
BRAZIL
ORDEM E PROGRESSO

BRAZIL ON THE RISE

An emergency economic agenda focuses on business-friendly reforms

Investor expectations of the newly elected President Bolsonaro and Economy Minister Paulo Guedes were high following an election victory based on an agenda of security and reform. In December 2018, Wall Street economists ranked Brazil as the top investment opportunity for 2019 according to the December 5-17 Bloomberg survey[i] of 30 economists and investors, largely based on the market-friendly campaign promises, and an economic agenda with four stated priorities:

1) Responsible fiscal and monetary policy
2) Reduced government presence in the economy, especially through privatization
3) Greater integration with the global economy
4) Business-friendly reforms

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RESPONSIBLE FISCAL AND MONETARY POLICY

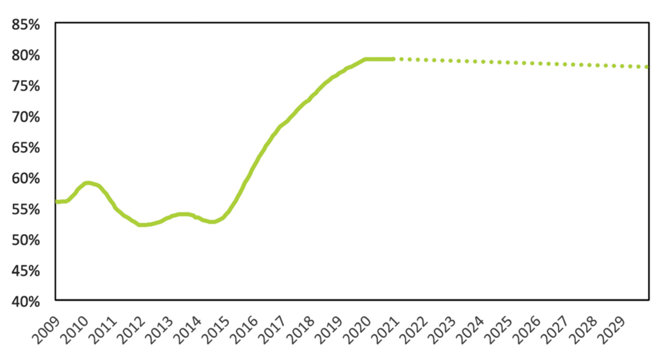
After years of setbacks, pension reform gained popular approval after the 2018 election and the new administration found support to pass the reform through Congress. In July and August 2019, the reform bill cleared the fractious Lower House with overwhelming support, receiving over 70% support in each of the two-round processes and exceeding the minimum 60% requirement of support. Notably, the bill received supporting votes from opposition parties, suggesting an ideological consensus on the need for substantial pension reform. The bill currently resides in the Senate for two rounds of voting scheduled for October.

Given strong support in the Lower House, Banco Itaú, the largest private-sector bank in Brazil, believes that the bill will be approved by the Senate with minimal changes. The current proposal would generate R$865 billion in savings, return the federal budget to a primary surplus by 2022, and result in a gradual reduction in public debt, according to Itaú and Bank of America Merrill Lynch.

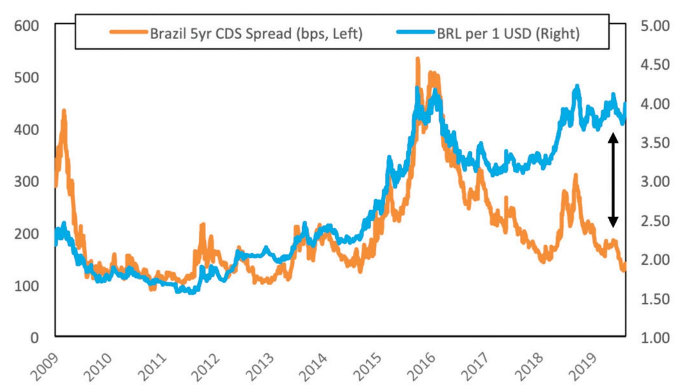
Following the successful vote in the Lower House, the Central Bank of Brazil announced a 50 basis-point interest rate cut in July 2019 and hinted at additional cuts due to lower investor risk premiums for the country. Combined with pension reform, low interest rates and low inflation will greatly improve the fiscal deficit, as 60% of public debt is floating-rate or inflation-linked. For comparison, only 10% of US government debt is not fixed.

The approval of necessary reforms greatly reduces Brazil's risk premium as illustrated by five-year CDS spreads, a market-based measure of country risk. Reform progress reduced Brazil's risk premium to levels reached when Brazil's sovereign credit rating was investment-grade. Near-term external tensions from the US-China dispute have resulted in a broad selloff of emerging markets, causing a temporary decoupling of Brazil's currency and risk premium, but Itaú expects the relationship to recouple in the long run.

Brazil Gross Government Debt (% of GDP)



Brazil Risk Premium vs. Exchange Rate



More Brazil, less Brasilia

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REDUCED GOVERNMENT PRESENCE IN THE ECONOMY

In addition to pension reform, Guedes also pushed for a sweeping R$1.0 trillion target privatization and asset divestment program and announced a plan to sell up to 100 state-owned companies. In total, the government estimates up to $1.0 trillion (US) in state-owned assets (excluding real estate) that could be divested.

As part of the state divestment program, Petrobras, a semi-public petroleum company, sold its natural-gas pipeline operator for $8.6 billion (US) and raised an additional $2.3 billion (US) from the sale of 30% interest in a gasoline distributor. In aggregate, Petrobras plans to divest $27 billion (US) of non-core assets by 2023. The federal government also plans to sell its R$130 billion listed equity portfolio owned by state-owned bank, BNDES, over a four-year period. In real estate, the government plans to sell R$1.0 billion in state-owned assets in 2019, or double the cumulative amount sold over ten years. The government has identified more than 3,700 real estate assets worth a combined R$36 billion that it intends to sell over four years.

GREATER INTEGRATION WITH THE GLOBAL ECONOMY

In 2019, after two decades of negotiation, Mercosur – the political and economic bloc comprising Brazil, Argentina, Paraguay, and Uruguay – reached a free trade agreement with the EU. According to government estimates, the agreement should lift Brazil's GDP by an additional $87-125 billion (US) over 15 years and increase investment by $113 billion (US).

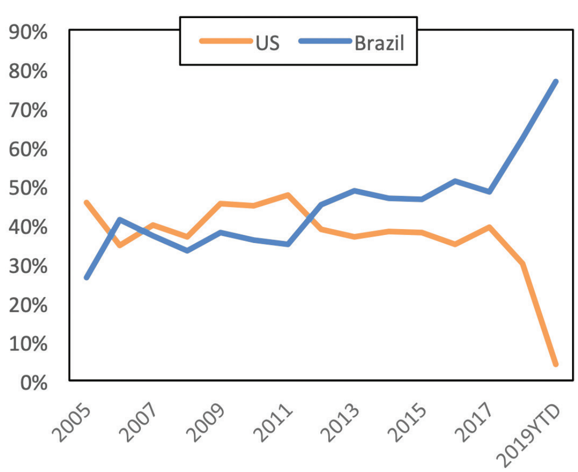
While ratification of the pact will likely be slow as European national assemblies must also approve the deal, it is symbolically important because it signals that Brazil is ready to open its economy. In addition to the EU-Mercosur agreement, Guedes and US President Donald Trump announced in July 2019 that Brazil is in official negotiations with the US over a trade deal, pointing to a shifting pattern of global alliances during a time of conflict between the US and China.

CHINA'S TRADE dispute with the US has also directly benefitted Brazil's producers at the expense of the US. Brazil's soy exports to China increased by 30% last year to fill the void left by the US, according to Apex-Brasil data reported by South China Morning Post[ii]. Bolsonaro has vowed to deepen ties with China, while his Chief of Staff Onyx Lorenzoni has welcomed Chinese investment in Brazil's infrastructure sector. Broadly, the government has encouraged foreign investment across all sectors. Cross-border inbound M&A activity reached $17.4 billion (US) in the first half of 2019, according to data from White & Case's compilation of data by Mergermarket[iii], surpassing the 2018 annual total and representing the highest first-half total since 2011.

In addition to trade, Brazil formally applied to join the OECD in 2017. Historically, the US has signaled that it could veto Brazil's membership due to its closed economy and difficulty for foreign companies to operate. However, progress on trade talks between Bolsonaro and Trump could remove a major hurdle for Brazil's membership.

Brazil remains one of the top investment opportunities globally, with significant opportunities following a long period of retrenchment that have made real asset values attractive.

China Soy Imports by Origin Market Share



BUSINESS-FRIENDLY REFORMS

Scheduled to follow pension reform, lawmakers have progressed on a substantive tax reform bill. The current proposal in Congress greatly simplifies the existing system. According to the World Bank, Brazilian companies spend an average of 1,958 hours annually on taxes[iv], compared to 240 hours in Mexico and 175 hours in the US. The tax reform bill should meaningfully improve the ease of doing business and increase productivity in the country.

Additionally, Bolsonaro also signed a provisional measure on economic liberalization that was approved by Congress in August. The measure emphasizes the role of the free market and greatly benefits small businesses, according to Brazilian law firm Lefosse Advogados[v]. The measure establishes three main economic principles, including freedom to compete in the market, belief that market actors are behaving in good faith, and minimal government intervention.

"MORE BRAZIL, LESS BRASILIA"

Investors ranked Brazil as one of the top markets under the promise that the new administration will deliver "more Brazil, less Brasilia." Within its first year, the administration has already delivered or substantially progressed on its promise. Reflecting substantial economic policy progress, Brazil remains one of the top investment opportunities globally, with significant opportunities following a long period of retrenchment that have made real asset values attractive.

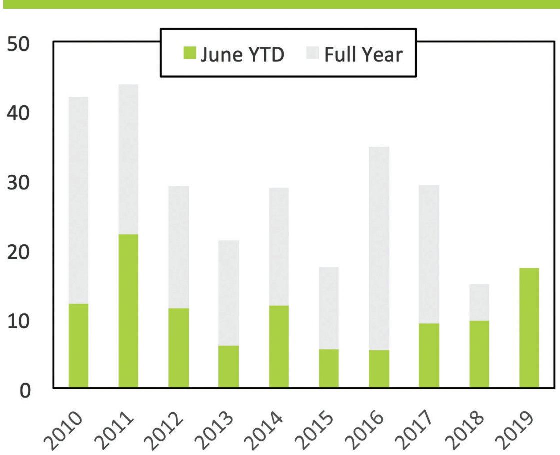
IN THE OFFICE and industrial real estate sectors, tenant demand has recovered to pre-crisis levels, but legacies of the crisis and limited private capital competition suggest that very little new supply will be delivered in the near term. As existing excess vacancy gets absorbed by the market, tenant competition for remaining high-quality available space will likely generate bidding pressures on rents and a significant need for new development.

In the residential sector, a bottom-up demographic model designed by GTIS suggests long-term housing demand well in excess of production capacity. The model estimates housing demand of 129,000 units annually in São Paulo solely due to demographics, compared to a market peak of 40,000 new unit launches. New supply will likely be severely limited as execution issues and impaired balance sheets during the recession forced many homebuilders to shut down production capacity.

Within hospitality, the broader economic recovery has fueled a significant improvement in operating fundamentals. As of Q2 2019, revenue per available room in Rio and São Paulo increased 45% and 20% year-over-year respectively, according to STR Global. Hotel development faces local structural barriers in Brazil that has led to a market dominated by fragmented small investors in condo hotels. Compared to institutional hotel assets, condo hotels typically lack central reservation systems, are managed inefficiently, and suffer from deferred maintenance over time, which make them uncompetitive to global hospitality platforms. The significant share of functionally obsolete existing room supply provides an attractive consolidation opportunity for international flags and for investors who can deliver differentiated high-quality assets.

WHILE GLOBAL CAPITAL has flowed into Brazil's public markets, private opportunistic real estate capital remains scarce. Over the past seven years, 2016 represented the only year of material capital raised, with GTIS Brazil Real Estate Fund III comprising nearly half that year's total. Given the limited availability of private real estate capital, coupled with the imminent need for new high-quality real estate supply, Brazil provides an exceptionally compelling investment opportunity for investors who have the local expertise to execute.

Brazil Cross-Border Inbound M&A (USD Billions)



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[i] https://www.bloomberg.com/news/articles/2018-12-19/brazil-tipped-to-lead-an-emerging-market-comeback-from-dour-2018

[ii] https://www.scmp.com/business/companies/article/3010480/us-china-trade-war-has-been-boon-brazils-soybean-farmers-can

[iii] https://whcs.law/2Ldw2WV

[iv] https://data.worldbank.org/indicator/IC.TAX.DURS

[v] https://www.lefosse.com/Another%20Provisional%20Measure%20to%20try%20to%20cut%20the%20infamous%20Brazilian%20red%20tap....pdf