



FOCUS ON

Brazil: light at the End of the Tunnel?

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Economic Analysis
and Research

EXECUTIVE SUMMARY

- *Brazil is experiencing an intense crisis; it is more important than ever now to understand what scenarios it presents for companies already in the country and for those beginning to explore the Latin American markets.*
- *Recent history offers little room for optimism. The country was awarded the 2014 World Cup and the 2016 Olympic Games, but it has not been able to transform the economic boom of 2010, driven by commodities, into sustainable growth. In 2015 the country entered a recession, with GDP losing almost 4%, and 2016 promises to be another difficult year. The first signs of recovery are expected in 2017.*
- *Along with the adverse economic situation, there is the **problem of corruption**, with the "Lava Jato" inquest into Brazilian giants **Petrobras and Odebrecht** and, on the institutional front, the **impeachment** of President Rousseff that led to her removal and the appointment of her V.P. Temer to succeed her.*
- *Companies must distinguish, however, between the strategies to adopt in approaching the country in the short and in the medium-long term. The country has many **strengths**. Brazil has a fair level of **diversification** in its economic structure, ample **availability of natural resources**, higher per capita income than other emerging countries, and a **solid financial system**, but also an **adequate level of currency reserves** and a limited ratio of foreign debt to GDP that shields it from possible external shocks.*
- *While it is true that the problems facing the country in recent years have caused an inevitable **decline of confidence** on the part of families and businesses, with an impact on our exports, which declined by 17.4% in 2015, SACE projections for 2017-19 suggest some light at the end of the tunnel, with a **3% average annual growth rate in Italian exports**.*
- *This recovery will be driven by **capital machinery** (used in the food, textile and clothing sectors, packaging and the processing of metals, glass, plastics, and natural stone), transport vehicles, textiles and apparel and chemical-pharmaceutical products.*
- *Beware, however, of a few **structural weaknesses** for those seeking to operate in the country: a shortage of qualified manpower, a low level of productivity, an inadequate education system, excessive protectionist policies, and legal uncertainty in economic matters.*

AN BUMPING LANDING AFTER THE TAKEOFF OF 2009

*Nas favelas, no Senado / In the favelas, in the Senate
 Sujeira pra todo lado / There's months everywhere
 Ninguém respeita a Constituição / No one respects our Constitution
 Mas todos acreditam no future da nação / But everybody believes in the progress of our nation
 Que país é they? / What kind of country is this?
 [...]*

These opening lines of the song of Legião Urbana (a Brazilian protest movement formed in the '80s), “Que País É Esse?”, clearly points up the contradictions in Brazil today.

This is a country where everyone wanted to invest six years ago. Emblematic was a cover of the Economist in 2009 where the Christ Redeemer was depicted as a missile launched into space. But things changed (figure 1). In 2013 the British magazine revised the trajectory, with the same "missile" plunging into the bay of Rio, and recession returned, **with GDP dropping by almost 4% in 2015 and the outlook for 2016 equally grim (- 3.3% by International Monetary Fund)**. Also weighing on the outlook was the impeachment of President Rousseff, which led to her removal from office and replacement by her V.P. Temer last September.

FIGURE 1: Economist covers showing Brazil's rise and fall



Source: The Economist

The crisis is due firstly to external factors, rather, to a fundamental factor that drove the boom: **the decline in international commodity prices that impacted coal, iron ore, petroleum and soybeans, the pillars of the country's exports.** Along with the economic problems, there problems linked to corruption, with the "Lava Jato" inquiry that concerns, especially, Petrobras and are Odebrecht, two Brazilian giants in oil & gas and construction.

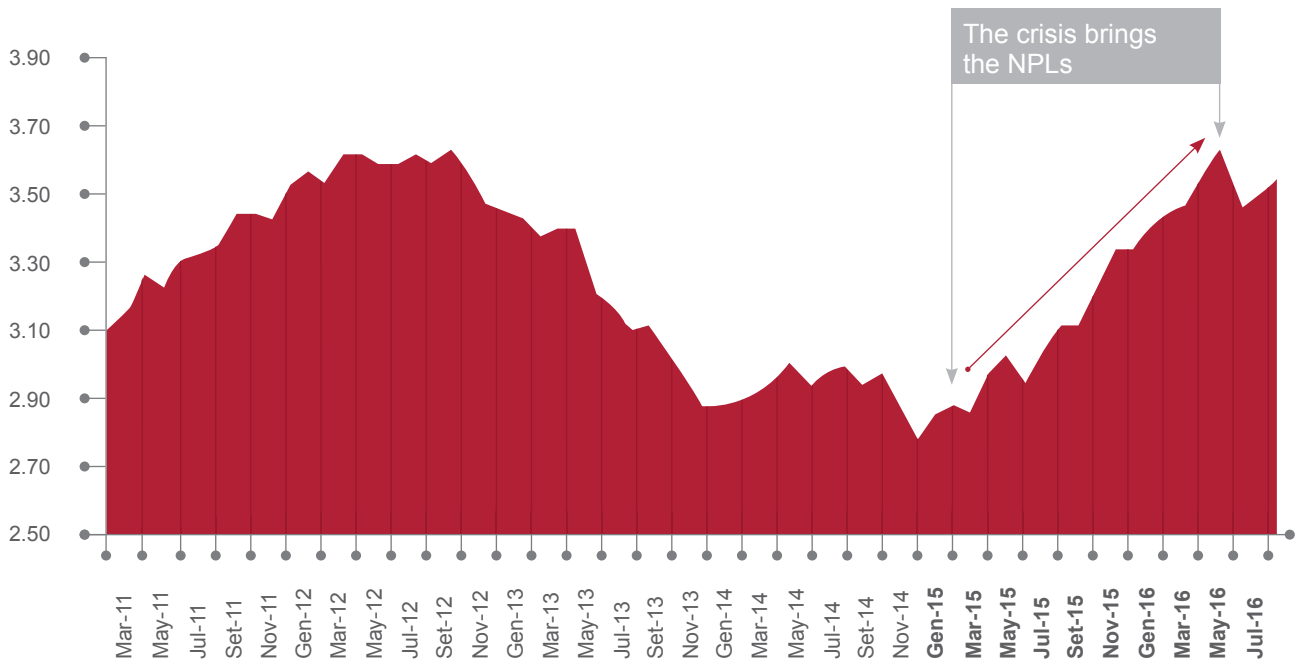


And in the past two years the country has seen its public accounts sharply deteriorate⁰¹, double-digit inflation (over 11%, the highest in South America after Venezuela and Argentina), a decline in corporate and consumer confidence, reduced investments, tighter conditions for access to credit, and less funding by the public sector.

The days of “easy money” are over, in fact. The companies that borrowed more heavily, encouraged by the public banks and the local development bank BNDES, are waking up to reality. According to Serasa Experian, 5,500 companies declared bankruptcy in 2015, the highest number since 2008. The country’s rating has been downgraded **below the investment grade** level, causing further difficulties for local companies in their procurement on the international capital markets.

The decline in company profitability is increasing nonperforming bank loans, further reducing the bank profits. In May NPLs were 3.8% of total loans (chart 1), the highest level in the past five years. Many banks are beginning to negotiate extensions of payment terms to avoid defaults by corporate customers. These critical factors are mitigated, however, by the fact that the banking system as whole remains structurally sound, and the largest banks are adequately capitalized.

CHART 1: Non-Performing Loans, % of the total



Source: Banco Central do Brazil

⁰¹ The crisis in the accounts public, in fact, drove the fiscal deficit to exceed 10% of GDP in 2015, while the public debt reached almost 75% of GDP.

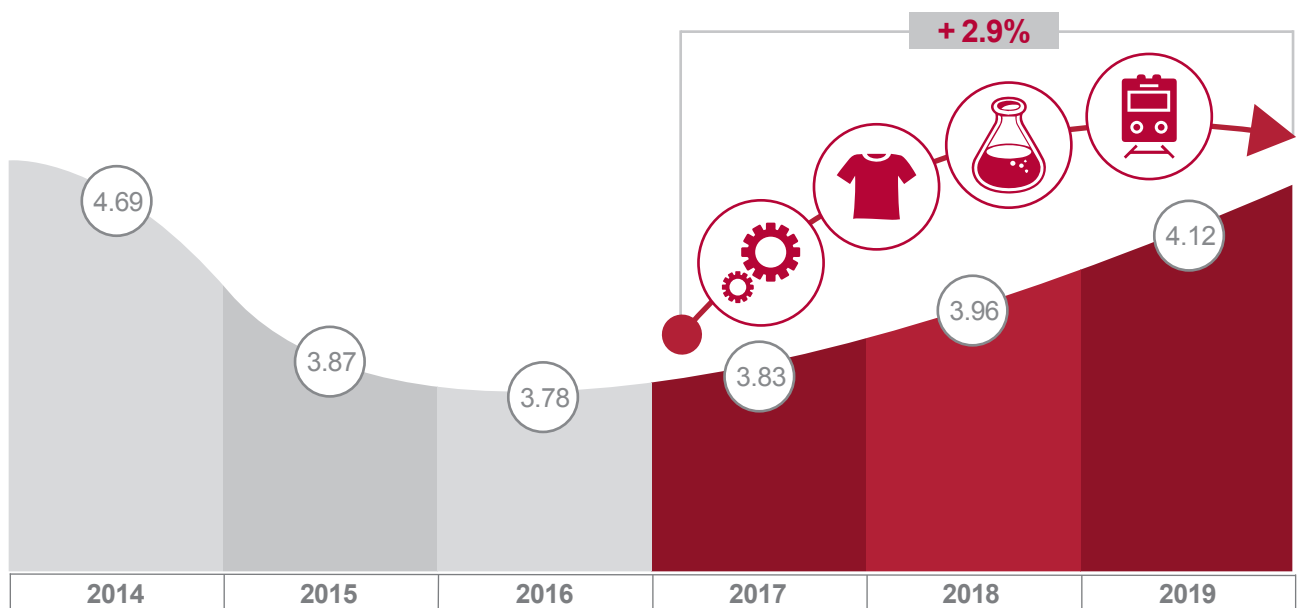
The deterioration of bank credit and the state of private counterparties is causing an increase in credit risk. According to SACE indicators⁰², in fact, credit risk in Brazil reached 53/100 in 2016, an increase of 10 points over the 2015 figure. **For exporting companies it has become increasingly important, if non vital, to protect their sales abroad from the risk of default by foreign counterparties.**

WHAT PROSPECTS FOR COMPANIES SEEKING TO DO BUSINESS IN THE COUNTRY

In a difficult, challenging context, exporting companies must seek to select the projects and sectors of greatest potential. They must be aware that if well-equipped and supported they can continue to operate in an uncertain economic context, due in part to the support provided by SACE and SIMEST. In our latest Export Report⁰³ we clearly pointed out a few opportunities for **Made in Italy in the country (capital machinery, textiles and apparel, chemical-pharmaceutical products)**.

Though Italian exports of goods to Brazil declined by 17.4% in 2015 versus (totaling € 3.9 billion)⁰⁴—not surprising considering that the country's difficulties have inevitably caused a drop in demand from households and companies—SACE projections indicate an average annual growth rate of 3%⁰⁵ in 2017-19 (chart 2). This rate seems modest, but compared to the negative rates of recent years it suggests some light at the end of the tunnel. The € 4.7 billion reached in 2014 will still be hard to reach at the end of the projection horizon.

CHART 2: Italian exports to Brazil (values in € bns)



Source: SACE

⁰² Sace, Risk & export map 2016: returns the Old Normal in a less flat world 2016.

⁰³ SACE, RE-action – Export Report 2016-2019, June 2016.

⁰⁴ Even 2016 has not begun in the best auspices, since our exports declined by 26.5% in the first nine months compared to the same period the previous year.

⁰⁵ Estimates are calculated based on a macroeconomic scenario that does not reflect the effects of the impeachment of President Rousseff.

The reason for this view lies in the fact that Brazil is a high-potential country because of its vast geographical size, its population of 200 million inhabitants with an average age of 30, and its middle class with access to rising levels of wellbeing and consumption.

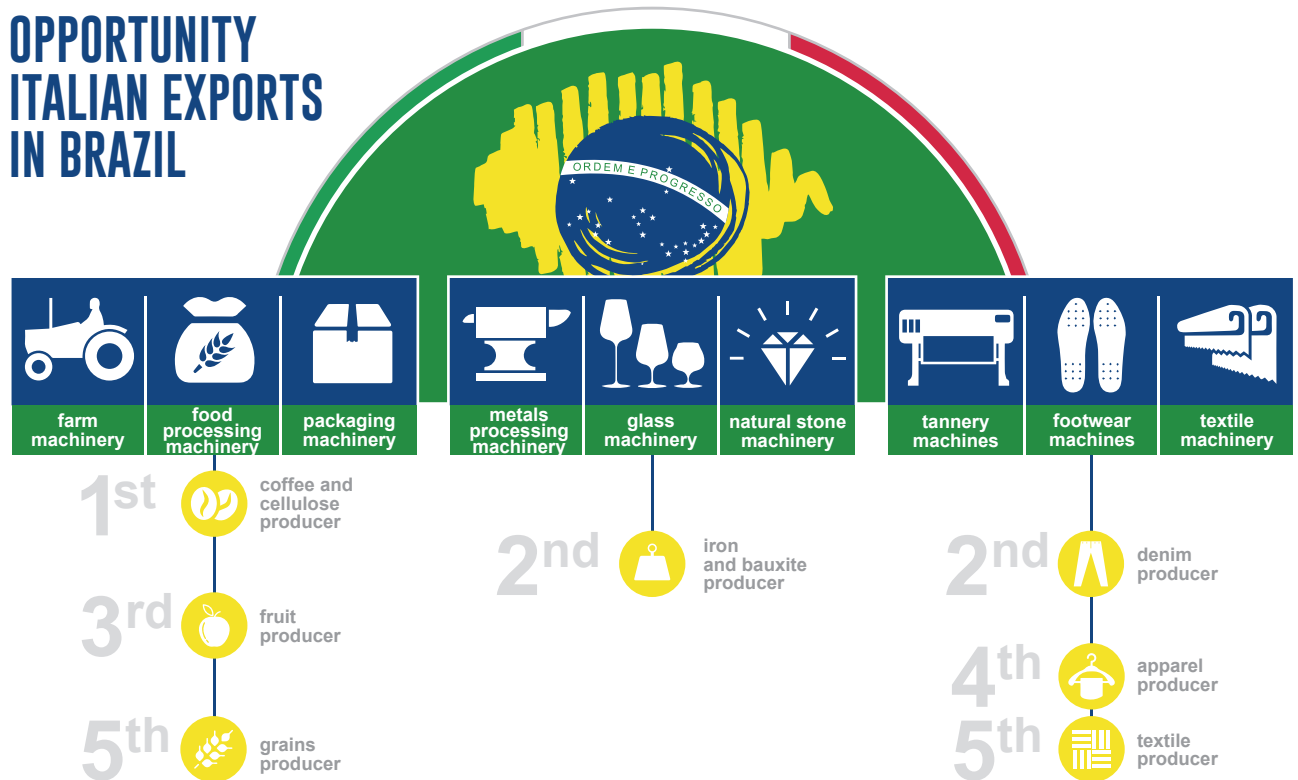
The Brazil is the fifth-largest producer of textiles in the world, behind China, India, the United States, and Pakistan; it is the no. 2 producer and no. 3 consumer of denim worldwide; and it is the fourth-largest producer of apparel after China, India and Turkey. **So there are still opportunities in textiles and apparel and in the associated capital machinery.**

Brazil is also rich in commodities. It is the world's largest producer of coffee and cellulose, no. 2 for ethanol, iron and bauxite, no. 3 for fruit, and no. 5 for grains.

It is also the world's largest exporter of beef and poultry, sugar and orange juice, no. 2 in soybeans and derivatives, and no. 4 in pork⁰⁶.

So there is potential demand for our farm machinery, food processing and packaging machinery, machinery for processing metals, glass, plastic, and natural stone, and machines for foundries, footwear and tanning. Local industry requires the transfer of know-how and constant updating of existing technologies to increase productivity, as well as spare parts and after-sale services.

FIGURE 2: Rising export opportunities to Brazil



Source: SACE processing of InfoMercatiEsteri

⁰⁶ InfoMercatiEsteri, Brazil, 2016; Government of Brazil, Brazilian Official Guide on Investment Opportunity, 2016.



The country remains the leading beneficiary of foreign direct investments (FDIs) in Latin America and no. 5 worldwide. After the boom of FDIs in 2009-2011, flows toward Brazil declined over time, dropping to 65 billion dollars in 2015 (versus 96 billion in 2011). The principal sectors include financial and insurance activity, extraction, telecommunications and automotive.

The Italian presence in the country includes over 900 operating subsidiaries and production facilities, generating over 140,000 jobs and revenues of 30 billion⁰⁷. The large companies include Finmeccanica, Alitalia, Azimut Benetti, Iveco, and FCA in the transport sector; Barilla, Campari, Ferrero, and Lavazza in food and beverages; Ghella and Salini Impregilo in construction; ENEL and ENI in the energy sector; and Luxottica and Safilo in eyeglass frames.

The net flow of direct investments from Italy to Brazil in 2015 was € 964 million⁰⁸, over 30% of the total concentrated in services and telecommunications and another 30% in transport vehicles.

Though our companies already have a strong presence, for those wishing to approach the country for the first time there are still many opportunities. But they must succeed in seizing them and protect against risks.

Thanks to the support of SACE-SIMEST, they can in fact consolidate and expand their business in high-risk but high-potential markets and with great potential for exploring new ones. SACE, for example, offers those wishing to invest abroad coverage against the partial or total loss of capital, profits, interest, and costs deriving from events of a political nature such as expropriations and civil disorder, currency restrictions, and violation of contracts by local public counterparties.

But SACE can also assist companies with insurance against the risk of default by counterparties, enabling them to offer extended payment conditions, which may favor the award of contracts.

SIMEST, for its part, to favor foreign investment, assists companies with a temporary minority equity investment in foreign and Italian companies. The equity investment may be made at the stage of incorporation (greenfield initiatives), share capital increases, or acquisitions (M&As) and may reach 49% of the capital of the investees. SIMEST also supports SMEs wishing to promote development plans in international markets or, if exporters, to consolidate their equity position through low-interest loans for participating in trade shows for promotion in foreign markets and for recapitalizing exporting SMEs.

⁰⁷ ICE-Reprint data, *Italian investments abroad*, 2013.

⁰⁸ Ministry of Economic Development. *Economic Observatory – Country report Brazil*, October 2016.



EVERY OPPORTUNITY HAS ITS RISKS...

Every valid investment decision must not only assess market potential but also consider the weaknesses in the country. In the case of Brazil, the principal problems are a **shortage of qualified manpower, a low level of productivity, an inadequate educational level, excessive protectionist policies, and legal uncertainty in economic matters.**

Brazil has increased consumption in recent years but has been unable to increase productivity. Investments versus GDP are low (below 18%), and the country ranks 123rd out of 189 countries in the World Bank's 2017 Doing Business classification. Between 1950 and 2014, Brazilian labor productivity increased 197%, a modest result if compared to South Korea and China, which registered +1605% and + 2176%, respectively. Low productivity and competitiveness are due in part to a protected economic model, internally oriented, that has resulted in an inefficient allocation of resources⁰⁹.

The education system needs reform. Although the ratio of education expenditures to GDP has risen in the past ten years, the quality of the public schools—at all levels—remains deficient, as demonstrated by recent OECD-PISA tests¹⁰. Teachers' salaries—among the lowest on the continent—and school construction—30% of Brazilian schools lack potable water—represent serious problems that no government has been able to resolve¹¹ (chart 3).

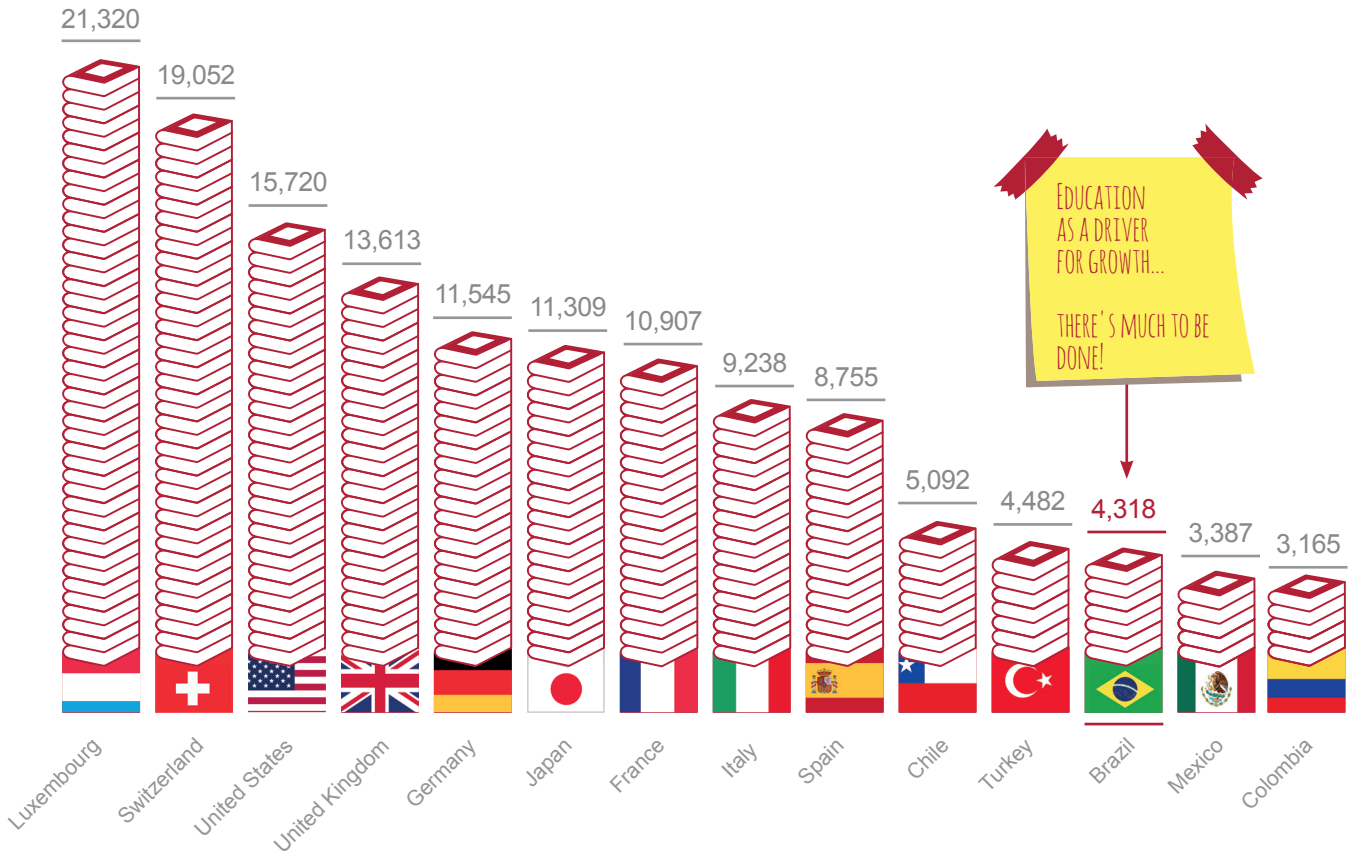
These aspects are reflected in the skill level of the labor force, an important aspect for potential investors in the country.

⁰⁹ *The Brics Post, Brazil Desperately Needs a New Growth Model, 2015.*

¹⁰ *OCSE, Education at a glance, 2016.*

¹¹ *ISPI, the origins of the Brazilian crisis: the investigation Lava Jato and the affair Petrobras, 2016.*

CHART 3: Annual expenditures per student from elementary to upper secondary school (in equivalent dollars)



Source: OECD - Education at a glance 2016

Brazilian customs and tax regulations are highly complex. Bureaucratic procedures, restrictions and taxes vary according to the product imported, the mode of transport chosen (air, sea, land) and, in some cases, the country of origin. Imports to Brazil may be subject to licenses, depending on the product category. Food products and cosmetics, for example, must meet special sanitary and pesticide control standards set by the administrative control agencies. Then there are barriers, both tariff and non-tariff (i.e. technical, health, environmental, labor, quantity, quotas, and minimum pricing requirements). The percentage of taxes varies according to the product imported and whether there is a similar product in Brazil, and the rate is calculated on the value of the goods (*valor aduaneiro*)¹².

The Government has also implemented measures (e.g. "**local content**") aimed at protecting and favoring the development of domestic industry. These measures, limited to a few sectors, may hinder access to the market by foreign investors. In the automotive sector, for example, the *Inovar-Motor* program permits the reduction or elimination of the tax on industrialized products, which stands at 30% of value, for cars produced in Brazil (at least 65% of local content) according to criteria of efficiency and environmental sustainability.

¹² "Business Atlas 2016: guida agli affari in 55 mercati per il business italiano" a cura delle Camere di Commercio italiane all'estero.



CONCLUSIONS

Low commodity prices, the return of debt with the weakening of the public accounts, and the increased risk of political violence have worsened economic and social conditions in the country. **Credit risk has worsened**, whether associated with individual counterparties or projects. The number of bankruptcies has risen, many projects have been postponed or downsized in some sectors, and the lending capacity of the financial system has declined, along with the involvement of institutions like the BNDES.

According to indicators developed by SACE, credit risk in Brazil reached 53/100 in 2016, an increase of 10 points compared to the 2015 figure. For exporting companies, therefore, it is increasingly important, if not vital, to protect their sales abroad from risks of default by foreign counterparties.

The important thing is to fear not and to seek guidance. In addition to financial support for internationalization as noted above, and with a view to expanding its support especially to SMEs, SACE provides an advisory service offering consulting services, tailored to company size, for formulating and implementing plans for growth abroad. These services include a strategy assessment, training sessions and briefings on countries of interest, and assistance in all phases of transactions, in part through our international network, present with ten offices and regional hubs in all the countries of greatest interest for Made in Italy.

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