

Highlights of Brazil

2010-2011 Edition

All in all, a very good year for Brazil

Brazil has overcome the recent international economic crisis and returned as a stronger and more attractive global player. A high degree of economic diversification, combined with a strong internal consumer market and a broad selection of trading partners, coupled with a regulated financial system, have been key to successfully mitigating the worst effects of the crisis. The long period of domestic economic instability in Brazil has been overcome. Both politically and economically, Brazil is now a mature country and one of the most attractive markets in the world for foreign investment.

The Brazilian economy has grown some 7.5% in 2010, contrasting with the much more modest growth rates observed in advanced and other developing economies, which are still struggling to overcome the 2008/2009 international financial crisis. Brazil's growth has been totally based on the expansion of the domestic market and far exceeded the 4.5-5.0 percent range estimated to be the long-run potential rate of growth in Brazil. Domestic demand has increased steadily at that high rate throughout the year, with consumption increasing 6.5% and private investment 23%. Booming current government expenditures and investments – especially Growth Acceleration Programs 1 and 2 (*Programa de Aceleração do Crescimento 1 e 2 – PAC 1 and 2*) – and spending on social programs and the social security system, which shaped Lula's administration, have helped increase the disposable income of the lower strata of the population. The effect of loose fiscal policy on demand has been complemented by a huge expansion of domestic credit by both private and government-owned banks (BNDES, Banco do Brasil and Caixa Econômica Federal). Special credit is due to BNDES, which has supported the investments of middle and large Companies during the past three years, in which overall and private credit has been scarce. Given the narrow limits of domestic supply, the excess demand has been accommodated

to some extent by the sharp reduction of the trade balance. Goods imports have increased 44% and exports 31% this year, while the services and income account are negative by US\$ 68 billion. The result is a current account deficit of US\$ 52 billion or 2.6% of GDP, up from 1.5% last year.

This exuberant growth has been made possible by the abundant supply of foreign capital to Brazil, both before and especially after the 2008/2009 international financial crisis, which has financed the current-account deficit and forced the Central Bank to accumulate an additional US\$ 46 billion of reserves (February 2011 reserves reached record US\$ 300 billions) to avoid further appreciation of the exchange rate. Capital inflow has been diversified, but arbitrage funds have been prominent, directed to the fixed income market to exploit the large interest rate differential between Brazil and advanced countries. While interest rates in the USA, Europe and Japan have been close to zero, Brazilian rates have remained at worldwide highs at c. 11% per year (the Central Bank rate). The consequence has been further appreciation of the real



relative to the dollar, despite the reserve acquisitions of the Central Bank. In turn, the strong Real has further stimulated the demand for tradable goods and services and enlarged the current account deficit. During the last months of the year, the government increased the tax on foreign portfolio capital (fixed income instruments) from 2% to 6%, but with little effect so far. As in many other countries today, the appreciation of Brazilian currency, and the consequent loss of competitiveness of the tradable sector in world markets, poses an important and difficult problem for the coming years (see section 2 below).

A consequence of the buoyant domestic demand, largely influenced by consumer credit, which in Brazil still has room for expansion, has been the return of inflationary pressures, especially stemming from the labor market. The rate of unemployment has fallen below 7%, the lowest in two decades, and unit labor costs for firms have been rising steadily. The consumer price index (IPCA) has increased 5.9% this year, well above the target rate of 4.5% set by the government under the inflation target framework, although the government has successfully maintained

actual inflation within a pre-determined inflation range over the past years. Toward the end of the year, the Central Bank abandoned its passive policy and increased the reserve requirements on the demand and time deposits of commercial banks to unusual levels, and raised their capital requirements for consumer loans, in an attempt to curb consumption demand.

Although very high by international standards, Brazilian real interest rates have never been lower. For instance, the Central Bank rate, in real terms, is presently at 5% per year, against the average of nearly 10% for most of the first decade of this century. This helps explain the expansion of domestic credit from 35% to 65% of GDP over the past few years. It also explains the resumption of private investment, which now stands at 20% of GDP. Brazil is currently experiencing a boom in residential and commercial construction, triggered by lower mortgage costs, longer maturities and easier financing requirements. The stock market, which has seen 25 new issues (11 IPOs and 14 follow-ons) in 2010, has recovered from the financial crisis – with stock prices remaining relatively stable during the year – and leveled with international markets. As expected,



foreign direct investment fell after the 2008/2009 crisis, but has shown some recovery this year. The bulk of foreign investments have been directed at exploring the opportunities offered by the growing domestic market and there have been record levels of M&A activity in 2010 (see section 3 below). Little investment has been made in the tradable sector, in view of the strong appreciation of Brazilian currency.

The general elections held in October-November were very favorable to President Lula and his party (PT). He has not only succeeded in electing his chosen successor (Dilma Rousseff), but also won a comfortable majority in both houses of the Brazilian Congress. The coalition parties supporting the government, led by PT and PMDB, took 73% of the seats in the Chamber of Representatives and 75% in the Senate. This theoretical majority, however, should not be overstated, due to the fragmentation and lack of unity among the 9 parties composing it. In Brazilian politics, the Federal Administration has to bargain each issue of interest on a case-by-case basis in Congress, as each party votes according to its own interests, and demands political benefits in exchange for its allegiance to the government. Moreover, despite Lula's enormous popular prestige, it should be observed that the opposition candidate, Jose Serra, won a substantial 44% of votes in the second round of the presidential elections, and the opposition parties elected many state governors, which will clearly limit the scope for arbitrary actions by the new federal government. As far as can be seen, Rousseff's government will be a continuation of Lula's. The officials appointed to the most important economic positions in the new administration, for instance, all occupied similar positions during the Lula administration, evidence that little will change in matters of economic policy. The other ministries have been distributed among the coalition parties according to their political importance.

Brazil is going through a very favorable cycle of its recent history, after decades struggling with hyperinflation, balance of payments crises and low growth. The outlook for the next few years is one of continuing growth at reasonable rates (4 to 5 percent per year), in a context of stable inflation and balance of payments equilibrium. There are, however, certain unbalances in the economy that have to be resolved if this positive outlook is to remain. Though from a positive angle Brazil is today more foreseeable and stable, a number of challenges still linger, ranging from economic through education and qualified labor to infrastructure and fiscal challenges.

The new government will face three major economic challenges in 2011. The first is to reverse the extraordinary fiscal expansion produced by Lula's government during his second term. During the past four years, the growth of current federal expenditure, in real terms, has been almost double the growth of GDP. Considering that the tax burden in Brazil is already approaching 40% of GDP and can hardly be raised, there is no other way out for the new administration than to adopt an austere stance in fiscal matters. In 2010, as the general elections approached, several new expenditure proposals were presented in Congress, largely focusing on social security benefits, income guarantees, redistribution programs, and a host of new entitlements. These initiatives can undermine any effort at fiscal stability in the future. The immediate task of Rousseff's administration is to abort these proposals and establish a clear and sustained line of fiscal austerity. In other words, it is time to promote the coordination between monetary and fiscal policies that lacked in the Lula administration, and alleviate the independent

Central Bank's task of maintaining the rate of inflation under control. A certain degree of slowdown in domestic demand is necessary to bring the rate of growth in line with the economy's capacity: if fiscal policy remains loose, real interest rates will have to return to the high levels of the past.

The second issue refers to the appreciation of Brazilian currency, a phenomenon that has been ongoing since 2006 and worsened after the international financial crisis of 2008/2009. The continuing appreciation of the Real threatens Brazil's industrial structure, both in terms of manufacturing exports and the capacity to compete with imports, especially from those countries, like China, that keep their exchange rate undervalued. Even recognizing the global nature of the problem – the so-called “currency war” – and that the defensive policies taken by individual countries may prove ineffective, the new government can be expected react and eventually introduce new restrictions on portfolio capital or on imports. The growing current account deficit has been a matter of concern and, if unchecked, may threaten the good performance of the economy.

Finally, in order to sustain growth rates of around 5% per year, Brazil needs to increase its rate of investment by several percentage points of GDP, up from the 18-20% range of recent years. Plenty of investment opportunities exist in the economy, especially in the area of infrastructure. A recent example is oil exploration in deep sea waters (pre-salt deposits), which is estimated to require hundreds of billions of dollars over the next years. The same can be said of other areas, like renewable energy, transportation, ports, and telecommunications. For that to happen, however, two things are necessary. The first is to generate positive rates of saving in the public sector (now negative), since many segments of infrastructure depend on government investment. Hence there is need for fiscal austerity. The second is to create a friendlier and more predictable environment for private saving and investment. At the end of last year, the government created



tax incentives for long term financial instruments, whose objective is to promote the private capital market. This is already a recognition of the resource constraint of the state-owned banks, particularly BNDES (fixed capital formation) and CEF (residential construction), in supplying the funds necessary for financing the investment effort. Brazil's successful bid to host the FIFA World Cup in 2014 and the Olympic Games in 2016 has provided an opportunity to mobilize resources to increase the rate of investment.

By the same token, as the present scarcity of labor reveals, Brazil needs to immediately rethink its entire educational system and its labor training programs, which rank poorly in international evaluations of educational performance. During the two past decades, a successful effort has been made to universalize primary and secondary education. But quality has failed to improve and even worsened. Lula's government did little in this regard, as it privileged higher education and spent a larger share of the federal budget expanding the network of federal universities across the country. A shift of priority back to primary and secondary education is in order, aiming now at improving the quality and efficacy of the system.

M&A Activity in Brazil

Brazil has seen a record 800 deals announced in 2010, an increase of some 20% over 2009. This is also 10% higher than 2007, a year that saw a then-record 721 announced deals. This booming M&A market is testament not only to Brazil's rebound from the global downturn, but also to its underlying strength. While international market sentiment about M&A recovery this year has swung between optimism and skepticism, in Brazil there is a positive momentum in what looks to be sustained activity – largely influenced by the context described before. Strategic and financial investors (Private Equity) have reached historical record levels of deal making, supported by a solid macroeconomic scenario and tremendous consolidation opportunities. Confidence – a key driver for M&A activity – has been further boosted by low unemployment rates, access to credit and c.40 million new consumers. Middle market M&A activity remains strong and is expected to drive M&A in 2011.

Majority stake transactions account for 52 percent of all announced transactions, while non-controlling positions account for 32 percent, indicating a long-term investment strategy. Strategic and financial investors are both participating aggressively in the fast developing Brazilian economy. An annual and more detailed monthly analysis of deal flows will demonstrate that M&A activity in Brazil is at high levels, the monthly average number of deals having risen from 54 in 2008 and 2009 to 63 in 2010.

A multi-sector and multi-region deal profile has been observed in 2010, with the leading sectors by deal volume being IT, Consumer Products (including Food/Agribusiness & Beverages, Healthcare and Cleaning products), Mining, Services (Healthcare, Education and general services) and Chemicals/Oil & Gas. Next in significance are Financial Services, Logistics, Retail and infrastructure/construction. It should be observed that the largest sector holds some 9% of total deal activity in terms of volume, the other sectors following close behind.



While worldwide private equity-backed M&A activity was severely affected in 2009, Brazil experienced a different scenario. Private Equity activity reached record levels. After representing 30 percent of the deals announced in 2009, it has reached 42 percent of the deals announced in 2010. This share, which was 15 percent in 2007 and 20 percent in 2008, reflects aggressive Private Equity investment strategies and consolidation of various sectors. This context has occurred in a market where the Private Equity industry is not reliant on financial leverage and is therefore less affected by the international credit crisis and liquidity constraints.

Capitalized and with some US\$ 15bn available for investments, a significant part of Private Equity activity in Brazil has involved consolidation opportunities in “cash for investments” deals. The largest investors this year are in the segments of food and beverage, real estate construction, consumer goods, IT, education and financial and energy sectors. Additionally, deal size has started to increase from the small- to mid- market transactions that have historically dominated the market.

The Brazilian private equity market has been stimulated by a combination of several factors that have strengthened Brazil's position not only as an emerging market alternative to China and India, but currently as an attractive alternative to more developed markets that have experienced a much slower return to growth. A combination of factors, such as increasingly sophisticated and liquid capital markets (which have seen 181 IPOs and follow-ons over the past 5 years, 2007 being a record year with 76), new financing instruments and existing exit alternatives (such as sale to a strategic player, capital markets/IPO or sale to another PE or funds of funds), along with the continuing demonstration of political and economic stability have opened the eyes of foreign Private Equity investors to Brazil, which is now regarded as a serious player in the global market.

And what to expect for the near future in the Brazilian M&A Market?

Expectations are that the Brazilian M&A and investments context will continue to mature and reach new levels. Capital markets are also expected to return to pre-crisis levels and market specialists expect some 40 IPOs in several sectors: from consumer products to construction and from industrial products to retail and finance. Benefitting from less reliance on financial leverage and therefore exposure to liquidity constraints, as well as the expected slow return to growth across the rest of the world and the continuingly successful differentiation of Brazil as an alternative investment prospect, the investment outlook is positive. In 2011, and onwards, we should see new records of overall M&A activity as well as new PE entrants.

The main sectors of investment will continue to be food and consumer goods, healthcare, education and outsourcing services, real estate, energy and finance, with consolidation in all these sectors continuing to be a key driver. Infrastructure, given Brazil's structural deficiencies, and oil & gas are also sectors likely to see to improvement in activity. Companies in Brazil are facing a transformation period. With better corporate governance and accounting procedures (IFRS has been mandatory for large companies since December 2010 and a more simplified and optional set of rules has been established for mid-size companies) in place, most companies are experiencing the challenges of having a local company that is being transformed into a regional, then a national and finally an international operation.

Main economic indicators

	2010 ⁽¹⁾	2009	2008	2007	2006	2005	2004
GDP (US\$ billion) ⁽²⁾	2.027	1598.4	1650.7	1366.5	1089.0	882.0	664.0
Real GDP growth (% per year)	7.5	(0.6)	5.1	5.7	4.0	3.2	5.7
Unemployment rate (% of labor force)	5.3	6.8	6.8	7.5	10.0	9.9	11.5
General price index - IGP-DI (% per year)	11.4	(1.4)	9.1	7.9	3.8	1.2	12.1
Consumer price index - IPCA (% per year)	5.9	4.3	5.9	4.5	3.1	5.7	7.6
Exchange rate at year's end (R\$/US\$)	1.70	1.75	2.39	1.78	2.18	2.44	2.93
Exchange rate change (% per year)	(3.96)	(25.3)	34.1	(16.9)	(5.9)	(15.8)	(7.1)
Public setor deficit (% of GDP)	2.5	3.3	2.0	2.7	3.6	6.6	2.3
Public sector debt (% of GDP)	40.4	42.8	38.8	43.9	45.9	48.0	48.2
(in US\$ billion)							
Goods export	201.9	153.0	197.9	160.6	137.8	118.5	96.7
Goods import	181.9	127.6	173.0	120.6	91.4	73.6	62.8
Trade balance	20.3	25.3	25.0	40.0	46.5	44.9	33.8
Current-account balance	(47.5)	(24.3)	(28.3)	1.5	13.6	14.0	11.7
International reserves	288.6	239.1	206.8	180.3	85.8	53.8	52.9
Foreign direct investment ⁽³⁾	48.5	25.9	45.0	34.6	18.8	15.1	18.1
Total foreign debt	350.4	277.6	262.9	240.5	199.4	188.0	220.2

⁽¹⁾ 2010 figures are based on the last published data.

⁽²⁾ At the year-average exchange rate. IBGE

⁽³⁾ Including intercompany loans.

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