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The Cautious Investors' Guide to Brazil

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It's no secret that Brazil has been going through hard times and that investors — with good reason — regard the country as a high-risk environment.

It's also well-known that foreign direct investment ("FDI") in Brazil has declined rapidly. In one month, for example, from May to June of this year, FDI dropped **from more than $6.6 billion to approximately $5.4 billion**.

In one month, that's more than a billion dollars gone.

Trends suggest that it may not just be a temporary phase – a cyclical downturn – with an inevitable rebound just around the corner. Large structural impediments exist. Brazil's existing regulatory framework, for example, has made the country less attractive to foreign investment. This is the case especially in the extractive industries, specifically the huge and enormously troubled oil and gas segment, now long roiled in a major scandal involving the national oil company, Petrobras. And the country's current political crisis means that a grand bargain to resolve Brazil's fiscal and structural problems seems off the table. That's especially true now that impeachment proceedings have been filed against President Dilma Rousseff in Brazil's lower house for allegedly doctoring fiscal accounts. Consequently, the sustainability of both Brazil's governmental and business cultures are being questioned from within and without.

However, in all this darkness — and partly *due* to this darkness — there is light ahead and not the light of an onrushing train promising further calamities.

In fact, in many areas, it has become more profitable and less expensive to invest and conduct business in Brazil. Because of the current economic turmoil, potentially high-value assets and opportunities are underpriced, particularly in US dollar terms given the depreciation of the Brazilian *real*. Even in the country's embattled oil and gas industry, for example, new legislation has been introduced to amend oil exploration rules. If approved, the new rules would make it more attractive for oil companies to invest in Brazil's vast offshore oilfields. Private equity firms are reserving capital for strategic acquisitions in a number of sectors, including agriculture, education, real estate, energy and high tech, as well as the oil and gas industry.

The opportunities are there, and some players are already seizing them. However, companies contemplating such a move must be realistic. They must make sure they are not buying into a time bomb that will explode in corruption claims, forced restructurings or other forms of dispute. Investors must avoid getting sucked into the vortex of Brazil's economic difficulties so that they can make it through the country's medium-term challenges to emerge with high long-term returns.

Bad News on Many Fronts

Over the last several years, Brazil has been rocked by social unrest and scandal. Combined with **relatively high interest rates around 14.5 percent** and **continuously falling global oil prices** (in mid-July of this year, **a barrel of crude was at $54; by the beginning of October, it had dropped to under $45**), Brazil has been experiencing what only generously can be termed lackluster economic growth. According to the World Bank, **Brazil's growth as a percentage of gross domestic product ("GDP") has fallen from 2010's high of 7.6 percent to 2014's zero**, and is now in free fall. The Central Bank of Brazil says the country is in a technical recession, with two back-to-back quarters of negative growth. And most economists at major financial institutions in Brazil expect growth of less than 1 percent in 2016. In an International Monetary Fund ("IMF") briefing this past July, Olivier Blanchard, Economic Counsellor and Director of the Research Department at the IMF, forecast a significant recession in Brazil due to **"low business and consumer confidence."** In October 2015, the IMF revised its outlook, **projecting the economy will shrink 3 percent this year and 1 percent in 2016**.

Adding to the country's economic woes, **inflation climbed to 9.56 percent year-over-year in August 2015**, and **unemployment increased to almost 7 percent, a rise of 2.6 percent between December 2014 and June 2015**. That, too, is forecast to rise.

And if these statistics weren't bad enough, in September 2015, **Standard**

& Poor's downgraded Brazil's credit rating to junk status. Moody's and Fitch are expected to follow suit, meaning that a number of pension funds (that require investment grade ratings by two agencies) would be forced to divest.

Not surprisingly, Brazil's **President Dilma Rousseff's approval rating fell to an unprecedented low of 8 percent last summer**, as protestors — all too aware of the convergence of political scandal and economic hard times — filled the streets across Brazil.

In Brazil's oil and gas sector (**which accounts for 13 percent of the nation's GDP**), the current regulatory framework makes it difficult for foreign oil and gas companies to invest in exploration and extraction. The government's take from oil and gas royalties, profit sharing and taxes means investors perceive the risks to outweigh the rewards in some of the country's most promising oil and gas plays. Also, under Brazilian law, the national oil company is required to maintain a 30 percent minimum stake in all pre-salt exploration projects. This has created a bottleneck, as Petrobras is under severe financial constraints due to the ongoing investigation into its business practices. With the company unable to come up with the required 30 percent, exploration has been severely impaired. Although foreign companies still are investing, they are downsizing investment budgets.

What all this adds up to is that Brazil is one of only two of the world's oil-producing countries (the other is Venezuela) that produces less oil than it did 10 years ago.

As a consequence, **Petrobras is reportedly putting assets valued at $14 billion up for sale**. Undoubtedly, these assets will be sold at fire-sale valuations.

This is typical of the opportunities that Brazil's economic downturn can offer canny — and cautious — investors.

Where the Opportunities Lie

According to the Latin America Private Equity and Venture Capital Association, last year Boston-based Advent International **launched a new fund with a $2 billion target focusing on buyouts and expansion financing, mainly in Brazil, Mexico and Argentina**. Advent is targeting sectors it believes promise high growth: financial services, airport services, business services, and retail and consumer goods.

And these are not the only sectors ripe for investment in Brazil. Attractive opportunities lie in agriculture, education, real estate and energy, to name a few.

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Agriculture

The **real has fallen against the U.S. dollar by more than 40 percent since the end of 2014**. Therefore, export industries have become more attractive, especially if they are not capital intensive or dependent upon imports. That describes agriculture, where Brazilian goods are more competitively priced on global markets. Not coincidentally, the Brazilian government has doubled down on its commitment to the agricultural sector in recognition of the difficulties in oil and gas and manufacturing. Last June, **legislation was introduced to liberalize regulations that would encourage foreign investment in Brazilian farmland**. Separately, the Brazilian government reached an agreement with the United States to allow Brazilian exports of fresh beef to the United States.

After a June 2015 meeting between President Barack Obama and President Rousseff, the White House released details of an agreement that would expand **"bilateral beef trading,"** as the U.S. Department of Agriculture amended regulations that previously prohibited the importation of fresh beef from Brazil. **Brazil today is the world's second largest beef exporter** (after India; together Brazil and India account for 4 percent of the world's beef exports), and with the opening of the U.S. market, Brazil's global share can be expected to grow.

In the face of other lagging economic indicators, Brazil's 2015 harvest is expected to be 8.6 percent higher than 2014's, according to the Brazilian Institute of Geography and Statistics. Grains such as soybeans, corn and rice should register growth of 11.9 percent, 6.5 percent and 3.6 percent, respectively. (Coffee and bean production is expected to decline.) According to the Organization for Economic Co-operation and Development data, **Brazil already produces more wheat than Russia and about the same amount of rice as the United States**.

Agriculture has been especially important to Brazil's economy, growing 1.8 percent year-over-year during the second quarter of 2015 even as the total economy shrank by 2.6 percent. Consequently, investment in the agricultural sector is increasing, and private equity firms are developing offerings that focus on Brazilian agricultural indices.

World demand for food is not going to shrink. As Mark Twain advised investors long ago, "Buy land. They're not making it anymore."

Education

In 2013, less than 15 percent of the Brazilian population between ages 18 and 24 was enrolled in universities. In the United States, it was 36 percent. Brazil's growing middle class, with increasing access to capital, is looking to improve educational opportunities for its young people, and the government, recognizing this demand, is encouraging investment in private education, especially from private equity.

In 2014, for example, the Brazilian investment firm Bozano Investimentos raised **$309 million focused on the education sector, with 40 percent of the fund contributed by German media conglomerate Bertelsmann**. The education companies in the Bozano portfolio include Anima Educação (that runs a number of postsecondary schools) and several startups.A second Bozanao-Bertelsmann fund of $38 million is targeting the education technology segment.

In September 2015, Advent announced that it was working on the consolidation of Brazil's private education sector, pointing out that the industry had many quality assets available even in the midst of hard economic times.

The emergence of a new lower-middle class in the last decade also has generated demand for lower-cost educational services and the creation of government incentives (such as the Prouni scholarship and tax breaks for for-profit universities). This has benefited investors in the segment; however, as many educational institutions have become heavily dependent upon government subsidies, these organizations remain vulnerable to regulatory changes and possible budget cuts.

It should be noted that the growth of private education in Brazil has not come without criticism as, just as in the United States, this type of education often leaves students burdened with high-interest loans. Private sector education also raises questions of equal access to equal opportunity in a country where higher education has historically been free for those students who can pass highly competitive entrance exams. Likewise, many private educational providers in Brazil have come under public scrutiny for allegedly deceptive practices to boost enrollment fees or have been tarnished by low graduation rates and poor job placement for graduates. Investors should be careful to adequately assess the local reputation of private educational providers in Brazil before acquiring or partnering with them.

Real Estate

According to a June 2015 *Bloomberg Business* report, New York-based Blackstone Group, the multinational private equity and investment banking giant, is bargain hunting for property in Brazil. Blackstone has established a global real estate fund of $15 billion based in São Paulo, where a building boom during the period of Brazil's economic expansion **created 7.5 million square feet of high-end office rental space**, much of it now empty. Consequently, values have dropped a reported 20 percent since then, and properties are selling at distressed prices.

Toronto-based Brookfield Asset Management, with more than $200 billion under management, is raising $1 billion to invest in Brazilian real estate. In September 2014, Brookfield purchased a historic building in São Paulo's financial center for $312 million. **Brookfield also is purchasing an office portfolio from BR Properties**, one of Brazil's largest commercial real estate firms, for $590 million.

Brookfield acknowledges that the market for commercial real estate in Brazil may not improve for two to three years, but the firm's strategy is both long term and disciplined. "We are investing large sums of capital [in Brazil]," said Brookfield CEO Bruce Flatt in August 2015, "and believe we are acquiring some incredible assets that will be great value investments over the longer term."

Energy

Just two years ago, the International Energy Agency reported that **Brazil could supply one-third of the world's oil needs by 2035**.

That oil is still there, waiting to be extracted, refined and brought to market.

And despite the daunting challenges facing the energy sector, this past August **Royal Dutch Shell signaled a plan to invest $5 billion, mainly in Brazil, after its acquisition of BG Group**, the British multinational oil company. This represents a strong show of confidence in the potential of Brazil's vast offshore pre-salt basin, a confidence that may have been buttressed by recent legislation introduced by the former governor of São Paulo to amend the aforementioned rule requiring a 30 percent contribution by the national oil company.

Companies that can gain a foothold in Brazil's energy sector now will be able to reap enormous rewards down the road.

That said, the political and economic situation in Brazil remains volatile. Many foreign companies already have been drawn into the Petrobras scandal, including several Swiss banks that Brazilian officials allegedly used to launder bribes. In addition to the 23 Brazilian construction and engineering companies implicated in the scandal, foreign companies that allegedly paid bribes include a UK-based auto and airplane manufacturer, a Dutch supplier of oil vessels and an expanding roster of others.

It, therefore, behooves investors and businesses looking to Brazil to proceed with caution.

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One of the many reasons Shell acquired BG was because of the company's strong culture of compliance and risk management. In other words, Shell

was able to acquire a sound company at a depressed price and will receive the upside benefits once Brazil returns to normalcy. This can be a template for cautious investors: Invest in businesses with sound anti-corruption and compliance programs that are unlikely to be sucked into the ever-widening whirlpool of Brazil's corruption investigations.

Accordingly, companies should pay great attention to the specifics of the Brazilian Anti-Corruption Law, enacted in 2013, and its differences from the U.S. Foreign Corrupt Practices Act ("FCPA") and the UK Bribery Act. For example, the FCPA requires intent for prosecution. The Brazilian Anti-Corruption Law does not: The fact that a bribe has been proffered is sufficient to establish liability. Unlike the FCPA, the Anti-Corruption Law does not impose criminal liability; this, however, does not mean the law is without teeth. It can mandate administrative sanctions. **These sanctions may impose a fine of up to 20 percent of a company's earnings for the year prior to the finding of a violation** and also may include loss of assets, suspension of business operations and even compulsory dissolution of the company.

Given the seriousness of these sanctions, companies must establish strong compliance policies supported by adequate on-the-ground staffing and local advisors, with the compliance function elevated within the company and given the proper resources. And all investors should employ sound risk management principles aligned with Brazil's political and social environment. This means that the risk management function must be appropriately staffed, resourced and funded, and it should include trusted local staffers familiar with Brazil's social mores, complemented by equally trusted external legal and communications advisors.

Finally, large companies should leverage their economic clout to drive change by engaging in the political process at both the federal and local levels, keeping in mind that lobbying is not yet regulated in Brazil. (A law pertaining to lobbying has been languishing in Brazil's Congress for more than 20 years.) As supported by FTI Consulting's recent report, **"What Companies Do Right (and Wrong) in Emerging Markets,"** successful companies try to help host countries establish a rational regulatory environment to benefit both investors and the local economy. Rational, economically beneficial regulations protect investors and the host economy against the vagaries of political change.

The Brazil Opportunity

They say it is always darkest before the dawn.

Right now, Brazil is pretty dark. But the dawn will come.

It is possible to identify distressed assets in Brazil — in agriculture, education, real estate, energy and other sectors, including high tech — with strong medium- to long-term potential for providing good returns. Many of these companies should be able to weather the storm and emerge with a positive balance sheet.

It is critical, however, that investors be able to identify fundamentally healthy companies that can withstand the intense, negative economic pressures and political uncertainty that will be inevitable in the coming years in Brazil. And smart investors will do so by relying on a strong risk management approach to avoid the operational or reputational issues that might jeopardize those investments.

In the long term, Brazil will remain Latin America's largest economy and a prime geography for business. No doubt, there will be more pain to come, but investors should not underestimate the resilience of what often has been called the "country of the future."

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