Brazil: the real deal?

Street protests may have put Brazil in the headlines of late, but its strong economic fundamentals mean there are plenty of opportunities for companies and investors prepared to look to the longer term.

Dilma Rousseff, President of Brazil since 2011, is helping to drive the country's unprecedented investment in infrastructure.

As one of the BRICS economies, Brazil has long been touted as one of the world's most dynamic emerging markets. It is the world's seventh biggest economy, has a large domestic market thanks to a population of almost 200 million people, low unemployment and a growing middle class eager to spend on consumer goods. It is one of the world's largest producers of agricultural commodities, a major energy exporter and has plans for significant investment in infrastructure. And the 2014 FIFA World Cup and 2016 Olympic and Paralympic Games taking place in Rio de Janeiro will drive some of that infrastructure development, as well as attracting visitors and the attention of the world's media.

"Brazil has a terrific entrepreneurial culture," says Don Baker, partner at White & Case in São Paulo. "We see Brazilian clients looking at opportunities in their home market – including regions that have traditionally been underserved, such as the north and northeast – as well as throughout Latin America, the US, Europe and Africa."

At the same time, recent street protests, coupled with the well-publicized difficulties of industrialist Eike Batista's EBX Group, have threatened to unnerve investors (though this should be balanced against Odebrecht Offshore Drilling Finance's successful overseas bond issue which raised US$1.7bn).

2.5%

growth in GDP is forecast for Brazil in 2013, up from 0.9 percent in 2012 but still below the high growth experienced in previous years – which means investors are watching the country closely.

And while forecast GDP growth of 2.5 percent for 2013 is an improvement on 2012's 0.9 percent, it is some way short of the rapid growth seen over much of the past decade. The situation is exacerbated by the recent depreciation of the Brazilian real against the US dollar.

According to Clinton Carter, head of research for Latin America at the Frontier Strategy Group, which advises multinationals on their emerging market strategies, these headlines are not necessarily surprising for "an economy in transition" in need of structural reform to shift from a demand-led model to become more investment-led.

"There hasn't been nearly enough investment in infrastructure or high-quality education, so there are big bottlenecks in the economy," he says. "Brazil needs reform efforts to boost productivity and competitiveness, such as large regulatory changes and a restructuring of the tax code."

Sarah Hunter, head of the Americas team at Oxford Economics, agrees – and adds that significant labor market reforms are also needed to make it more flexible and boost productivity.

"If the government doesn't implement structural reforms, there's a real risk that growth will stall," she says. "But with the [presidential] election coming up next year, it's unlikely that they'll start making these quite painful changes before then."

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Strong fundamentals

"There is a continued need for economic development. Will the plans for infrastructure investment and development and the various concessions due to be rolled out over the coming months come to fruition?" asks Someera Khokhar, partner in the Energy, Infrastructure, Project & Asset Finance Practice at White & Case in New York. "The fundamentals are there. The robust banking system and liquidity in the market, as well as the momentum and support from the Brazilian Development Bank (BNDES), inspire confidence that this need will be met."

The drive to improve Brazil's infrastructure will be a major source of opportunities for international companies and investors, even putting the Olympics and World Cup to one side. According to McKinsey, the country spends just 20 to 40 percent of GDP on infrastructure, compared with a global average of 70 percent.

The Brazilian government recognizes the urgent need to address the situation: in 2013, it scheduled auctions for concessions for 7,500km of roads, 10,000km of railways (with an auction for high-speed rail currently scheduled for 2014), ports and the airports of Rio and Belo Horizonte.

Following a five-year hiatus, an auction of blocks of Brazil's offshore oil and gas reserves took place this year, including the high-quality "pre-salt" Libra oilfield, which was auctioned in October with a consortium of international oil companies led by Petrobras winning the bid. Auctions for concessions for hydro and wind power generation and the installation of electricity transmission lines are also in the pipeline.

While there are concerns over the government's administrative ability to keep these numerous plans on track, the level of ambition is evident: "There will be a lot going on across the board – from electricity, ports and airports to roads, rail and urban transport," says David Bunce, senior partner at KPMG in South America. "We've seen a number of foreign players in that segment that haven't previously invested in Brazil but are now looking at it quite actively. The government is making monies available so any project sponsor, including foreign engineering companies and so forth, can step in, and you can agree to fund 60 to 70 percent of a project with BNDES money."

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In a bid to attract international investment in such projects, the federal government has launched infrastructure bonds, which carry a withholding income tax rate of zero percent on interest payments and are exempt from the *Imposto sobre Operacoes Financeiras* (IOF) financial transactions tax.

But Khokhar says the key will be the way in which concessions are structured: “They’ve got to be attractive to both the financing parties and the sponsors coming in to operate the concession,” she says. “That’s part of the problem Brazil has had in the past: they haven’t structured the concessions in a way that would be attractive to international investors.”

Brazil’s consumer market offers another significant opportunity for international businesses. The consumer sector has grown more strongly than the industrial sector for a number of years – though there are some signs of a slight slowdown in consumer spending, possibly caused by people “maxing out” on credit. But as more of Brazil’s population moves into the so-called middle class, demand for consumer goods is likely to continue to rise over the longer term.

“There are still a lot of opportunities in the consumer space,” says Frontier Strategy Group’s Carter. “Vast regions of the country are still relatively underpopulated in retail terms. What’s on offer in the north is considerably different from what you see in the south.”

“Companies are seeking financing for investments in these new regions – and beyond – through a variety of sources, including corporate and project bonds, syndicated loans, and loans from development banks and multilaterals,” adds White & Case’s Baker. “Given the recent turmoil in the global markets, we are seeing more interesting and innovative structures that are far from plain vanilla and require substantial knowledge of how to get deals done.”

Long-term potential

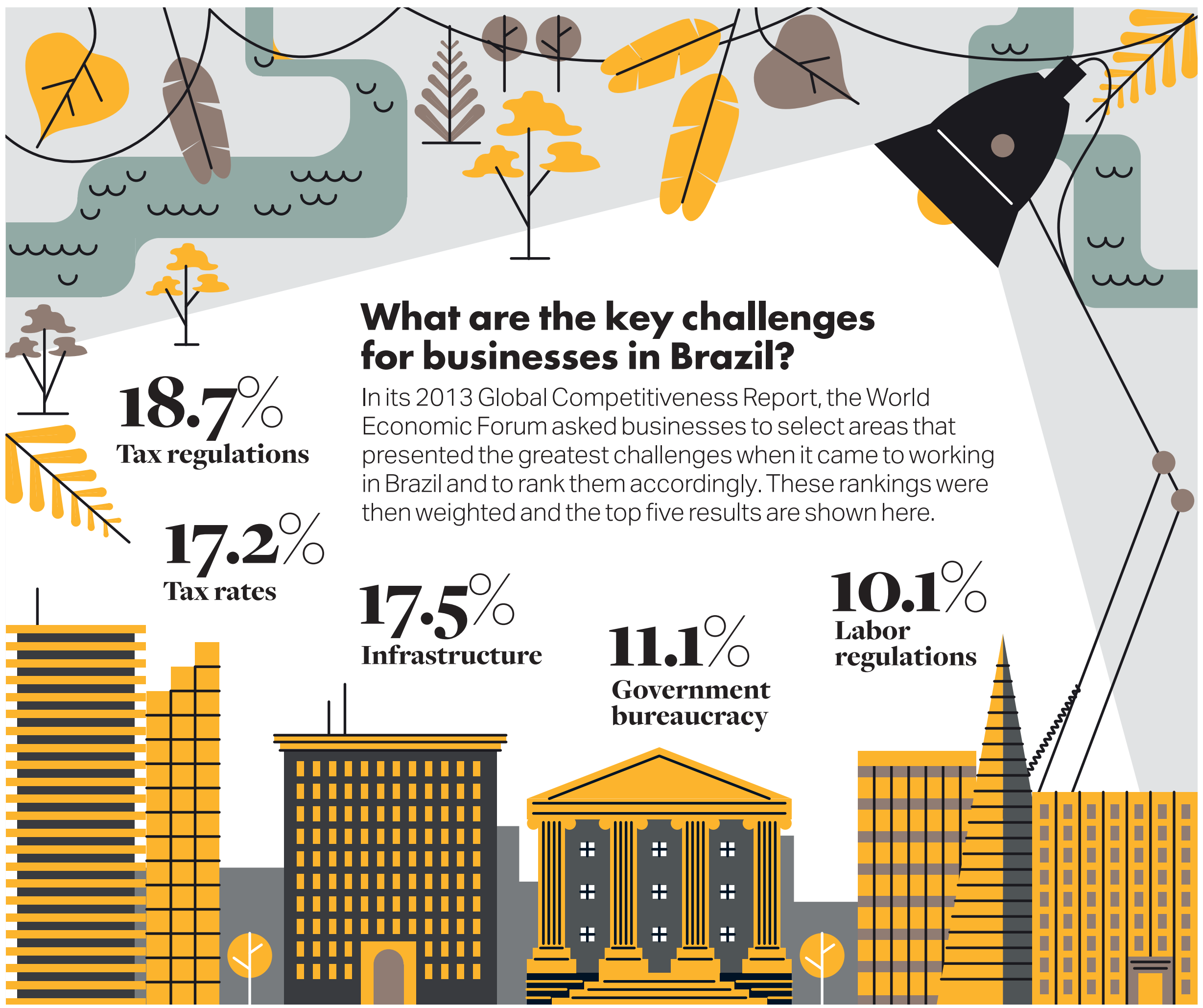
KPMG’s Bunce suggests that the current uncertainty may present an opportunity for inward investors as prices for business assets have been corrected down slightly: “If you believe the long-term story for Brazil – and I think most business investors still do – arguably the next few months is a great time to come here because you can take advantage of the volatility to buy more cheaply and come in at a more favorable exchange rate,” he says.

“You have to look at Brazil as a medium to long-term game. But many of the large subsidiaries of foreign companies operating in Brazil are some of the most profitable operations that their groups have in the world. And that’s true across a whole series of sectors.”

While there are opportunities, challenges remain for international companies and investors entering the market: Brazil ranked 130th out of 185 countries in the World Bank’s “Ease of Doing Business Index 2013,” down two places from 2012, and scored particularly badly for the complexity of its tax system. “The tax compliance burden is very high,” says Frontier Strategy Group’s Carter. “Within their Brazilian operations, companies commit a fairly considerable percentage of revenues to internal teams to get their taxes right. Even then they get it wrong all the time because it’s exceptionally complicated.”

Another issue is the legal regime: “Concessions are all governed by local law,” says White & Case’s Khokhar. “People have to believe in the integrity of the Brazilian judicial system and the whole legal process. That’s one of the challenges that any developing economy has, particularly when it comes to infrastructure investment.”

Despite such problems, the reasons why Brazil has long been touted as a source of significant growth potential – from its demographics and market dynamics to its natural resources and a strong financial sector – haven’t gone away and represent significant grounds for optimism.



An infrastructure play

For engineering consultancy Arup, the opportunities in Brazil are being built from the ground up.

One company that’s already active in the infrastructure sector in Brazil is the global engineering consultancy Arup. As well as a range of urban development projects in São Paulo and a masterplanning project in the port of Santos, it is working on a number of venues for the Rio Olympics, including the velodrome and Olympic Training Centre.

The firm is also providing sustainability advice to Rio’s city government on the Olympic Village – a project that Pablo Lazo, Arup’s masterplanning leader for Latin America and associate principal of its São Paulo office, says is both challenging and exciting: “It’s twice the size of the Olympic Village in London, in an area of the city not yet totally urbanized, so it needs a lot of infrastructure and public transport connections.”

Lazo believes that major infrastructure projects such as new metro lines, airports and ports will be a source of significant demand for the firm over the next few years.

“I’m optimistic; every week we have something new coming in,” he says. But he warns that more joined-up thinking is required.

“Many of these projects will require multi-level coordination and approval by federal, state and city governments. And because of the way Brazil is structured, that’s just taking too long.”