This is not the first time in recent history that Brazil has been the focus of the international private equity community. Brazil has received steadily increasing attention over the last five years, with 2010 garnering the most yet. Earlier, during the 1990s, there was also a period of heightened interest in the Brazilian private equity market – what later became known as a “gold rush” after many investors were disappointed and nearly all international private equity managers left the country. Thus, the question that begs answering is: “What is different about Brazil this time around?”

Simply put, Brazil has made significant political and economic improvements in the past two decades, allowing it to establish solid building blocks for business and providing a stable ground for private equity development. Combined with four key strengths — a vibrant economy, ongoing economic growth, plentiful natural resources and the industry to support those resources — both business and private equity are flourishing in Brazil.

Brazil is the largest and most populous Latin American country, with over 190 million inhabitants and a geographical area similar to the continental United States. Goldman Sachs’ Q1 2011 Global Economics Analyst report forecasted Brazil’s nominal GDP level would reach $2.1 trillion in 2010, a 7.5 percent gain from the previous year when it stood as the ninth largest economy in the world. More than 60 percent of Brazil’s GDP is generated by internal consumption.

Furthermore, although consumer loans increased by an average of 26 percent per year over the 2003-2008 period, when compared to developed economies, there is still scope for further controlled credit expansion. Mortgages comprise only around 3 percent of GDP (compared to 38 percent and 73 percent for Europe and the US, respectively) and overall credit comprises just around 43 percent, leaving room for expansion as availability of leverage increases.

Brazil’s economy is underpinned by substantial amounts of natural resources such as: over one-third of the world’s fresh water reserves, bauxite, clay, gems, gold, granite, iron ore, limestone, manganese, nickel, petroleum, phosphates, platinum, sand, timber, tin, uranium and hydroelectric power. Brazil is an agricultural power, and the world’s leading exporter of sugar, coffee, beef and orange juice. Brazil is also a top exporter of aircrafts, electrical equipment, automobiles, ethanol, textiles, footwear, iron ore, steel and soybeans. With resources ranging from natural to technical, Brazil is a wellspring of business activity that is strengthening the economy, increasing personal wealth and attracting further entrepreneurial and investment interest.

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Notable measures include: (i) controlling hyperinflation and adopting an inflation targeting system; (ii) switching to a floating foreign exchange; (iii) trade and capital account liberalisation; (iv) eliminating many price and wage controls; (v) privatising certain government-sponsored entities; (vi) tax, social security and judiciary reforms; (vii) the endorsement of a fiscal responsibility law; and (viii) implementing new corporate and bankruptcy laws and the creation of long-term credit facilities by state-controlled banks.

The changes have been reflected in Brazil’s strong macroeconomic indicators, which show signs of further improvement. The country’s risk rating is at an all-time low and now considered investment grade by Fitch, Moody’s and Standard & Poor’s. Inflation has been controlled at 5.91 percent and the government is targeting a rate of 4.5 percent. Brazil’s overnight interbank interest rate (SELIC) hit its bottom at 8.75 percent in July 2009, and although the central bank is expected to lift the rate in the short term from its current 11.25 percent (as of January 2011), the medium-to-long term expectation is that it will continue to drop. Each above-mentioned aspect has resulted in a stable currency with controlled volatility that has been gaining ground against all major currencies.

Brazil now features a substantially different private equity scenario than the one found by the “pioneers” of the 1990s as hyperinflation, high interest rates, out-of-control currency exchange rates and a lack of clarity in the legal framework made private equity investing challenging.

When the financial tsunami shook the world and resulted in a drop in global M&A activity, Brazil weathered the storm well. The Brazilian private equity market posted an almost fourfold jump in private equity activity since 2006, spiking to 243 deals as of September 2010, from 63.

This surge in deal flow has been followed by an abundance of new funds in the market – from international managers setting up shop in Brazil, spin-offs of entire teams and new players wanting to participate. In 2010, there were at least 55 funds raising capital on the primary market, with more expected in 2011.

Yet what is behind the accelerated private equity deal flow that is enticing so many new funds to market? Indeed, observers might ask how the Brazilian private equity market was able to boost its transactions fourfold when there was virtually no debt financing available and other geographic markets were suffering dramatic declines. The answer is simple: Brazil is a growth market, and private equity is financing growth businesses in a growth market, rather than employing leverage. Thus, it is necessary to have a precise understanding of where the opportunities lie, and it is vital to carefully consider and select those strategies and managers that will perform well in this market.

Returns in the Brazilian private equity market are mainly driven by operational improvement. According to McKinsey’s Productivity Imperative study in 2004, Brazilian company productivity lags other developed countries: for example, US companies are 5.4 times more productive, French companies are 4.6 times more productive and Portuguese companies are 2.3 times more productive. Private equity managers have identified this gap and see attractive return potential by acquiring family-owned or poorly managed businesses and providing them with professional management and strong corporate governance. A similar opportunity springs from privatising segments of state-owned or large conglomerates.

**THREE COMPELLING INVESTMENT THEMES IN BRAZIL**

**Expanding middle class**
Since 2002, Brazil has enjoyed sustained economic growth. Consumer incomes have risen across the socio-economic board, amid strong economic growth with controlled inflation, which has boosted real wages. As a result, the Brazilian middle class has expanded.
significantly. According to the Brazilian Institute of Geography and Statistics, the lowest-earning segment of the population narrowed 14 percent, the middle-earning segment swelled 10 percent and the highest-earning segment increased 4 percent from 2000 to 2008. Putting the percentages into perspective, 34.9 million Brazilians moved into the middle- and highest-earning segments of the population – representing the total population of Canada and roughly half that of France, Italy or the United Kingdom. The majority of these 34.9 million people lived previously at the edge of poverty. Now for the first time, many are contributing to the nation’s GDP growth by sending their children to private schools, and buying new cars and even first homes. This drives consumption, leading to attractive investment opportunities in the consumer market segments.

2014 World Cup and 2016 Olympic Games

Brazil will host the 2014 FIFA World Cup and the 2016 Olympic Games, during which hundreds of thousands of athletes and spectators will visit. As seen with previous events in other developing countries, this will initiate unprecedented investment activity that will have a positive influence for many decades. In total, both events are expected to attract more than $75 billion in direct investments, and the Brazilian government announced that between 2011 and 2014, it will spend:

- $62 billion to improve transportation infrastructure, primarily by upgrading the international airports in the twelve host cities – Rio de Janeiro, São Paulo, Belo Horizonte, Brasilia, Cuiaba, Curitiba, Fortaleza, Manaus, Porto Alegre, Salvador, Recife and Natal, as well as by upgrading roads and constructing a bullet train between São Paulo and Rio de Janeiro;
- $34 billion on host city sanitation, hazard prevention, urban mobility and basic pavement;
- $18 billion to grant water and electricity access to urban areas.

Those industries poised to benefit the most will be construction, electric, water, waste management, food and beverages, services, IT and tourism. Nonetheless, many others, such as apparel, education, sanitation, pharmaceutical and publishing will also be able to capitalise on the opportunities surrounding the influx of capital. Ernst & Young is predicting the FIFA 2014 World Cup alone will generate 3.63 million jobs per year and an estimated $38 billion in income for the local population between 2011 and 2014.

Private equity managers have already identified the surrounding opportunities. Funds targeting investments in the innovative companies whose products and services are focused on the FIFA 2014 World Cup and the 2016 Summer Olympics value chain are already being raised. The private equity managers that help finance this large-scale upgrade will be uniquely positioned to deliver attractive investment returns.

Natural resources

Brazil has substantial deposits of non-renewable natural resources such as oil and iron ore. It also has significant renewable natural resources including timber, ethanol, soybeans and livestock. Brazil is home to more than one-third of the world’s fresh water reserves and more than 85 percent of the country’s energy comes from renewable sources; primarily hydroelectric.

The Brazilian government announced in 2010 it would spend $278 billion from 2011 to 2014 and $356 billion after 2014 to develop the generation and transmission of electricity, petroleum and natural gas and renewable fuels, as well as advance energy efficiency and mineral research.

As the world’s population grows, so too does the demand for non-renewable and renewable natural resources. And as commodity prices continue rising, Brazilian private equity managers are presenting investors with surrounding opportunities for attractive returns.

CONCLUSION

Today’s Brazil has changed substantially from the one encountered by private equity in the 1990s. Two decades of improvements have resulted in a stable political environment and a favorable business climate. Brazil’s vibrant economy, continued economic growth, substantial natural resources and industries supporting those resources have, in turn, given rise to new and compelling investment themes.

Three main investment themes in particular – the country’s expanding middle class, its natural resources and the forthcoming World Cup and Olympic Games – are presenting investors with attractive growth-market investment choices. However, it is essential to carefully select those managers that properly understand the local market and its surrounding opportunities to fully benefit from Brazil and its private equity potential.