PERSPECTIVE

Challenges and Opportunities Facing Brazilian Companies

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There's no question Brazil is facing challenges (some of which I explored in my prior blog), and recent news headlines have led to bouts of market volatility. We can't predict exactly how the political situation will pan out in Brazil, but we do know that as markets dislike uncertainty, things could be a bit bumpy in Brazil for a while. However, that doesn't mean long-term investment opportunities aren't there. We can't ignore macroeconomic factors in a particular country, but we are bottom-up investors and look at individual companies and their individual prospects. Here, I share my observations of a few of the many companies my team and I visited recently in Brazil, the challenges they are facing, and the ways they are working to overcome them. It is our job to pick and choose the companies we believe can survive and prosper when the situation turns brighter in Brazil—which we think it will in time.

Exports: Engine of Growth

Amid some rather dire domestic data, we've seen exports as a beacon for many Brazilian companies. My team and I had the opportunity to visit a bus body manufacturer based in Brazil but with worldwide operations and manufacturing. We were not surprised to learn the environment was very difficult, as demand had collapsed with no immediate expectations for recovery. Profitability took a dent and the company's leverage had spiked up. The lack of credit availability is a major concern for the sector, but more/better transportation is needed in the country, so the company felt longer-term demand for buses should increase. On the more positive side, the drop in Brazil's currency, the real, has aided export growth, and executives at the firm were more optimistic about foreign markets driving business.

Visiting an auto parts plant in Brazil

We also sought to obtain some insight into the Brazilian auto industry by visiting an auto parts plant. To reach the plant, we traveled along a five-lane highway that was owned and operated by a different company we would also be visiting. During the ride, the driver passed through three toll booths, each collecting 10 reals, or about US$2. The creation of toll plazas is interesting, as it becomes a political issue. Drivers will try to turn off a toll road, avoiding payment when a plaza is located beyond a major population area. On one road, we learned only 8% of users pay tolls, while for another, about 40% pay. We stayed on the road and paid all our tolls, finding this highway to be in excellent shape and flanked by beautiful green countryside as well as some eucalyptus tree plantations. The highway had to be cut out through the mountainous area, terraced on both sides to prevent mudslides.

When we arrived at the car parts factory, the finance director gave us a history of the company, which supplies pistons, piston rings, crank shafts, air and oil filters and a number of other parts both for original equipment manufacturers (OEMs) and the car repair industry. The processes included hot metal casting of molten steel or aluminum into rough parts and then machining them to fine tolerances. That part of the factory was hot and dirty, with the workers pouring the white hot metals into molds. Then after cooling, the molds were opened and moved to the machining area where workers augmented with robots drilled, cut and ground the parts down to shiny instruments with fine tolerance. We noticed that each part was tested multiple times for accuracy. It was a grimy and dirty process except in the air-conditioned room where the final inspection and packing was done. At the plant we found a mixture of hand labor and robots being used, giving the flexibility to produce small batches for different clients. Similar to what we heard from the bus body company, company officials said car production and sales in Brazil were quite bad, but they were benefiting from exports and aftermarket sales.

We also had dinner with executives of a car rental company. They confirmed the impact of Brazil’s devalued currency and told us more local tourists were visiting other cities in Brazil rather than traveling abroad. However, one problem was that sales of their used cars will likely now be more difficult as local auto manufacturers are selling their autos at lower prices, and consolidation in the industry could occur. When we asked about the threat of competition from US companies, one executive said, “Brazil is a tough place to do business! We are not afraid of foreign competition.”

Consumer Sector Struggling, but Surviving

We also met with executives of a large food products company. Although it appeared to be a well-managed company, a large proportion of its costs were in US dollars. With the weak Brazilian real and consumer weakness reducing their ability to raise prices, the company was facing a difficult year. Wheat is a key ingredient for many of their products, but the currency weakness didn’t offer them much of an advantage, as much of the supply has to be imported. The company is trying to maintain margins by raising prices slowly and restructuring plants. Officials at the company told us they hope to increase their exports in view of their competitive prices in foreign currency terms, particularly to the United States. They also are considering acquisitions of other companies to gain market share in this depressed market, but have found that most of the targeted companies are family-owned groups that resist selling and have not been as badly impacted by Brazil’s economic downturn because they are not heavily leveraged.

At a beverage company we visited, executives said that the current crisis in Brazil had given time for the company to consolidate some of its prior acquisitions and operations. They reported that beer sales have been more resilient than soft drinks (which is generally true all over the world during economic downturns) and foreign operations offered a buffer. When we asked executives how they saw the affordability of beer in Brazil, they told us they were focusing on supermarket returnables—the beer in glass bottles that consumers return after use for a refund of their bottle deposit previously paid. This is also a win for the supermarkets, as returning customers bring more foot traffic back to the store. Nevertheless, the company expected it to be a tough year overall given the difficult macroeconomic environment and the threat of higher sales taxes on beer in states with money-hungry governments. They said they are trying to work together in the industry to show that governments can make more money by not raising taxes and counting instead on consumer volume growth.

Also in the consumer sector, personal care products are of interest to us. Brazil is a very fashion- and beauty-oriented country and its cosmetics, fragrances and toiletries (CFT) industry is among the largest in the world. Brazil's weak economy and higher taxes have taken a toll on many businesses in this area; in 2015, the government raised taxes on cosmetics and personal care products, which affected the entire industry. Officials at one firm we visited also told us the market is crowded with fierce competition. However, the company has been expanding into faster-growing Latin American countries outside of Brazil, and that effort has been more fruitful.

Meanwhile, a pharmaceutical/healthcare products company we visited in Brazil was diversifying its product line into new areas (including cosmetics), which has enabled the firm to deleverage its balance sheet. The pharmaceutical market in Brazil is highly concentrated, with 20 companies accounting for roughly 65% of sales. This firm felt it had a strong market position and was expecting sales to increase, but government intervention in the price of drugs was a risk.

At a department store chain catering to low- and middle-income customers, we learned that Internet sales were quite robust, and fashionable apparel was a popular offering. Executives said they had purchased a delivery and IT company to work for them exclusively so as to improve their Internet and delivery services. Talking about their Internet operations, they said that in Brazil most companies offer a five-day delivery period for free but if the client wants to have delivery faster, there's an extra charge. So, logistics related to delivery are among the challenges facing the company, and earnings have been lower because of high interest rates. One way the company is trying to keep prices down for their shoppers is by buying larger quantities and keeping them in inventory. For better control, the company has introduced a new computer system and has various incentives to reduce staff turnover, including a bonus system.

In the financial sector, we visited a company involved in banking, asset management and insurance. The Brazilian banking system is highly concentrated, and government-controlled banks have an important market share. Executives at the bank we visited told us about the impact of the recession in Brazil (the worst since the 1930s) and its political paralysis. Given the dire situation in Brazil, it wasn't a surprise to learn the risk of non-performing loans had increased. However, there was hope for a positive change in government with the next presidential election in 2018—if not sooner—and the bank has been posting good results in spite of the economic scenario due to a conservative loan portfolio, higher interest-rate spreads, benign competition, cost-cutting measures and healthy fees.

One of Brazil's Biggest Assets: Youth

Education in Brazil is in high demand because of the inability of the government to supply it to a large, young population. Thus, there has been rapid growth of commercial firms in the education business. We visited one of these companies, which, like other such firms, has been coping with the government's withdrawal or reduction of loans for students to pay for private school tuition. The firm, being large and diversified, claimed it could surmount the current difficulties and was in a good position to purchase other firms. However, their main risk continued to be changes in government regulations. The executives said that even with the declining availability of the government lending program and weaker macroeconomic conditions they have been able to grow, and the firm's executives were proud of how they have been helping students increase their income after graduation. A director of the company told us there was room for rapid expansion of new campuses and distance-learning centers. The most important criterion for quality assessment in the area of education is employability after graduation. Competition is regional, so large national brands aren't as important, they said. The main barrier to entry into the sector is regulation. The sector is tightly regulated and most openings of new institutions and courses must go through a lengthy process for approval by Brazil's Ministry of Education.

To help clothe Brazil's fashionable youth, we visited a major retailer which has plans to launch a new athletic-oriented brand for young women. As we had been hearing elsewhere, executives told us that operations continue to be challenged by the weak economy, high government taxes and competition. A few years ago, the Brazilian government offered some tax incentives to the textile industry, which is very labor intensive, by substituting some payroll taxes for value-added (VAT) taxes. However, that measure was recently reversed, going back to the old tax system on payroll, taking away a benefit that was otherwise assumed to be permanent. High unemployment was also a challenge to sales growth, but the company was still finding opportunities to recover margin and sales, and there was good potential for increased Internet sales.

Infrastructure: Building for the Future

Brazil's infrastructure is in need of improvement, particularly with Brazil hosting the 2016 Summer Olympics—which I will address further in a future commentary. One way the government is trying to get investment moving in infrastructure is to award private sector concessions to private firms. To attract bidders, the government is finally listening to the private sector, which has been asking for higher return rates to make the concessions attractive, in particular for the shipping ports and rail lines. In Brazil, the government has licensed private companies to take the risk of building public or civil works (such as a toll roads, ports, and so on) but with the right to charge fees to obtain a proper return on the investment. Most projects are only viable with cheap finance from Brazil's Development Bank (BNDES), which has dispersed about US$88 billion under a subsidized lending program. But now with Brazil's government finances in trouble, it could be difficult to continue such a program.

In mid-2015, the government announced a multibillion-dollar infrastructure plan for ports, airports, railways and roads. It even included a railroad that would connect the Atlantic and Pacific oceans from Brazil to Peru. The problem, of course, is Brazil's high interest rates, which make such projects commercially difficult to justify. Also, since many were designed to improve logistics for export of raw materials, with the decline in prices of commodities like iron ore, their viability will likely be questioned. To make electric utility investments attractive to the private sector, Brazil recently raised electricity tariffs. However, investor appetite has not been good in view of the high political volatility and weakening currency.

We met executives of one of Brazil's largest power producers, which also has operations outside the country. In Brazil, they both produce and distribute power. They told us "green" energy is important, with some 65% of Brazil's energy supply coming from hydro power, 21% from thermal and 14% from renewables. There is a big problem with stolen electricity—essentially people using electricity and not paying for it. One key aspect for electricity-generating companies is the difference between contracted power sales and sales on the unregulated market to large customers. In this case, the firm had completed a long-term contract on the price-regulated market with a major distributor of power to homes, and now has to depend on selling to the unregulated market to large companies at lower prices.

São Paulo, Brazil

We also visited a large car park company, one of the largest in Latin America. It uses technology to improve efficiency, including online pre-booking, mobile payment and a central control room to monitor all sites. Over the past few years, the company has been awarded concessions at airports and for various municipalities. One concern was debt, since the cost of debt has been rising and putting a crimp on their ambitions to purchase more concessions and even car park buildings.

Looking Longer Term

After visiting these and other companies and speaking with management and executives, we learned a lot about how the country's economic malaise has been affecting businesses. We also heard about the challenges common to nearly all industries, including debt/high interest rates, high taxes and fear of government intervention or policies that do not support business owners and foreign investment.

The debate about whether President Dilma Rousseff should stay in office or leave continues, and there is no clear consensus on the best way forward for the country. As we've said before, Brazil has great potential to improve its economic standing, but we aren't alone in stating that many policies need to change. We can't predict when this will happen, so investors there need to be patient. Benjamin Franklin was thought to have once said democracy is like two wolves and a lamb sitting down to decide what to have for lunch, and liberty is a well-armed lamb contesting that vote. You can decide for yourself how that applies to Brazil! We continue to look for investment opportunities in Brazil, and we do see many companies with the potential to navigate the current challenges. There's no question to us that once the Brazilians begin to get their house in order, investors who have lost confidence will return.

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