value opportunity as the low interest expense to revenues signals that Mendoza can tighten its belt on the capital spending front and easily meet its obligations. Moreover, Cornejo's seniority in the Cambiemos party should facilitate the province's ability to tap financing from the Banco de La Nacion, and the recent devaluation should provide an uplift to Mendoza's leading economic sectors.