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Brazil: Emerging with Stability

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At Janus, our goal is to deliver alpha by taking an unconstrained, in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of Janus' seven global sector research teams via monthly analyst interviews. In this edition of *Analyst Viewpoints*, Janus' Matt Hochstetler discusses the investment climate in Brazil with Client Portfolio Manager Adam Schor. Hochstetler provides an overview of key growth drivers in the country, and argues that Brazil is an attractive way to get exposure to the growth occurring in a variety of emerging markets.

Q: Give us your perspective on Brazil today versus Brazil 15 years ago.

Matt Hochstetler: Brazil today is a fundamentally different country from 15 or 20 years ago. In the early 1990s, hyperinflation was present in the country; inflation was more than 1000 percent a month during some of the worst times. Many people were very reluctant to save any of their income. As soon as they received their paychecks, they would immediately run out to the market, buy hard goods and store them because they knew prices would often change two or three times a day.

Today, we see continued macroeconomic stability in Brazil. With a strong central bank, foreign exchange reserves, political stability and a lot of other things in place, the country is experiencing lower interest rates and higher growth. Growth projections for this year should be approaching six percent to seven percent and, with inflation coming under control for the first time in a generation, interest rates are below 10 percent. As a result, now we are seeing investment back into the economy—the building of roads and housing, and the ability to take on long-duration debt.

Q: Why has it taken so long to see the effects of the declining inflation and other changes in the Brazilian economy?

Matt Hochstetler: It takes a long time to turn an economy around. Even though Brazil created macro stability 10 or 15 years ago, it takes time to overcome risk adversity. Many Brazilians have lived through some terrible decades—seven, eight or nine different currencies; government defaults on its debt; and periods of inflation of 1000 percent.

Look at mortgages, for example. Up until this decade, they were shorter than five years in duration. Brazilian consumers didn't

Key Points

- Brazil has a stabilising economy and some of the more attractive population demographics globally.
- Short-term volatility created by the upcoming presidential election may provide opportunity for long-term investors.
- Areas of investment opportunity in Brazil include natural resources, home builders, utilities, banks and education companies.

have a 30-year mortgage, let alone a 10-year or 15-year mortgage until the mid-2000s.

Mortgage-to-gross-domestic-product rates in the United States tend to be close to 70 percent. In Brazil, they are approximately three percent. It takes a very long time for a population that has been through so many difficult periods to be willing to releverage personal balance sheets. On the other hand, in the West it will likely take a long time for us to deleverage.

Q: How would you compare Brazil with India and China?

Matt Hochstetler: Brazil is very different from both India and China, even though they are often classified as being similar because they are BRIC countries [the related economies of Brazil, Russia, India and China] and all have exhibited high levels of growth relative to Western economies. In comparing Brazil to China, growth in Brazil will undoubtedly be slower than growth in China. But we don't believe that means Brazil is a less attractive market for investors. Given the consolidation that exists in a lot of industries and the high interest rates, the returns of many Brazilian companies are actually very high. In a lot of cases, the growth of these companies—particularly in the steel, iron ore, pulp, paper and oil industries—plays on the same Chinese growth theme.

The other difference between Brazil and China that is important to mention is that Brazil is a democratic society. China doesn't have a democracy, and it has huge capital controls. The ability to get money out of the country is highly restricted, and there is a lot of government interference in markets, which can be both positive and negative.

Looking at India, the country's demographic profile is relatively similar to Brazil. Given its slightly higher savings rates and much poorer income base as a country, India should have higher levels of growth over the next five to seven years. However, India is in an earlier stage of development than Brazil, so the country's ability to get stability is more difficult. In addition, India is very susceptible to international commodity prices in a way that Brazil just isn't because Brazil has a lot of natural resources and policies in place to establish self-sufficiency for oil.

We believe India and China are both very attractive long-term investment opportunities, as is Brazil, but they are all very different countries.

Q: Talk about Brazil's natural resources and how they impact its economy and economic growth.

Matt Hochstetler: Brazil has been endowed with a lot of world-class natural resources. Iron ore is one example. In the northern Brazil area called Carajas, the grade of iron ore is absolutely the highest in the world. The cash cost of getting that ore out of the ground is about one-tenth of the cash cost of getting the ore out of the ground in China. And even after the Chinese ore is refined, it is still not as attractive as the Brazilian ore.

People often think the best way to potentially benefit from Chinese growth is to invest in Chinese corporates. However, the cost of capital is very low in China and the government spurs a lot of competition, so Chinese companies oftentimes have growth—but they don't have high returns on that growth. We believe an attractive way to get exposure to Chinese growth is via a lot of the Brazilian resources. For instance, the building of infrastructure in China will likely benefit Chinese construction and steel companies, but we think it will also benefit Brazilian iron ore companies, as iron ore is the key raw material for steel.

A second example of Brazil's natural resources is oil. Petrobras, for instance, is a large Brazilian energy company that has what we believe to be some of the most attractive oil reserves globally in its offshore basin—not only the Santos Basin, but also in the Campos, Espirito Santo and a lot of the northern basins across Brazil.

A final example is agriculture. Brazil can more than triple its production of agriculture without encroaching on any rain forest land. All it has to do is convert cattle pastures into additional land. As people in China and India develop more sophisticated diets, we will need more food coming out of the world. Brazil and Eastern Europe are the only places with significant land available to expand production.

So to summarise, we believe that Brazil provides an attractive, high-return way to get exposure to a lot of the growth that is occurring across a variety of different emerging markets.

Q: What is your view on Brazil's population demographic and its impact on the country's economy?

Matt Hochstetler: We believe that Brazil has some of the more attractive demographics globally. The demographic trends in China look relatively similar to those in Japan and given the onechild policy, there is a large aging demographic in China. That is probably not a concern in the next two to three years. But in our view as long-term investors, that is a challenge for China. Brazil, on the other hand, has a much younger population. As members of that population move into the work force, they will earn more income, adding more productivity to the economy and consuming more goods. We believe that will be an attractive tailwind for the Brazilian economy.

Q: So, we have a country with a stabilising economy, good demographics and great advantages in natural resources. What are the risks in Brazil—both now and in the near future?

Matt Hochstetler: When we think about the risks surrounding the Brazilian economy, the most immediate risk is the election coming up at the end of this year. Dilma Rousseff, who is the successor to current President Luiz Inacio Lula da Silva, would basically be a continuation of the Lula government. The other candidate, Jose Serra, would potentially provide more privatization and some attractive transformations to the economy. We don't view the long-term risks of the election as material, but there is a chance for a lot of headline risk from negative media coverage. From a short-term perspective, that creates the possibility for significant volatility, but we believe it can be a positive opportunity for long-term investors.

In terms of long-term economic risk, Brazilian savings rates have never been near Asian savings rates. People haven't been willing to save money because of hyperinflation. We are somewhat optimistic that with inflation well-contained now and the younger demographic coming up, we will see the savings rates increase on a more sustained basis. But if we see leverage continue to rise 20 percent or 30 percent per year over the next 10 or 15 years, that could pose a risk to the economy. But we think that is more of a 10-year concern versus a one- to three-year concern.

Q: How do you research Brazil and get a perspective on the companies you are following?

Matt Hochstetler: We travel to Brazil frequently. We don't just meet with companies and invest based on what the companies are telling us. Instead, the main objective of our research is to get a much broader perspective from various industry participants and competitors. For instance, when we started following the mining company Vale, we visited all of its various mines and met with the company's competitors. We went to Brasilia to meet with the government agencies that regulate the mines as well as industry lobbying associations to understand their perspective. We even met with an environmental group that opposes the expansion of some of Vale's mines to obtain a holistic picture of the long-term opportunity set for this company.

In researching Petrobras, we spent a lot of time with geologists from around the world—from the Colorado School of Mines, located right here in Colorado, to specialists located in Rio de Janeiro—to really understand the potential economics and size of its future fields. Another component of our research on Petrobras involved meeting with industry associations, the Brazilian government's equivalent of the U.S. Department of Energy and suppliers. Again, we tried to piece together a comprehensive picture of the company's growth strategy based on what suppliers, the government, geologists and people on the ground were saying about the company.

Instead of taking Petrobras' guidance—which is what we believe a lot of Wall Street players do for a very complex oil field discovery like this—we built a ground-up view of what we believed the "pre-salt" development [a vast geological formation located approximately 170 miles off the coast of Brazil where oil is beneath ultra-deep waters] was worth.

Q: Do you work with other Janus sector analysts to build out your investment thesis on a company?

Matt Hochstetler: Absolutely! It's a very collaborative process. I spend a lot of time with energy team leader Geoff Jay, who has been following the global energy industry for well over a decade. Not only do I want to understand his direct perspective on certain companies, but I also want to know about the other international oil companies that Geoff follows—what are they saying about a company on the projects they are co-partnered? What are suppliers saying about a company? On Vale, for example, there has been a lot of collaboration with analysts who cover commodities as well as with China analysts and various portfolio managers to understand what Chinese demand is going to look like from a global perspective.

Q: Beyond natural resources, what other areas of opportunity do you see in Brazil?

Matt Hochstetler: There are a lot of plays on domestic consumption that we believe are also attractive on a long-term basis. One example is Brazilian home builders. As we discussed earlier, mortgage-to-GDP is about 3 percent, and the country is hugely underleveraged. Many Brazilians don't realise that they can get a mortgage for longer than seven years. Others don't know that they can buy a home without having cash for nearly the full purchase price in their savings account.

Another area of opportunity is utilities within Brazil. Given the high interest rates in Brazil, it is actually possible to find a lot of utilities that have double-digit dividend yields. It is rare to get a 10 percent dividend yield that is hedged to inflation. If inflation goes up, the utilities get to fully pass through changes in costs. So there is the full inflation hedge that everyone talks about with gold or a lot of other commodities, but in utilities, that also results in a meaningful cash yield every year.

Education companies are another way to tap domestic consumption. Brazil's demographics continue to be very favorable for the education sector; however, 70 percent to 80 percent of the sector doesn't earn a profit. So we have tried to invest in companies with management teams that we believe can materially expand margins.

Finally, we believe Brazilian banks are attractive long-term businesses. They have been through hyperinflation and through government defaults, so they are generally very cautious about extending credit. Relative to their Western peers, Brazilian banks fared very well in the recent economic downturn, largely because the country never extended the type of credit that a lot of its Western counterparts did. Brazilian banks have some of the best deposit franchises of any bank globally and, combined with relatively high interest rates and a consolidated industry, has allowed for pretty attractive returns in terms of where the price of credit is.

Q: A lot of investors have had a bad experience with Brazil. Why should someone put history aside and consider investing in Brazil now?

Matt Hochstetler: It is very difficult for a lot of investors who were burned in Brazil in the '80s and early '90s—and even the late '90s and early 2000s—to have an open mind and consider it as an investment opportunity. A lot of the problems then were driven by external debt and the country being significantly overleveraged. Brazil today has more foreign exchange reserves than external debt, so the devaluation helps the country. The aggregate leverage outside of the government sector is still relatively low. And a lot of the inflation concerns came from the central bank's prior policies.

In addition, the stability that we have seen through President Lula's two terms in office—and through the political pendulum swinging from the right in the 1990s to the left with Lula—is evidence that the country's stability should be more lasting than what we have seen in the past. So, looking back at what caused all of the problems—debt, a faulty central bank, political instability, even military dictatorships—those problems have been corrected, which we believe should lead to meaningful stability in the Brazilian economy.

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See following page for important disclosures.

About the Featured Analyst

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Matt Hochstetler is an equity research analyst, primarily focusing on emerging markets. Mr. Hochstetler joined Janus in June 2005 as a research intern and became a permanent member of the investment team in July 2006. Prior to joining Janus, Mr. Hochstetler worked at Bain & Company for several years. Prior to joining Bain & Company, Mr. Hochstetler worked at Chase Capital Partners. Mr. Hochstetler received his bachelor of science in foreign service from Georgetown University, School of Foreign Service, where he graduated magna cum laude, with departmental honors, and Phi Beta Kappa. He also holds an MBA from Harvard Business School where he graduated with high distinction as a Baker Scholar. Mr. Hochstetler has 7 years of financial industry experience.

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