



Interview: Fábio Rosas, Partner Tozzini Freire; Rafael Fritsch, Partner, Peninsula Investments; Robert Ellison, Partner, Sherman and Sterling

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Lack of credit in the Brazilian financial system is causing many companies to sell assets rather than search for loans. Asset prices are falling as a consequence, creating an investment opportunity. But the current Brazilian crisis comes with some unsettling, and hard to evaluate risks. Foreign investors have not yet waded into the Brazilian asset market in significant numbers. A group of experts discussed Brazilian investment scenarios at a recent meeting with investors and reporters in São Paulo. Excerpts follow:

- **Rafael Fritsch:** “To beat Brazil risk today, you have to offer foreign investors a yield of 25%. Who’s going to pay that? The domestic market is also risky. This year the growth of loan portfolios held by private Brazilian banks will come in below the rate of inflation.”
- **Fábio Rosas:** “Some foreign funds with money and risk appetite have kept away from Brazil because of the difficulty in evaluating real risks against possible returns.”
- **Robert Ellison:** “We’re going to learn a lot from the Petrobras scandal about how we should treat overseas bond holders of bankrupt Brazilian companies. There are going to be a lot of tensions with these bond holders and a lot of overseas suits.”
- **Fritsch:** “There was a *lot* of credit kicking around in 2010 and 2011. We got used to it. Now, the lack of credit is causing companies to unexpectedly sell assets. Prices of these assets are falling. There are opportunities, but you’ll notice that the big global investment funds are not picking up on this, at least not yet. A big part of the problem is that, in Brazil, picking up distressed assets can be a fraught process, complicated and exasperating.”
- **Ellison:** “Overseas subsidiaries of the bankrupt Brazilian contractors are responsible for the issuance of overseas bonds. It’s important to involve these subsidiaries in the Brazilian bankruptcy proceedings so that these bond-holders can be involved. In the OGX bankruptcy case, the Rio de Janeiro judge didn’t involve the overseas subsidiaries. When the foreign bond holders came to him for relief, he told them to seek a solution in New York. But U.S. law says the question can only be resolved as part of a bankruptcy case. The OGX subsidiaries weren’t involved in any bankruptcy case because the Brazilian judge wouldn’t allow it!”
- **Rosas:** “Often, in Brazil, bankruptcy is used by controlling shareholders as a way to escape costs, problems, and responsibilities. The creditors are losers, and the minority shareholders are bigger losers still. There is still a pattern in Brazil in which even publicly traded companies are effectively controlled by a family or a small group of individual investors.”

- **Fritsch:** “Any potential investor needs to evaluate two variables—valuation risk and process risk. In Brazil, you can easily make an analysis of valuation risk. The problem is analyzing process risk, things like sudden rule changes, politics, and macroeconomic instability. This risk is higher than in other countries, and it means that asset yields have to be higher.”

Top News of the Week

Government sets October 30 to auction concessions at 29 power stations. Brazil’s government last week set October 30 as the date to auction concessions at 29 hydroelectric power generating stations. All 29 are currently operated by utilities which opted not to renew 30-year concessions coming due this year. In 2012, the government gave utilities the option of renewing concessions early in exchange for agreement to reduce power rates. Most utilities opted in favor of renewal. However, according to economists, most now regret their decision. Lack of rainfall and other factors have driven generating costs higher while the 2012 rate cap held down revenues. Brazilian utilities are expected to post losses this year of about R\$12.5 billion. The October auction will feature bids including both proposed concession payments as well as proposed rates. Winners will be determined through a formula taking both criteria into consideration. The government expects to obtain much needed revenues of at least R\$17 billion from the auction.

Public banks pick up the slack for distressed auto industry with new credit lines. Two major public banks last week announced creation of special credit lines designed to help the ailing auto industry. Brazil’s largest retail bank, Banco do Brasil, and the government-run CEF mortgage bank announced plans to extend loans to auto makers and suppliers at “best customer” interest rates. They also pledged to fast-track loan applications. The CEF will make R\$5 billion available through the end of the year while the Banco do Brasil will start with R\$3.1 billion. The Banco do Brasil intends to expand its program to other economic sectors, with total credit lines rising to R\$9 billion.

Congress passes last of the original fiscal adjustment measures. Brazil’s Congress last week completed action on the final bill from an original batch constituting a broad ‘fiscal adjustment’ proposed by President Dilma Rousseff. The legislation passed last week will hike payroll tax rates for 56 separate industries. The industries had previously paid rates running from 1% to 2% over payroll. They will now pay between 2.5% and 4.5%. The measure should produce some R\$10 billion per year in additional revenues. Other bills in the fiscal adjustment package include restrictions on certain unemployment and social security benefits and a hike in the PIS/Cofins social welfare tax on selected imports. Officials, however, have said the original measures may not be enough to close Brazil’s fiscal gap. More spending cuts and tax hikes may be necessary for 2015 and 2016.

Prosecutors seek indictments for Chamber of Deputies Speaker and former President Collor. Federal prosecutors last week sent up indictments for Chamber of Deputies Speaker Eduardo Cunha and Senator Fernando Collor, a former Brazilian president. The indictments will be considered by the Brazilian Supreme Court, which may accept them or throw them out. The indictments stem from an ongoing investigation of alleged corruption at state-run energy company Petrobras. Prosecutors accuse Cunha of obtaining the equivalent of \$5 million in bribes while Collor would have received more than \$7 million in exchange for their influence over Petrobras distribution contracts. Both men have denied the charges. Political risk analysts predict that Cunha will face a move in the Chamber of Deputies to remove him as Speaker in the event the indictment is accepted. Cunha has vowed to stay on.

Business News

Investment News:

Global telecommunications giant **Telefonica** last week unveiled its investment plan for Brazil covering the period 2015 through 2017. The plan amounts to a vote of confidence in the Brazilian market, previewing total investments of R\$25 billion, up from R\$17.2 billion for the company's previous investment program. Investments will focus on coverage expansion and technical upgrades. Telefonica owns the Vivo brand name in Brazil.

Company News:

Brazilian **publicly listed companies** suffered a modest decline in billing, and a sharp falloff in profits, in the first half of 2015, according to a study last week by consulting group Austin Asis. The study covered 124 major companies, representing about a third of listed firms in Brazil. It showed an overall 2.2% decline in billing against the first half of 2014 to R\$308.8 billion. Profits plunged 50% to R\$20.9 billion. Earnings fell as companies faced climbing costs due to inflation and high interest rates. A weaker Brazilian Real, meanwhile, pushed up debt-service costs for companies with overseas obligations. The first half of 2015 also saw a decline in consumer demand, undermining billing.

Brazilian Calendar

-Monday, August 24, Latin Retail Congress and Exposition, Expo Center Norte, São Paulo

-Tuesday, August 25, Brazilian Central Bank release of monthly current account data, Brasília

-Wednesday, August 26, Brazilian Central Bank release of monthly financial system data, Brasília

-Friday, August 28, Brazilian Central Bank release of monthly primary budget surplus data, Brasília

-Friday, August 28, Brazilian Census Bureau (IBGE) release of second quarter GDP figures, Rio de Janeiro

Indicators

Foreign exchange rate: **R\$3.50 = \$1.00**

Consumer arrears rose by an alarming 16.8% during the period January through July against the same period a year earlier, according to a report last week by the Serasa Experian consumer credit rating agency. More than 56 million consumer accounts were in arrears, according to the report. Arrears are rising for a number of reasons, including inflation, stiff increases in utilities rates this year, and rising interest rates. But the latest factor is increasing unemployment, a phenomenon that could lead to a rise in long-term arrears and individual bankruptcies, according to economists.

July proved another disappointment for **tax collections**, with total revenues falling 3.1% against July of 2014, in inflation-adjusted terms, to R\$104.9 billion, the Brazilian Tax Authority said last week. It was the fourth straight month of declining revenues. January through July revenues of R\$712.1 billion were down 2.9%, in real terms, from the same period in 2014. Tax collections have fallen this year on a stagnant economy and a sharp decline in consumer spending. Falling revenues led the government last month to reduce its 2015 primary budget surplus goal from 1.1% of GDP to just 0.15%.

Brazil's **unemployment rate** shot up in July to 7.5% from 6.9% in June and just 4.9% in July of 2014, the Brazilian Census Bureau (IBGE) said last week. Unemployment has been growing on the back of a sluggish economy. Companies are retrenching because of high interest rates and slack consumer demand.