Opportunity wasted?

Brazilians have a favourite joke: “Brazil is the country of the future...and always will be!” After stellar growth in the second half of the last decade, it wasn't supposed to be like this, especially with the Olympics and World Cup heralding the country’s arrival on the global stage. Where has it all gone wrong?

In truth, it was always going to be tough. Shifting global growth dynamics, including notably waning Chinese commodity demand, have hit the balance of payments and the currency (down 75% since July 2014), and affected inflation and interest rates (now 700 basis points above the 2013 lows). But it didn't need to be this bad. Former President Lula’s poor governance and missed opportunities to enact reform during better times exacerbated the situation before current President Rousseff’s re-election bid meant more inappropriate fiscal and monetary policy. Even this was reversible, but then the Petrobras corruption scandal led to a sovereign rating downgrade to junk. Even the football team has been chastened. Its World Cup thrashing by Germany was its worst defeat in its 100-year history.

Is the country’s relegation terminal? No. Brazil is certainly in a difficult place and needs wholesale political change. But this was done to great effect in 1994, creating the foundations for 15 years of growth. Reform is the great hope. Until then it shouldn’t be forgotten that, in all of this, there are still many Brazilian companies well-placed to generate growth.

“Reform is the great hope”
**Market Overview**

**Is this for real?**

Despite the newsflow, Brazil’s Bovespa Index is only down low single digits in local currency terms over the year-to-date. That said, it is 35% lower than its 2010 peak and a staggering 72% weaker since then in dollar terms, demonstrating the weakness of the Brazilian Real. Consumption has fallen sharply due to over-leveraged households and a crisis of economic confidence. Meanwhile, Brazil has also faced a vicious circle of external pressures beyond its control that has compounded the situation.

Weaker demand and oversupply have hit commodity prices and the important agriculture and hard commodity industries particularly severely. And yet the stock market is still not cheap, especially after the demise of lower-rated commodity stocks, which have a large index weighting.

Gloomy though this may sound, the international competitiveness of the country’s exporters has been given a huge boost by the Real’s decline, and a number of domestic companies are still performing well in a tough and changing environment. This demonstrates the value of a careful, bottom-up approach to investing in Brazil.

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**Investment Insights**

**Global competitiveness a Valid focus**

Having invested in Brazil for over 10 years, I find most management teams are dynamic and investor friendly. Corruption and governance issues are largely confined to the public sector, helping investors to invest with confidence. We are certainly finding good opportunities just now, especially in companies with international exposure.

Take the growing use and sophistication of financial, personal identification, and mobile SIM cards for example. The penetration of non-cash payments continues to grow across developed and emerging markets. Even the US has lagged here and is catching up through a mandatory rollout of chip and pin cards to reduce fraud. Demand for personalisation, through the addition of photos and use of more appealing designs and colours, has also increased bank card complexity. Here, manufacturer scale allows more competitive pricing for customers.

Meanwhile, global mobile penetration is reaching maturity, yet incremental data usage and the spread of online payment tools will require network upgrades and ongoing SIM card demand. In countries like the US and Mexico, the arrival and demands of 4G long-term evolution (LTE) wireless technology is expected to end the co-existence of different operating networks, boosting SIM card growth as users change over. In personal identification, it used to be a simple job of card issuance, but is now about complex data gathering and database management.
This requires a range of solutions and advanced software, helping best-in-class providers to benefit from these incremental revenue opportunities. The importance of security means high barriers to entry and better margins. Retail is another area of complementary growth, as loyalty cards evolve into market intelligence tools for retailers, gathering more granular customer preference data to allow better sales targeting. The sophistication required here brings pricing power for manufacturers with these capabilities. I believe Brazilian firms such as Valid can benefit from this growth potential. Its strong Brazilian ID market presence, card origination skillset and SIM card expertise bring high barriers to entry and provide a base from which to further grow international revenues, currently 50% of total sales.

Home or away?

While certain internationally exposed Brazilian companies are attractive at the moment, it would be wrong to give the impression that there aren’t domestic opportunities as well. Over the past 10 years, a sizeable middle class has developed, and services and leisure are growing as a proportion of consumer discretionary expenditure. The travel sector is a particular standout.

 Brazilians developed a taste for travel over recent years given the strength of the Real. With the currency now much weaker and the economy suffering, it’s an obvious area where people could cut back. However, travel spending seems to be more resilient than other consumer areas. It appears you can live with your old TV and clothes for a little longer, but the kids want to go on holiday again this year!

During difficult times, consumers tend to stick to trusted brands in the travel sector, mainly due to concern about potential bankruptcies at lower-tier, cheaper alternatives. As the Real weakens, people are noticeably choosing to travel more at home rather than internationally. Here, the bargaining clout of large domestic travel brands means better margins for Brazil’s travel companies, as well as an affordable package-holiday option for customers, particularly when attractive financing and payment instalment options are available.

I think companies like travel agent firm CVC Travel could be key beneficiaries of these trends. The company continues to consolidate the market and take share due to strong awareness of its brand, while its extensive local store presence and marketing strategies are successfully helping to combat competition from the rise of online travel agents.

The current situation is undoubtedly difficult, and there is some distance still to travel before it’s over. But it’s not as bad as previous bouts of turmoil, and there are still many bottom-up opportunities, as I hope I’ve shown. Brazil has many companies with robust competitive advantages and increasingly positive cost dynamics that make them more than able to compete in both the global and domestic arenas.

“Travel spending seems to be more resilient”

Jonathan Toub
Fund Manager

“The importance of security means...better margins”
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