ROBERTO LAMPL
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BRAZIL UPDATE

LATIN AMERICA FUND

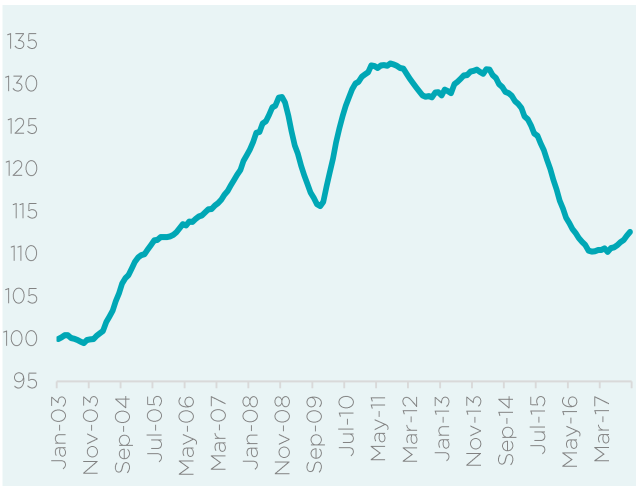
The purpose of my trip to Brazil was to evaluate the potential momentum of its economic recovery, the risk of an adverse outcome to the upcoming presidential elections, and companies' outlooks and investment plans.

BACKGROUND:
THE RECOVERY AND POLITICAL RISK:

Over the past 18 months, economic reforms implemented by Finance Minister Meirelles engineered a recovery in confidence, which ignited a cyclical recovery after industrial production fell to 2005 levels (see graph 1). Reforms such as linking fiscal expenditure growth to inflation and labour market rationalisation, helped cut inflation and allowed for an aggressive interest rate easing cycle. The short-term rate (Selic), reached 6.75% while inflation (CPI) fell below 3% (see graph 2).

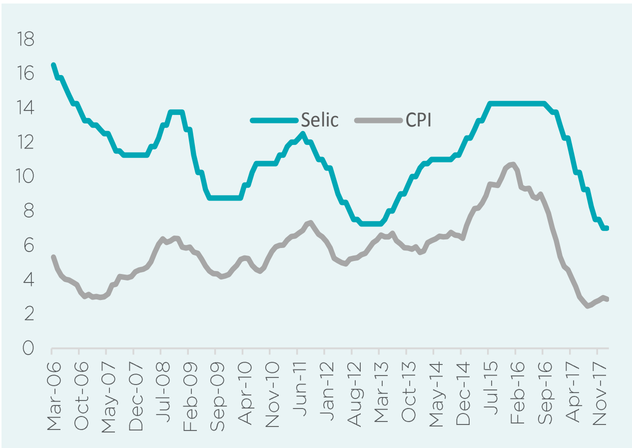
We are positive about the cyclical recovery gathering momentum as this is occurring while the overall credit impulse to the economy decreased (see graph 3). In other words, it is highly likely that a continuation of current economic policy will improve banks appetite to accelerate loan growth, which acts as another lever of growth.

Graph 1: Brazil Industrial Production



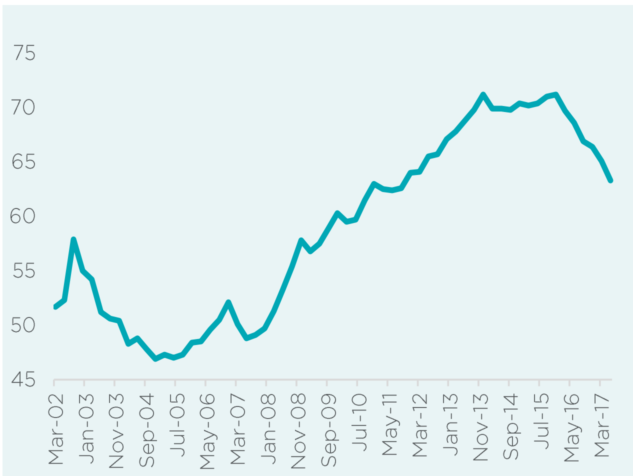
Source: Bloomberg

Graph 2: Brazil rates and Inflation



Source: Bloomberg

Graph 3: BIS Brazil Credit to Private Non Financial Sector as % of GDP



Source: Bloomberg

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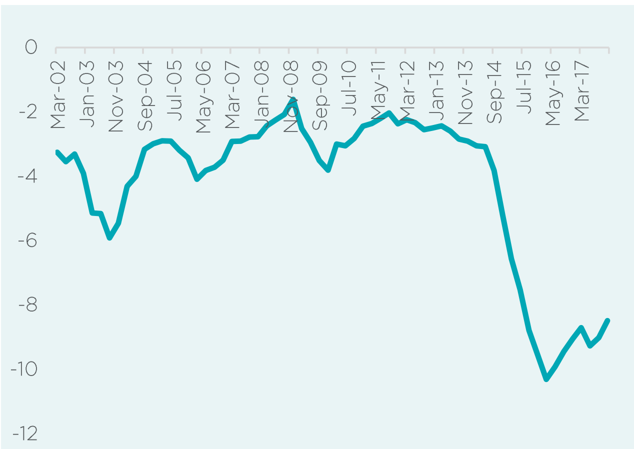
The efforts made by Meirelles, coupled with a growing economy, are therefore improving the country's fiscal positioning. Moreover, the risk to Brazil's growth momentum is lower than many Brazil watchers perceive. These observers are concerned by a renewed level of political turmoil and uncertainty related to October's upcoming presidential elections. The reality is that Lula will not be able to run after his conviction was upheld in appeal. In addition, Bolsonaro, an extreme right politician and former military officer and congressman, lacks the political machine to succeed in a nationwide oriented presidential campaign. For example, he will likely have at most 10 seconds of daily TV oriented advertisement once the campaign gets underway. This compares to candidates from leading coalitions having close to 6 minutes per day. Air time is the most effective tool in Brazilian political campaigning to build nationwide appeal, and it is the steadily improving domestic economy with investment and job creation beginning to improve, that will ultimately be the message that voters will want to cheer. Hence, barring a tail event, a centrist oriented candidate will win.

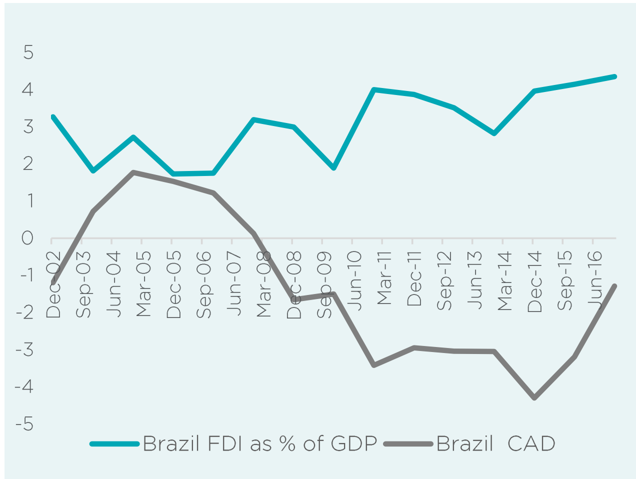
Graph 4: Brazil Fiscal Deficit



Source: Bloomberg

Of course, there are challenges. Graph 4 depicts Brazil's fragile fiscal positioning. The combination of a cyclical rebound and capped fiscal expenditures will reduce the deficit towards 6.5% of GDP by the end of 2019. This is a step in the right direction. However, the country must tackle their overly generous pension system, which if left unaddressed, will consume 100% of fiscal revenues by 2030. Fortunately, there is a consensus that something must be done as none can disagree with the math. The way it will be addressed is contentious. For now, Brazilian politicians can kick the proverbial can down the road; the privatisation of Eletrobras, the state-owned integrated utility, is expected to raise more than US$ 3.5bln; this alone will shave approximately 0.5% of GDP in terms of deficit as long as GDP growth meets consensus estimates and grows over 4.5% from 2017 through to 2019.

Graph 5: Brazil FDI & Current Account



Source: Bloomberg

BALANCE OF PAYMENTS:

From a balance of payments perspective, the risk of a crisis is very low, with Brazil's terms of trade improving its export capabilities and FDI remaining strong (see graph 5). Imports fell much more during the crisis as consumer credit demand fell, reducing demand for imported discretionary goods. Strong soft commodity crops have been the driving force of greater exports and the outlook for crops are supportive. Hence, the relatively small current account deficit of close to 1% of GDP, whilst the steadily high amount of FDI of over 3.5% of GDP removes funding pressure on its external indebtness.

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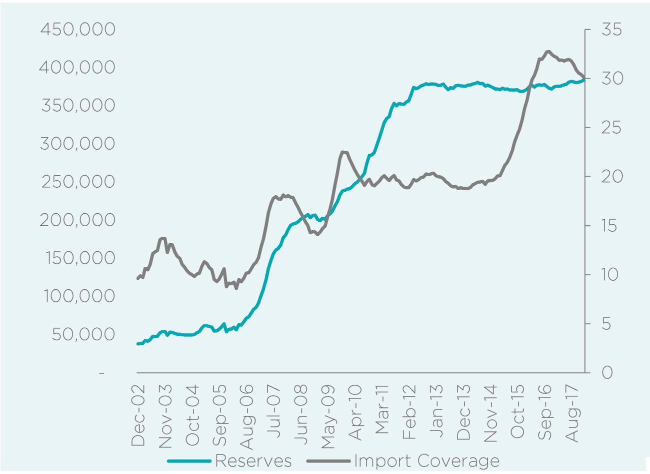
Brazil's high and steady level of international reserves, coupled with their low level of external indebtedness, supports our view regarding the stable outlook of its ability to service its debt. Hence, we are not concerned about its externally viewed sovereign credit risk, due to its comfortable import coverage at over 30 months (see graph 6).

Graph 6: International Reserves & Import Coverage

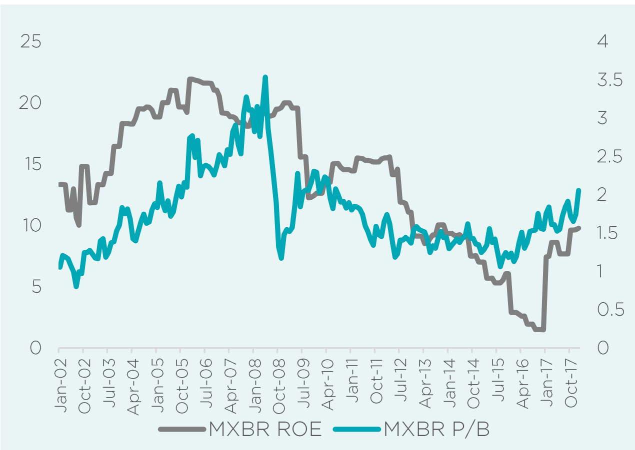


Source: Bloomberg

VALUATION:

The current valuation of Brazil's equity market, expressed by the MSCI Brazil, illustrates Brazil is at levels way off its cyclical highs in 2007, with profitability having already recovered from the extreme low levels witnessed during 2016 (see graph 7). The combination of an economic reform program, a normalisation of inflation, an aggressive easing cycle and resurgent industrial production are all supportive of an environment in which equities can benefit from the country's cyclical tailwinds.

Graph 7: Brazil P/B & ROE



Source: Bloomberg

COMPANY MEETINGS:

We met with 19 companies and attended presentations from government officials as well as polling specialists. Virtually every company we met with discussed their expansion strategy and were comfortable with the political outlook. Three companies epitomise the mindset and opportunities in Brazil;

KLABIN - a pulp & specialty products producer, that is in the last stages of its evaluation of an expansion of its Puma production site. Its global status as a lowest cost producer together with the scale benefits and its export distribution network make it highly confident about the value creation of its expansion project.

HYPERA PHARMA - Brazil's largest pharmaceutical producer and distributor (25% domestic market share); the company has the largest production facility in Latin America, nationwide distribution and is primed to benefit from structural growth in demand for generic drugs. Health care per capita expenditures in Brazil are 40% lower than in Chile and 3.5 times smaller than in France. Moreover, there are 1mn new customers entering the 60+ years of age market annually, implying a growing segment that tends to spend more on pharmaceutical products annually. The company's 75 thousand points of sale provide it with a unique platform to further build on its markets share as the #1 consumer health and #2 branded generics Brazilian company. The main takeaway from my meeting, was that the company has a clearly defined plan to monetise this opportunity. In particular, they will focus on flu medication, digestive drugs, pain relief and entering new categories such as vitamins, the latter having a lower formulaic and regulatory approval complexity. A significant competitive advantage across these areas is that their pipeline of approvals from ENVISA, Brazil's FDA equivalent, is likely to mature in the next 12 months, whereas the competition entering the process today, given better economic conditions, must wait up to 4 years to get a final answer.

LINX - an ERP and POS technology company, where our meeting provided us with the insight of a company seeking to capitalise on its 40% market share in the retail industry and use data analytics to build an advisory business. Linx has access to the data as it goes through their POS systems, but their clients use it principally for inventory management and sales analytics. Linx identified an opportunity to implement a marketing solution based on the insights from its "big data". Specifically, to deliver targeted solutions to FMCG companies in categories/geographic regions in which their market share is trailing. Leveraging their proprietary data to improve advertising budgets is in test phase, and so far clients are reacting positively to targeted solutions with high success rate. The barriers to entry for Linx business is tied to owning the POS relationship, which is the engine capturing data.

Conclusion:

Lula will not be able to run as the appeals process for his criminal conviction will get stalled in the courts beyond the elections. His party, the PT, has until mid-April to submit a candidate and most other candidates are compromised in one way or another. Regardless, this party is rudderless and has no natural alternative leader to capitalise on Lula's popularity. The risk of Bolsonaro, the extreme right candidate, is also remote given his lack of a national political machine and his low allocated TV advertisement. It is also likely that he is his own worst enemy; he is known to make vulgar and demeaning comments.

The candidates from the centrist parties have the best chance of winning, and I would currently estimate this to be an 80% probability. Companies unanimously agreed that Brazil is changing, applaud the reforms and are investing for the future. Interest rates are significantly lower, inflation is under control and they believe the reform agenda will move forwards after elections. The equity and currency market recovered from their crisis lows, but in our opinion, the medium-term earnings potential for Brazilian companies continues to be underestimated.

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All data correct as of March 2018.
Sources: Alquity, Bloomberg

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