What's ahead for business in Brazil

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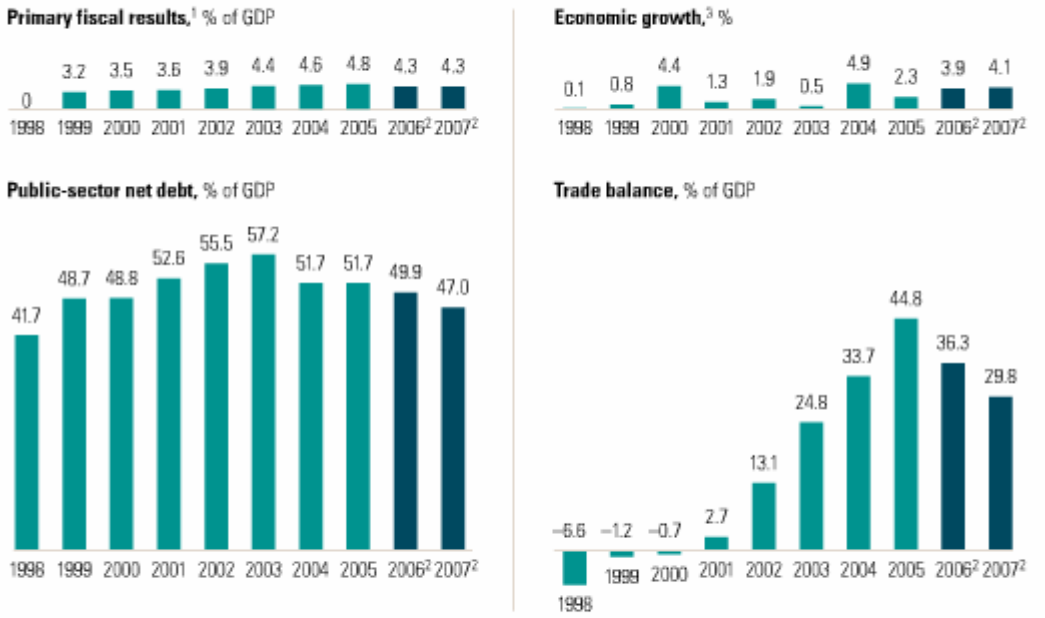
The economy is more stable that it's been in quite a while, and many industries are riding high—for the time being.

A pivotal moment has arrived for corporate Brazil: the economy as a whole is healthier, just as some of the country's biggest industries are enjoying a strong competitive position. With plenty of global liquidity and better economic fundamentals, large local companies are benefiting from the lower cost of capital and a greater degree of choice in financing their growth. Stable conditions are also helping multinational companies to establish export platforms in Brazil or to seek growth in its domestic market.

As confidence in the economy rises, investors, credit raters, analysts, and policy makers say that Brazil could reach investment-grade status by 2009 (Exhibit 1). That achievement would give local companies far better access to international capital markets. Brazil's local-currency markets would become more comparable to developed financial ones in costs, terms, and maturities.

EXHIBIT 1

Brazil's improving economy



[1]Government's surplus before interest expenses.
[2]Estimated.
[3]Real change in GDP.

Source: Central bank; MCM; UBS (forecasts); McKinsey analysis

These developments have implications right across Brazil's corporate landscape. Clearly, solid business opportunities exist, but the country's volatile economic history suggests grounds for caution as well. Indeed, some of today's economic optimism reflects strong commodities markets, and parts of the economy might face a downturn.

State of the nation

Brazil has a wealth of natural resources—high-quality deposits of bauxite, iron ore, natural gas, nickel, oil—and excellent conditions for forestry and agriculture. Yet chaotic macroeconomic conditions,1 limited access to capital, government intervention, and an ever-

increasing informal sector have left the promise of booming economic growth largely unfulfilled. Corporate success, limited to the members of an exclusive club—a handful of family-owned conglomerates, large state-owned enterprises, and a few multinationals—required access to private or internal capital markets and exceptional know-how in a tightly regulated environment.

Since 1994 relative economic and political stability has permitted Brazil to tackle many of the obstacles that formerly hindered its development. More must be done before faster growth can become truly sustainable. But even the partial removal of obstacles that prevented all but a few companies from thriving has been enough to allow some of the country's inherent strengths to be exploited at last.

In the past five years, Brazil's federal government has turned large primary budget deficits into surpluses (currently at 4.3 percent of GDP), thus reducing competition for available funding in the capital markets. Combined with political stability, this fiscal effort has brought down interest rates to less than 15 percent, from more than 40 percent at the height of the 1998 financial crisis, and let Brazil's risk premium fall to around 200 basis points (from more than 1,000) over US Treasuries. These developments have promoted the reemergence of long-dormant segments of the capital market—those dedicated to the private sector. Local issuance of corporate debt has reached 74.7 billion reais in 2006,2 against only 7.4 billion reais five years ago.3

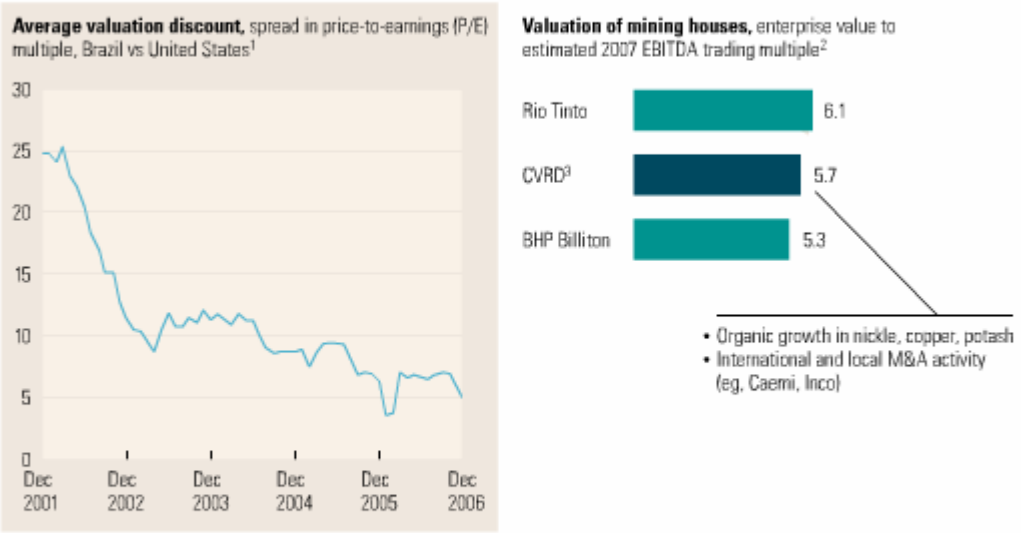
Brazil's equity markets suffered from not only economic instability and political uncertainty but also weak corporate-governance standards, which led to hefty control premiums.4 Brazil's legislature resisted governance changes proposed in 1999, and adjustments to the existing securities law, though positive, fell short of aspirations. The solution—a market-driven one—came in 2000 with the introduction of Novo Mercado, a special-listing segment of the existing São Paulo Stock Exchange (Bovespa). Novo Mercado's higher corporate-governance standards allow only a single class of share structures and require a higher level of disclosure. Reactions to the initiative were positive, prompting a wave of new issues.

Entry into Novo Mercado is optional, but shareholders have clearly felt the benefits of the improved governance standards: new issues enjoy an average premium of 70 percent over shares in the broader market,5 which has stimulated interest from foreign investors.

All in all, some local blue chips now enjoy encouraging conditions for financing. Valuations of strong local players, such as the mining giant Companhia Vale do Rio Doce (CVRD), have risen rapidly, and discounts compared with global peers have all but disappeared (Exhibit 2). The menu of financing alternatives has broadened to include instruments such as the securitization notes Banco Itaú recently issued and securities with longer maturities—for example, the perpetual bonds Banco Bradesco and Braskem have issued. Long available to international competitors, instruments such as these are only now being offered in Brazil under reasonable terms and conditions.

EXHIBIT 2

Shrinking discounts



[1]Difference in forward PE multiple between MSCI US and MSCI Brazil indexes.
[2]Trading multiple as of January 18, 2007; EBITDA = earnings before interest, taxes, depreciation, and amortization.
[3]Companhia Vale do Rio Doce.

Source: McKinsey Global Institute analysis

Check out the opportunities

Local companies have long relied on a combination of regulatory protections (such as import tariffs) and structural advantages (such as low-cost labor) to thwart the global competition. With the competitive environment changing rapidly, they must not only go on refining their operational skills to offset a strengthening local currency and falling regulatory protections but also accelerate their growth to achieve the scale and scope required to compete globally. Multinationals, on the other hand, strive to properly structure opportunities to gain access to the country's unique natural resources as well as its promising domestic market. Four sectors—infrastructure, basic materials, consumer goods and retail, and banking—point to the challenges and possibilities that lie ahead.

Infrastructure

Private investment in Brazil's infrastructure is poised for growth. The federal government has been more intent on returning its budget to fiscal health than on funding new projects, and the result has been decades of underinvestment. From electric power to transportation to housing, the needs are huge. To avoid power shortages such as those that struck in 2001, and to support growth in demand, generating capacity must rise by more than 40 percent during the next ten years. Distribution and transmission operations must be revamped to meet service benchmarks and also expanded to support rising generation capacity from large projects such as the Belo Monte (in northern Brazil) and the Madeira River Hydro-electric Complex.

The need for new housing has been estimated at about 15 percent of the existing stock, or seven million additional units. A multitude of existing ones lack basic services: only 65 percent have access to sewage systems, and 15 percent are without running water. Regulatory uncertainty, however, remains a major obstacle to both private- and public-sector investment in housing.

Investment in transportation is vital as well. Government statistics indicate that less than 30 percent of Brazil's extensive road network (72,000 kilometers, or about 45,000 miles) is in adequate condition and that more than 40 percent of it urgently needs renovation. Canal and rail systems, besides requiring modernization and mending, are neither broad nor reliable enough to become useful alternatives.

According to a survey among senior executives in Brazil, 90 percent of the barriers to infrastructure projects involve financial, environmental, and regulatory constraints.6 Financially, at least, progress has been made: the steady fall in the country's risk premium has cut the cost of capital—a crucial element in making projects economically sound. Progress in regulation has been irregular, however: the telecom sector enjoys a stable regulatory environment and a well-functioning government agency, but sanitation, for example, still awaits the issuance of clear rules for private investment.

Heartening legislation governing public-private partnerships has underpinned recent successful road projects and should offer favorable conditions for private investment in other projects as well. Yet investors should have a clear perspective on the evolution of the targeted segment's regulatory environment. Before they commit themselves to important capital projects, they should also build strong regulatory-management skills, since tariff review processes continue to be crucial for performance. In any case, companies in construction and building materials are expected to benefit from the first wave of change as Brazil strives to close some of its infrastructure gaps.

Basic materials

A healthy combination of economic stability, structural advantages, and a superior position in global cost curves has rapidly made Brazil an upstream supply base for agricultural products (such as soy and sugar cane), aluminum and alumina, copper, iron ore, nickel, pulp, and steel. Outright expropriation is uncommon, so the political risk is low. Domestic markets for those commodities remain attractive, with high concentration in many segments, big premiums over international prices, and growth potential. Still, domestic markets are small compared with export ones.

Thanks to rising valuations and the falling cost of capital, big global players such as CVRD, Gerdau, and Votorantim Pulp and Paper (VCP) can pursue both domestic organic expansion and acquisitions abroad. Moreover, a strengthened capital base and access to global capital should allow these companies to defend their local positions. After consolidating regional markets, the big Brazilian companies have competed for assets in hopes of repelling the attempts of foreign companies to enter local markets. The joint bid of VCP and Suzano Bahia Sul Papel e Celulose for Ripasa, to give one example, reflected this strategy.

Several multinationals in basic materials already have profitable stakes in Brazil and stand to benefit doubly—from the sharp rise in the price of local assets and from the expectation that the domestic market's growth will gain momentum. Now that local dominant players have consolidated, however, entry into the Brazilian market has become more challenging for multinationals. Alliances with local companies are therefore emerging as a sensible alternative.

Brazil's big companies are major competitors in the region but are also bidding for assets around the world. The steelmaker Gerdau, for example, is expanding in the Americas. Meanwhile, CVRD acquired one of the world's leading nickel miners: Inco, of Canada. To get the most from growth, Brazil's basic-materials companies must nurture their managerial and technical talent—a critical bottleneck, since the sector's traditional sources of human capital still suffer from years of neglect. These companies should also make sure that their ownership structures satisfy international standards (avoiding discounts for poor governance practices and opaque control blocks, for example) and that their leverage is satisfactory. In fact, low leverage should allow Brazil's companies to maximize their strategic flexibility if the country reaches investment grade. Rising share prices will also aid further consolidation moves.

Consumer goods and retail

Falling interest rates and the growth of mass-market consumption should have a large impact on the consumer goods and retailing industries. Consumer credit has increased by more than 26 percent annually during the past six years, with no significant rise in delinquency. That increase has been fostered by banking legislation that lets financial institutions extend loans to corporate employees with minimal risk because monthly interest and principal payments can now be deducted directly from paychecks.7 As real interest rates for individuals continue to

fall, expanded consumer credit could go on supporting growth in consumption. Consumer credit-related debt levels, currently 5.4 percent of GDP, are below those in countries such as Chile (7 percent of GDP) and Spain (7.5 percent).

The number of people living below the poverty line is expected to decline by about 5 percent annually during the next four years, in view of projected economic growth and the slowly improving distribution of wealth across classes.8 Falling levels of poverty will have a direct impact on opportunities to serve the mass market, whose share of total consumption could grow from 48 percent in 2004 to 60 percent by 2009. Coupled with that trend is the faster growth of consumption in midsize and large cities (250,000 to 500,000 and 500,000-plus inhabitants, respectively), at the expense of the largest ones (São Paulo, Rio de Janeiro, Porto Alegre, and Belo Horizonte).

The ability to capture the opportunities associated with these emerging consumers depends in part on understanding their preferences and constraints. A recent McKinsey survey suggests that more than 60 percent of this group's higher incomes would be devoted to more and better food. By contrast, the average consumer elsewhere in the world spends roughly 60 percent of any additional income on nonfood items such as consumer electronics, clothing, and entertainment.

One big issue holding back the sector, however, is the gray market. Informal enterprises represent about 80 percent of total retail sales, in spite of being far less efficient than formal retailers (Brazil's formal and informal retailers are 23 and 88 percent less efficient, respectively, than US retailers). Informal enterprises have, at most, restricted access to capital and an actual disincentive to grow: the larger retailers become, the more effective the law is at finding and monitoring them. In view of the formal sector's heavy tax burden, tax evasion and lean overheads can give informal retailers a five-percentage-point advantage over formal ones in operating margins, despite the formal sector's advantages in bulk purchasing and higher labor productivity. By reducing the tax burden on retail food stores, some countries, such as Mexico, have almost eliminated informal enterprises among modern retailing formats.

Banking

The economic chaos of the past 25 years has severely atrophied Brazil's domestic loan markets, and areas such as insurance and long-term investment remain underdeveloped. Yet the uncertainty regarding macro-economic factors has also promoted high spreads on both asset and liability products, and Brazil's banks are among the world's most profitable and highly capitalized.

Brazil's banking sector should benefit significantly from a stable macro-economic environment and sovereign investment-grade status. Indeed, Mexico's and Portugal's experiences with improvements in sovereign risk and falling interest rates suggest that these developments can greatly accelerate the growth of local capital markets: banks extend credit to consumers and private enterprises more freely, and the mortgage market flourishes. Segments such as asset management, derivatives, underwriting, and M&A advisory services emerge as well. Nevertheless, an effective regulatory framework is the foundation of any banking market. Vigorous growth can take place only after such a framework has been introduced.

Brazil's households and corporations are underleveraged compared with their counterparts in the developed world.9 In fact, corporations pursuing an investment-grade rating in a country lacking that status tend to have more conservative capital structures than similarly rated corporations in countries that have it.

With few exceptions, commercial banking in Brazil is firmly in the hands of local institutions, which have led the sector's consolidation and enjoy a broad customer base that cuts across segments and geographies. These large local universal banks—tightly controlled by the state, families, or foundations—have valuations ensuring their competitive access to capital and opportunities for further consolidation, thus making acquisition by global banks less likely (and less attractive). Only multinational banks with big ambitions in the region and high market

growth assumptions could justify buying those local players to enter the market or expand. An alternative for the multinationals might be to participate in the eventual privatization of the remaining state-owned banks or to enter into a partnership with a dominant domestic bank whose controlling shareholder (typically a family) seeks liquidity and diversification.

Enlarging the corporate-loan portfolio organically can be an attractive alternative—gains from improvements in sovereign rating generate greater returns on debt than on equity, assuming similar risk premiums across asset classes. Expansion in the industry's investment-banking side typically depends on organic growth. Both the advisory and the underwriting league tables are dominated by global players, which in some cases acquired domestic houses to establish a local presence before starting an organic effort. Credit Suisse and UBS both chose this route: the former by acquiring one of the most successful local investment firms, Banco Garantia, in 1998 and then acquiring the financial-services provider Hedging-Griffo in 2006; the latter by acquiring Banco Pactual, the last independent house with a prominent market position, during the first half of 2006. Large local commercial banks are the only domestic representatives among the elite of banks offering underwriting and advisory services.

On the consumer-lending side, some foreign banks, such as Banco Santander Central Hispano (Santander) in credit cards and HSBC in lending to low-income consumers, are exploring niche retail markets.

Although the financial sector as a whole is not only growing but also expanding its product and service offerings, the size of the profit pool may not increase proportionally. Despite the general improvement in financing conditions, credit for Brazil's middle-market companies, small businesses, and individuals remains among the most expensive in the world. With greater stability, the factors that now benefit large companies will likely spread to the rest of the economy, aiding borrowers of all sizes. Fees and spreads in products such as mortgages and consumer credit will probably decline, so even as the sector grows, the impact of stability on its overall profit pool might be less positive.

Brazil's businesses still face big risks. The reduction in the country's current-account deficit was achieved on the back of one of the strongest bull markets in commodities. Its collapse could lead to a reversal of the current account and consequently of the momentum toward an investment-grade rating. A weakening commitment to prudent fiscal policy could lead to even greater government participation in the capital markets, essentially crowding out private borrowers. Infrastructure upgrades are spotty. And government services (such as the judicial system) and the fiscal system may be improved only in the medium term.

What should a multinational executive make of this situation? One important element in any multinational's entry strategy is strong local knowledge: experienced managers committed to the region and accustomed to dealing with its regulatory agencies, government officials, and local suppliers. As for local companies, economic improvements and the development of domestic capital markets should affect their prospects profoundly. The enhancement of local corporate-governance standards ought to improve managerial practices and create a healthier investment environment for domestic savings. With hard work (and some luck), local enterprises should emerge from these changes in much stronger shape to face a less protected business environment and to accelerate gains in productivity.

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