GOOD NEWS FOR financing growth

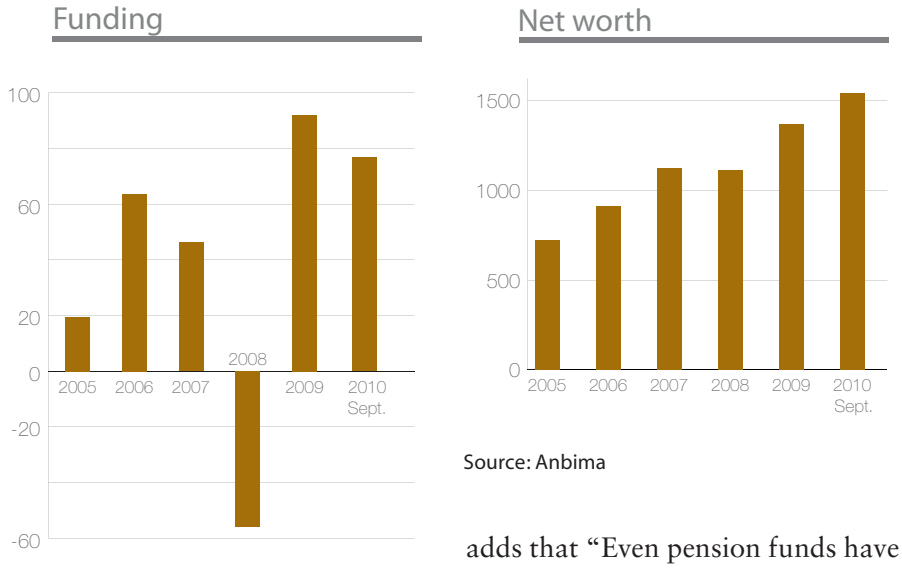
Solange Monteiro, Rio de Janeiro

An exceptional outlook for growth, employment, and income have caught the attention of investors around the world who are impressed by the Brazilian economy. A massive injection of capital into numerous sectors is expected in the next few years. The National Bank for Economic and Social Development (BNDES) projects that through 2012 infrastructure and mega projects related to deep sea oil and production for both domestic consumption and exports will attract investments totaling R$1.3 trillion (US$765 billion).

Brazil is in a position to take advantage of the positive change in capital markets in the last decade. Its stability, good macroeconomic fundamentals, modernized regulation, and international investment grade ratings have helped produce a diversity of investment instruments in capital markets. According to market projections, investment funds could double over the next five years, to R$3 trillion (US$1.8 trillion). The Brazilian Association of Organizations in Financial and Capital Markets (Anbima) reports that in September domestic investment funds had a net

GROWING

Brazil's investment funds (Billions of reais)



Source: Anbima

worth of R$1.54 trillion (US$910 billion), of which institutional investors accounted for 41%. In September, Anbima reports, 101 funds were opened, bringing the total to 9,730.

This expansion of investment funds is welcome, since low domestic savings and the limited access of corporations to financing deter economic growth. "The biggest source of business financing is still companies themselves," says William Eid, coordinator of the Center for Finance Studies at the School of Business Administration of São Paulo of the Getulio Vargas Foundation (FGV-EAESP). Carlos Rocca, director of the Center for Capital Markets Studies of the Brazilian Institute of Capital Markets (Ibmec), adds that "Even pension funds have not participated much in capital markets so far. In late 2009, almost 80% of public debt outside banks was in the hands of institutional investors, while the same proportion of stocks and private bonds was in the hands of foreign and non-financial investors."

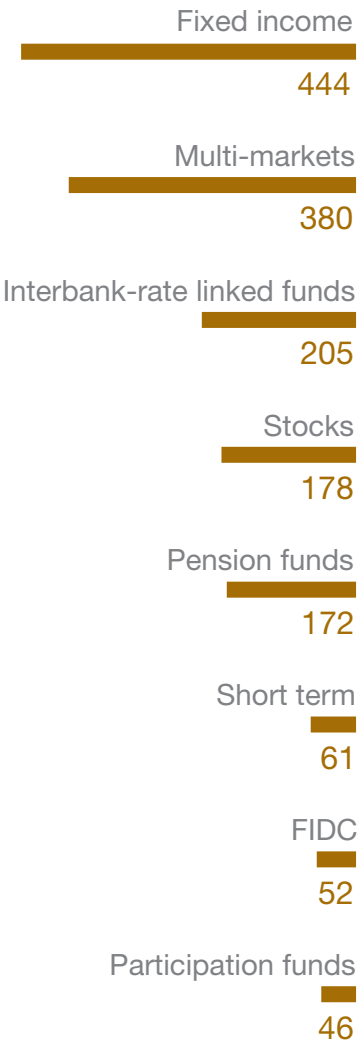
Claudio Maes, manager of the department monitoring investment funds of the Securities Exchange Commission (CVM), points out that this market has gradually been opening up, which may be part of what is attracting investment funds. Alternatives such as receivables funds (FIDCs) and real estate receivables certificates (CRI) have brought a new dynamic, he says. Private equity (PE — equity securities of corporations that are not publicly traded) and venture capital (VC

In September this year, according to Anbima, the domestic fund industry had a cumulative net worth of R$1.54 trillion (US$910 billion).

WHO'S WHO

Net worth by type of investment fund

(Billions of reais)



Source: Ambima.

— financial capital provided to early-stage, high-potential, startup companies) as well as real estate funds (FIIs) have been surging. Foreign demand for Brazilian assets abroad generates changes not only in the market environment — with banks creating mirrors of their funds abroad — but also leads to direct acquisition of PE and VC management firms. However, the rapid growth of investment funds is nourished by the hope that Brazil will reverse its extremely high domestic interest rates — a challenge for the next government.

STRUCTURED SUPPORT

Though lower interest rates have not yet materialized, the increased attraction of private equity is evident in Brazil. Investment in PE and VC funds grew to US$34 billion in 2009. Private equity offers alternatives to traditional bonds and stocks. The cost of listing on the stock market is one of the factors that limit corporations' access to capital market funding.

The growth of PE and VC funds has impacted on mergers and acquisitions of Brazilian companies as well as generating employment and income. Today in Brazil, pension funds are major investors in private equity, holding 22% of the total. "These are important investments not only in themselves, but also because they are catalysts for other long-term funding sources, such as the BNDES," explains Luis Carlos Fernandes Afonso, director of finance and investments for Petros, the pension fund for employees of Petrobras (the state-owned oil company), which has invested R$ 2.5 billion (US$1.5 billion) in PE and VC funds.

Owning R$500 billion (US$290 billion) in assets, pension funds have benefitted from the diversification options now available. As government securities began to be less profitable after 2003, pension funds began to search for other assets to meet their actuarial targets (inflation plus 6%) and cope with the increase in life expectancy of beneficiaries. The result so far has been a transfer of about 10% of assets from fixed income securities to equities.

For Valia, the pension fund for employees of Vale, the Brazilian mining multinational, private equity assets now represent 4% of the portfolio; the target, says Mauricio Wanderley, director of investments and finance, is 5%. "In 2001, Brazil had only three funds, today there are ten, with expected returns of 25%," he explains.

Funcef, the pension fund for employees of Caixa Econômica (the federal savings bank), began to change its investment policy in 2004. "We began to focus on growth, adopting new strategies: increase the share of equities, reduce exposure to assets tied to interest rates, and extend the maturity of the portfolio of fixed income and equity," says Mauricio Marcellini,

Funcef manager of investment. Funcef has created a growth profile consisting of real estate, funds of stocks, and shares in companies; its share in the total portfolio rose from 29% in 2003 to 44% in 2010. "The highlight is private equity, for which we have committed capital of R$3.6 billion, 8% of the whole portfolio," says Marcellini.

Today, pension funds, owners of assets of R$500 billion (US$290 billion), are the biggest investors in private equity, holding 22% of the total.

LARGE COMPANIES

Marcellini also highlights Funcef investment in participation funds (FIP),[1] which gives it a presence in large companies as well as companies with promising growth prospects. "This is the case with the power industry, in which we have Desenvix," he says. The renewable energy company is a good reflection of the dynamism resulting from increased capital. Because of the Funcef investment, Desenvix in March launched a new subsidiary, Cevix, for hydroelectric projects, wind and biomass, with total capital of R$1 billion. It is preparing for an initial public offering of shares soon.

Private equity can encourage new public offerings, which São Paulo Stock Exchange transactions failed to do. International examples show the potential of private equity: Canada's TSX Ventures Exchange, established in 2002, by this June had 2,360 listed companies and had daily movement of U$236 million and a market value of US$38 billion, and Hong Kong's Venture

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Exchange, launched in 1999, by last June had 174 listed companies, average daily trading volume of U$84 million, and a market value of U$17 billion.

PE management firms are also concentrating on another promising segment: infrastructure funds, a new market instrument that has attracted about R$800 billion. These managers buy a majority stake in midsize businesses, helping management to focus on improved outcomes in order to build the company up to sell.

Real estate funds have also experienced significant growth based on both more ambitious housing plans and larger commercial building projects. Data from the Brazilian Association of Real Estate Credit and Savings (Abecip) indicate that by 2013 demand for funding will exceed the amount available. "The need for credit grows at a rate of 50% a year, but savings grow at 20%. The gap does not close," said Luis Antonio França, Abecip president. Attracting long-term funding is also a priority for Brazil's banks, so they can continue real estate lending over the next few years.

CHALLENGES

While the investment fund industry is very promising, not all is rosy. "The best environment for growth is in place; now the main factor that will dictate how far we can go will be the interest rate," says Wanderley. What happens next will depend on whether the next government adopts policies that provide the right conditions for new financing instruments for business. "The priority will be reducing public debt, which pushes the interest rate up and increases financing costs for the private sector," says Rocca. "Without doubt, the government needs to spend money well and reduce corruption, which makes money more expensive, but we also need the government to invest, too," says FGV's Eid. "What is lacking today is a scenario with interest rates of 4% or 5% to spur the appetite for risk," says Marcellini, "It is essential that the market be prepared for this new reality."

According to Rocca, to sustain average annual growth of 5.5% for 2001–2013, Brazil will have to mobilize more savings, both domestic and foreign, by leveraging the attractiveness the country enjoys abroad; currently investments in developed countries are less profitable because those countries are recovering only slowly from the global financial crisis. He supports tax exemptions for the capital market "to attract more foreign investors to the Brazilian stock exchange. For now, the word seems to already be out: the quality of foreign capital inflows is good. According to the central bank, the total recorded stock of foreign investment in Brazil was US$1.13 trillion (about 60% of GDP) in August: 37% was for direct investment (FDI) and 31% for shares. The United Nations Conference

on Trade and Development (UNCTAD) recently ranked Brazil as third among countries favored by multinational corporations for investments abroad.

Domestically, there is a need to improve liquidity in the secondary capital market, mainly by reforming taxation. Rocca gives an example: "Every time a private debenture changes hands, it is taxed, which undermines the capital market, while government bonds are exempt from income tax." Also, Eid points out, it is necessary to enhance legal certainty for investments. "We have plenty of laws, but they are not necessarily enforced," he says.

It is also necessary to stimulate increased savings by institutional investors, including pension funds. "Today's pension fund assets represent about 17% of GDP, but in countries like the United States it is 80%," Marcellini says. However, some pension funds have already reached their maturity level; slower resources growth means less to invest. Private pension reform would help to boost savings.

EDUCATING FOR SAVING

A long-term focus is needed not only for pension funds. Eid highlights the need to teach the importance of saving to those consumers who have just arrived in the middle class. "We are still oriented to consumption," he says. The new middle class represents a universe of 95 million people who have the potential to save money. Credit for consumption accounts for 25% of GDP, while the new middle class's share in investment funds accounts for only 10%. In contrast, in the past five years, private banking and high-income classes increased their share to 70% of the total invested in industry by individuals. This group is more willing to accept new products and risks, while the middle class has an aversion to any kind of risk. "Mutual funds are ideal for the middle class because it is difficult to pick individual stocks and assess market behavior," says Eid.

Though today the middle class is marginal for the investment fund industry, the industry will have to educate these people to invest over the long term. "We need to simplify and create products tailored to the risk profile of each one," says Eid. "Each may have different needs: Invest in low-risk securities for the education of children and on riskier ones when the goal is next year's vacation — there is a trade-off between time and cost," he explains. "This way, we will change the focus from short-term liquidity, which most Brazilians want (often not even knowing what for) and encourage them to save and invest."

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1 FIP allocate a preponderant part of their portfolio to stocks, debentures, and securities convertible into stocks. Brazilian regulation requires that the FIP participate in setting the strategic policy and management of companies in which they invest, especially through appointment of members of the board.