A RESEARCH AND ANALYSIS SERVICE FROM THE FINANCIAL TIMES

BRAZIL CONFIDENTIAL

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BRAZIL CONFIDENTIAL

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SUPERMARKET FIGHT HIGHLIGHTS GROWTH POTENTIAL

EDITOR: **RICHARD LAPPER**

Brazil's consumer market will likely attract more interest from foreign players, but the government needs to clarify its strategy for the sector

For many investors the furore surrounding the proposed merger between supermarket groups Pão de Açúcar (PCAR5:SAO) and France's Carrefour (CA:PAR) will simply reinforce concerns about the closeness between the Brazilian government and the country's leading businesses.

In particular, the proposal from BNDES, the state-owned development bank, to finance the deal seems questionable, bearing in mind the limited benefits for Brazilian consumers.

But the very ferocity of the controversy between Carrefour and Casino (CO:PAR), a rival French operator that had expected to assume control of Brazil's biggest supermarket chain next year, serves to underline a stark reality. With stagnant and debt-laden developed markets offering limited prospects, international businesses are obliged to seek out opportunities in big and relatively fast-growing markets such as Brazil.

Since 2005, when Casino signed the deal to take control of Pão de Açúcar (it now has a 43% stake), the volume of products leaving Brazilian supermarket shelves has risen by a cumulative 43%. That outperformance reflects how Brazilians, with increased incomes, are choosing to buy more and higher-quality items. By comparison supermarket sales in Europe and North America have been flat.

No wonder then that the world's biggest supermarket groups are eyeing opportunities. Brazil already accounts for a third of Casino's international sales, with emerging market investments (Casino has bought in Colombia, Thailand and Vietnam, as well as Brazil) expected to account for four-fifths of growth in the three years to 2013.

By merging with Pão de Açúcar, Carrefour would increase overall exposure and gain a dominant position in Brazil, with the new entity becoming Brazil's third-biggest company (after the oil and minerals giants Petrobras (PETR4:SAO) and Vale (VALE5:SAO)).

The two companies were first and second in the supermarket sector in 2010 with gross sales of R$36.1bn ($23.0bn, £14.4bn, €16.1bn) and R$29bn respectively. Walmart (WMT:NYSE) of the US was third-biggest last year with gross sales of R$22.3bn, but has aggressive plans to expand further.

Nor, given this degree of foreign interest, is it a surprise that the government, with its promotion of "national champions", should look to the supermarket sector for its latest foray.

Yet last week's announcement that the BNDES would invest R$3.91bn in the combined entity through its equity arm (BNDESpar, which operates along the lines of an investment fund) was greeted with blistering criticism by the local press.

That is partly because neither the BNDES nor the government ministers, who spoke out on the matter, managed to explain adequately the business case. In particular, it is unclear exactly how the government expects the merged entity to open a channel for the sale of Brazilian products in France, especially since Pão de Açúcar's existing links with Casino have allowed it to make precious little progress in this respect.

Exactly how Brazilian consumers will benefit from the deal is another doubt, since the merger will reduce competition, especially in those parts of the south and south-east where both Carrefour and Pão de Açúcar have higher market shares than they do in the country as a whole.

At the same time, the proximity of the 74-year old president of Pão de Açúcar, Abílio Diniz, to the government of former President Luiz Inácio Lula da Silva, has given rise to allegations of political favouritism. During last year's election campaign, Mr Diniz's wife, Geyze Diniz, organised a dinner among senior businesswomen in support of President Dilma Rousseff's presidential candidature.

Brazilian supermarket sales have risen by over 40% since Casino secured its deal with Pão de Açúcar in 2005

Last week, after news of the deal broke, two ministers publicly defended the proposed transaction, arguing that BNDES's involvement was driven by purely financial motives.

"This is a purely commercial operation," said Gleisi Hoffmann, the recently appointed chief of staff, at the end of a meeting organised to improve competitiveness and the quality of public sector management that had been attended by Mr Diniz.

Fernando Pimentel, the minister of development, explained BNDES backing by arguing that the private sector had been unwilling to provide backing – even though BTG Pactual, the local investment bank, is planning to invest R$690m into the deal. "Everything would be resolved if the private financial sector were to play its role, that is to finance Brazilian capital. Since it didn't do this, the BNDES had to step in," said Mr Pimentel.

But in the last few days the government has shown signs that it is retreating from this position. Government officials have told Brazil Confidential that Ms Rousseff herself has urged the bank to take a cautious approach and has instructed ministers not to defend the operation.

Advisers insist that Ms Rousseff personally took no part in decision-making. The BNDES has repeatedly insisted that the deal will not go ahead without Casino's agreement. During a trip to Brazil this week, the company's president Jean-Charles Naouri said his company intended to stick to its guns, setting the stage for a drawn-out battle.

This issue of Brazil Confidential, meanwhile, provides two other – more unusual examples – of the attractions of the Brazil story. Just as Brazilian consumers are buying better quality yoghurts, razor blades and perfumes, they are also buying better quality cachaças.

As our report shows, consumption of smoother and more expensive versions of sugarcane alcohol is rising fast in upmarket bars and restaurants, increasing margins for producers and potentially cachaça's attractions to international drinks companies. After their recent forays into Turkey and China, it would not be too much of a surprise if one of the international players were to make a purchase in the Brazilian market.

In a different way, our story on green building materials also highlights how Brazil's potential is lurking in unexpected corners of the economy. Admittedly, the market for recyclable plastic floors, certified wooden doors and ecological paint is small. But Brazil's growth, its construction boom and relative eco-awareness means that it is punching above its weight in this niche area.

Finally, our report from the state of Sergipe highlights how rising income levels and large commodity investments are transforming the face of the Brazilian north-east. ■

THE BOTTOM LINE

114%
Year-on-year growth in mortgages contracted by Banco do Brasil in May, to R$289m
Source: BB

$45bn
Japanese Toshin inflows into Brazil during the past year, over 2% of GDP
Source: Nomura

18.3%
Of GDP, or R$663.4bn: the size of the informal economy in 2010
Sources: IBRE-FGV, ETCO

3.2%
Increase in consumer confidence in June, back to April's level
Source: FGV

7.59%
Capital-to-assets ratio of Brazilian banks in 2010, down from 8.12% in 2009
Source: The Banker

R$980m
Value of rights to screen games in the Brazilian championship 2012-15, paid by Rede Globo to football clubs
Source: Veja

CACHAÇA: THE BILLION-LITRE DRINKS OPPORTUNITY

SUMMARY

> **The market for** cachaça is characterised by high volumes and low margins. However, the cane-based spirit is beginning to shed its downmarket image, with premium cachaças and cocktails appearing in upmarket bars and restaurants.

> **With developed markets** either stagnant or growing slowly, Brazil's cachaça industry could be attractive for international drinks companies or private equity investors. International companies have already moved into local spirits markets in China, Turkey and some other emerging markets.

Caipirinha, the country's national cocktail, is made from cachaça, sugar and lime

Producers of Brazil's favourite alcoholic drink by volume are launching premium brands to attract rich consumers, while trying to hold on to the emerging middle class.

Cachaça, or *pinga* as the locals call it, is as engrained in Brazilian folklore as samba and carnival. Outside Brazil, the drink is little-known and rarely sold. But what's more surprising, given cachaça's colossal local sales volume, is that multinational drinks companies have yet to grab a significant piece of the market. The conditions are right for that to change.

According to new research and forecast data from Brazil Confidential, Brazilians will knock back around 1.3bn litres of cachaça in 2011. If sales of homemade spirit are included, the market almost doubles.

The top Brazilian seller, Cachaça 51, shifts annually more cases in Brazil than Bacardi rum shifts globally. Diageo (DEO:NYSE), Pernod Ricard (RI:PAR) and Bacardi each have a cachaça brand in their portfolio, but they have done little to promote them beyond tiny niche markets. For example, Diageo's Nega Fulo, acquired in 2000, is sold in some European bars and clubs but demand has been volatile and vulnerable to the slowdown in the continent's economy.

Changing perceptions

Historically, the big international drinks groups have been put off by the downmarket image of cachaça. The market for the spirit is cluttered with economy brands, many of them packaged in unattractive refillable bottles. Typically, margins have been low. Instead, companies such as Diageo and Pernod Ricard have sought to appeal to Brazil's upwardly mobile middle class by promoting the idea that the latter's choice of drinks should reflect their social success.

Several developments may now be forcing a change. First, stagnant consumption in Europe and the US could prompt international companies to take a new look at Brazil. Western Europeans are cutting back on top-shelf drinks and there is a growing cocooning culture as consumers rein in social activity to hunker down at home. Diageo itself has forecast that 50% of its sales will come from the developing markets by 2015, compared with around 35% last year. All of which suggests that investment in Brazil's growing domestic market could be something of a strategic imperative.

Second, cachaça might be cheap but it is virtually a grocery staple in Brazil's low-income neighbourhoods. According to new industry research by Brazil Confidential, Brazilians spent over $9bn (R$14.0bn, £5.6bn, €6.2bn) on *pinga* last year, mostly in bars. That is roughly six times the cash they threw at Scotch whisky, and almost one-third the money splashed out on beer (Brazil has the third-biggest beer market in the world, after China and the US).

Brazilians spent over $9bn on cachaça last year, roughly six times the cash they threw at Scotch whisky, and almost one-third the money splashed out on beer

In addition, the product is often sold in returnable bottles, allowing producers to make cost savings. In the soft drinks market, Coca-Cola (KO:NYSE) uses returnable bottles for this reason. The format also helps cement brand loyalty and is eco-friendly.

Third, more expensive premium cachaças – i.e. those that retail at over R$15, more than three times the low-end price – are becoming more popular in Brazil. Ten years ago, the drink was out of fashion among trendsetters: even caipirinha, the country's national cocktail made from cachaça, sugar and lime, was wiped off cocktail menus in some of the more snobbish bars and restaurants of São Paulo and Rio, and replaced with the vodka-based caipiroska. A number of cachaça producers even started making their own vodkas.

Now, premium aged cachaças and cachaça-based cocktails are back on the drinks menus of high-end bars. The category is now cool enough for the Brazilian version of Playboy magazine to list its top ten cachaça brands. And super premium sipping cachaças are growing in popularity as a gift between business clients and as a fashionable tipple for women. "I have noticed more women asking for the smooth, premium cachaça, and people willing to pay more, like they used to only for whisky," says the proprietor of Bar do Gomez in Rio de Janeiro, which stocks more than 100 different brands.

Fourth, there is a new sense of national pride in cachaça, even nostalgia. Former president Luiz Inácio Lula da Silva liked the drink, helping this association. Like Havaianas, Brazil's leading brand of flip-flops, cachaça is developing a home-grown, egalitarian appeal, encompassing rich and poor Brazilians. And the growth of premium products – especially in the so-called on-trade (mainly bars and restaurants) – can invigorate sales of cheaper brands too.

Mexico's Tequila lessons

What has happened in Mexico could provide something of a guide. Back in 2000, President Vicente Fox toasted his election victory with a glass of tequila, pushing aside the proffered champagne with a shout of "*Mejor con tequila*" (Better with tequila!).

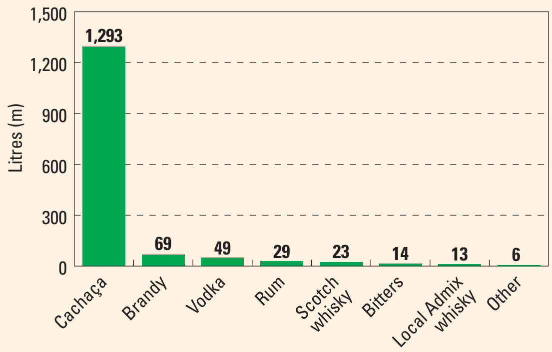
Tequila's popularity was helped by a shortage of agave, the cactus from which the spirit is made. The

Spirits consumption in Brazil, by volume

Data built from industry interviews, trade estimates

Category	2010 (m litres)	2011* (m litres)	CAGR 2011-2015* (%)
Cachaça	1,293	1,305	0.7
Brandy	69	70	1.8
Vodka	49	51	4.4
Rum	29	29	1.4
Scotch whisky	23	24	4.2
Bitters	14	14	1.6
Local Admix whisky	13	13	2.1
Other	6	6	3.8

2010 consumption



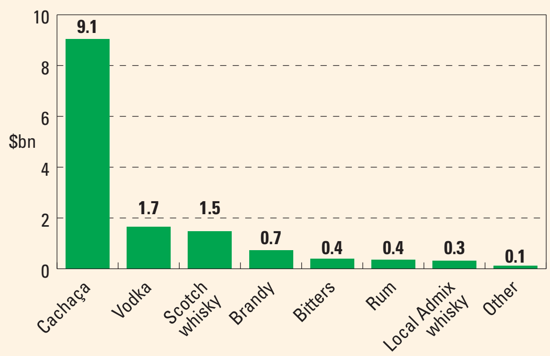
*Forecast
Source: Brazil Confidential

Spirits spending in Brazil

Data built from industry interviews, trade estimates

Category	Consumer spending, 2010 ($m)	Consumer spending, 2011 ($m)	Estimated on-premise share* (%)
Cachaça	9,051	9,240	82
Vodka	1,660	1,720	80
Scotch whisky	1,470	1,530	66
Brandy	722	731	77
Bitters	388	392	87
Rum	358	361	72
Local Admix whisky	322	320	71
Other	126	122	76

2010 consumer spending



*Bars, restaurants, clubs and other establishments serving drinks for consumption on location.
US dollars at fixed 2010 exchange rates
Source: Brazil Confidential

shortage pushed up prices of standard brands, hitting sales. In reaction manufacturers made greater efforts to sell premium products, in order to protect their revenues. The move paid off as middle-class Mexicans developed a new taste for aged and reposado tequilas.

By volume, tequila sales nose-dived, but the total value soared. And there was a positive knock-on effect abroad, notably in the US, where the premium image supplanted tequila's association of college students.

Cachaça could follow a similar trajectory. Brazil does not face a sugarcane shortage to match Mexico's agave crisis, but production costs are increasing. That is a viable trigger for premium brands to take a larger share. There is also a craving for sophistication and novelty, amid robust consumer spending.

In other emerging markets, traditional spirits are also seeing interest. Last month Chinese regulators approved Diageo's bid to take control of China's Shui Jing Fang, a maker of white spirit *baijiu*. LVMH Moet Hennessy Louis Vuitton (MC:PAR) and Pernod Ricard have also taken stakes in makers of *baijiu*. Like cachaça in Brazil, *baijiu* is China's most widely consumed spirit and has been going through a fashionable renaissance among middle-class consumers.

Cachaça 51 still has a huge following, and by volume is one of the top-selling spirits brands in the world

Earlier this year, Diageo agreed to pay $2.1bn to acquire Mey Icki, Turkey's largest maker of *raki*, an aniseed flavoured white spirit. Such spirits limit the room for Diageo to expand its sales of Johnny Walker and Smirnoff.

The movers and shakers

One of the new breeds of premium cachaça brands on the market is Santa Dose, a honey-flavoured cachaça with slick i-generation packaging. The brand has targeted women, who are drinking more in bars and restaurants. With the slogan "Reinventing traditions", it sells in ice buckets in upscale bars of São Paulo and Rio for around R$100 per bottle.

Another example of this growing "premiumisation" is the aged version of Cachaça 51, called 51 Reserve, which retails at about R$145. The owners of Cachaça 51 are keen to show they are not bargain players, but can compete in the upmarket segment as well. Sales of 51 Reserva were below 1,000 (9-litre) cases last year, but the brand's real impact is to give impetus to the whole category.

Sagatiba is another premium brand. Its makers have looked to develop an international profile before addressing the domestic market. Sagatiba launched first in Europe and subsequently in Brazil in 2004. That European foray, defined by a slick Saatchi & Saatchi advertising campaign, does appear to have boosted the brand's fashionable credentials.

In Brazil, Sagatiba is positioned at the same price range as Smirnoff, the top-selling white spirit in the country that is not a cachaça. Sagatiba currently accounts for almost one-third of all premium sales of premium cachaça.

The sweet spot in the north-east

Premiumisation may be the buzzword, but traditional low-price brands are still the mainstay of the industry. The highest-selling brand in Brazil, Cachaça 51, is owned by family-run Companhia Muller de Bebidas and based in Pirassununga, São Paulo. Sales last year totalled around 182m litres (20.2m cases), according to data from Brazil Confidential, but have been dropping over the past decade as poorer consumers started to buy beer rather than spirits in bars.

Cachaça 51 still has a huge following, and by volume is one of the top-selling spirits brands in the world. But Brazil Confidential forecasts that sales growth will continue to slow over the next five years, mainly because consumers will continue to try new drinks. Overall, the brand is untouchable as market leader. And the brand equity of Cachaça 51 – boosted by the category's growing image as a patriotic tipple – will give verve and credibility to its premium spin-off.

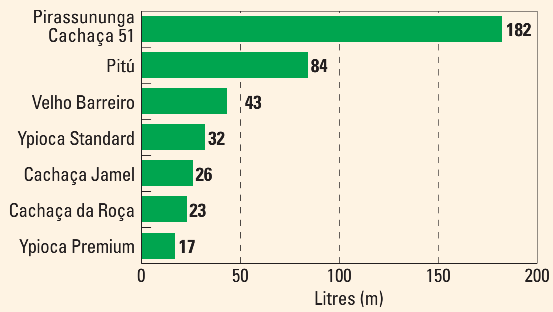
Companhia Muller de Bebidas has more than 1,500 employees, having started in 1951 and launching formerly as a brand eight years later. (Initially William Muller transported cachaça bottled in used beer bottles in his own Ford F-8.) The company has two factories in Brazil and three distribution points. It recently started segmenting into sub-brands such as Mix 51, a pre-mixed caipirinha with lime and sugar already added, and 51 Ice, which is a ready-to-drink cachaça in four flavours, tangerine, lemon, passion fruit and traditional lime.

Leading cachaça brands in Brazil

Data built from industry interviews, trade estimates

Brand	Consumption 2010 (m litres)	Regional focus	Growth 2010-2015* (%)
Pirassununga Cachaça 51	182	São Paulo	-9
Pitú	84	Pernambuco	24
Velho Barreiro	43	São Paulo	3.5
Ypioca Standard	32	Ceará	15
Cachaça Jamel	26	Paraná	6
Cachaça da Roça	23	Rio de Janeiro	-20
Ypioca Premium	17	São Paulo	19.5

2010 consumption



*Forecast
Source: Brazil Confidential

Of all the cachaça players in Brazil – and there are reckoned to be upwards of 35,000, representing over 5,000 brands – Muller has the strongest national penetration, though the state of São Paulo still accounts for a big percentage of overall sales.

Brands' regional focus is key to understanding investment opportunities. Pitú and Ypioca, for example, the second and fourth biggest brands on the market, in that order, are both strong in the home north-eastern states of Pernambuco and Ceará, respectively.

According to forecast data from Brazil Confidential, these north-east brands present the most attractive growth prospects to 2015. Adulterated cachaça (produced and sold illegally, normally in used branded bottles) are common in this region, but as growing numbers of households are brought into the formal retail sector, brands like Pitú and Ypioca will benefit from a windfall of new consumers.

Pitú, founded by the Cavalcanti family three-quarters of a century ago, looks particularly attractive, with volume forecast to grow 24% to 2015. Pitú's consumption base is the state of Pernambuco, which is tipped to generate some of the country's strongest economic growth over the next ten years. It is also fast becoming a distribution hub for the north-east as a whole. As Pernambuco's most popular spirit drink, Pitú is well positioned to take advantage of the steady improvement in the state's economic prospects.

One of the biggest assets of Pitú, Ypioca and other companies focused on the north-east, is their local distribution. They navigate the highly-fragmented retail network, and, in the case of Pitú and Ypioca, control platforms that could distribute other drinks too.

Entry-level investment

Off the beaten path, international investors could get a foothold in the cachaça market through a number of well-run small and mid-size businesses. The Magnífica brand in Rio de Janeiro state, for example, produces some 682,000 litres of cachaça a year but has ambitions to double that volume, and will increase production next year to around 900,000 litres.

Owner João Luiz de Faria believes that cachaça has the potential to become the world's number one spirit. Currently it holds third spot in terms of volume, after vodka and South Korea's national drink, soju. (Cachaça ranks above soju if unbranded volume is included.) "What needs investment is marketing, and the industry hasn't always been the most well-organised in the past", he says.

Mr de Faria started producing the drink 25 years ago on his farm in Miguel Perreira, north of Rio city, and still performs the tasting himself. The business is only now beginning to break even, but is well placed to turn a corner if cachaça hits a new purple patch of growth. Currently, Magnífica employs 22 people but Mr de Faria is looking to take on at least ten more as he increases production.

While four-fifths of what he produces goes to the home market, Mr de Faria is trying to increase exports. The US is the key target, since, on average, cachaça can be sold for \$3 per litre, compared to around \$1 per litre in Germany. Last year, one container was sent to the US, one to the UK, three pallets to Germany and one container to Switzerland, totalling 30,000 litres, while this year he is sending two containers to the UK, two to Germany and at least one to the US, totalling 44,000 litres. He aims to increase that tally to at least 66,000 litres next year.

International investors could get a foothold in the cachaça market through a number of well-run small and mid-size businesses

In a deal with the Latin American-themed UK restaurant chain Las Iguanas, Magnífica produces cachaça branded with the restaurant's name. The drink is distilled to be slightly weaker, at 39%, as this puts it in a cheaper bracket for import tax. As the chain has grown from one to 22 restaurants across the UK, the deal has become an important driver of new business and is an example of inventive ways cachaça can penetrate foreign markets.

Mr de Faria is aiming to increase production to 1.5m litres in the next five years. He also wants to buy a new farm to produce cachaça under a different trademark, positioned between the aged artisanal format and the quick turnaround industrial products. He believes there is currently a gap in the market at the low-end of the premium market, below Magnífica, which retails at around R\$25.

Sporting marketing platforms

Tie-ups with foreign producers could inject cachaça producers with marketing expertise, particularly regarding international development. Exports currently account for only 1% of total production, and that has changed little over the past five years. The global cocktail market, which is competitive and volatile, is responsible for almost all of this external demand.

Perhaps the highest-profile marketing of cachaça so far was a 2004 billboard campaign in Portugal by Cachaça 51. The campaign, which cost around R\$4.5m, coincided with the European football championships. The 2014 World Cup and the 2016 Olympics could provide similar promotional opportunities.

Also in 2004, the owner of Sagatiba, Marcos de Moraes, is reckoned to have channelled upwards of \$30m into advertising and marketing activity when he launched the brand in Europe. That was very much a lavish one-off geared to promoting an export-led premium segment.

Another promotional tool would be the recognition of cachaça as a drinks category of its own, rather than its current categorisation as Brazilian rum. The Brazilian Institute of Cachaça (IBRAC), founded in 2006, has been lobbying the US to this end. Delegates have visited Washington twice, as part of a \$150,000 campaign (half the cost was paid by the Brazilian government). But while the US is a crucial long-term growth area, in the short term cachaça's fortunes depend on the evolving domestic market. ■

ACTION POINTS

01 The cachaça market is highly fragmented, with regional companies having built tight distribution networks.

02 Rapid consumer growth in the north and north-east has bolstered Pernambuco-based Pitú and Ceará-based Ypioca. Premium cachaças are becoming increasingly popular among upwardly mobile Brazilians.

03 Foreign drinks companies are largely invisible but Brazil's cachaça market resembles spirits markets in other emerging markets that have seen recent acquisition activity.

CARREFOUR-CBD: THE ANTI-TRUST VIEW

SUMMARY

> A combined Carrefour-CBD operation would represent 32% of Brazilian supermarket sales, but its impact on competition would need to be measured on a neighbourhood scale. The post-merger analysis, culminating in a decision by the Cade, could take over two years. Previous retail mergers have led to the sell-off of some stores.

The proposed merger could be frozen, and asset sell-offs are a likely price for any approval.

There are several reasons why the proposed merger between Carrefour (CA:PAR) and CBD/Pão de Açúcar (PCAR5:SAO) could collapse. The most likely reason is that Casino (CO:PAR), CBD's largest shareholder, refuses to give its consent, which all parties have accepted is essential. And, even if the merger goes through, it will face a competition inquiry.

Here's a summary of how Brazil's anti-trust authorities, led by the Cade agency, would view the case:

The Cade could freeze a merger of operations, while analysing the case. This was the agency's approach to CBD's 2002 purchase of Sé Supermercados, a São Paulo-based chain, and CBD's more recent acquisitions of electrical goods retailers Casas Bahia and Ponto Frio. Gabriel Dias, a partner with law firm Magalhães, Nery e Dias, sees a "very high probability" of a freeze being applied to any CBD-Carrefour merger. The measure – known as an agreement for the preservation of merger reversibility (Apro) – would order the parties to maintain their separate brands and not to close stores. Meanwhile, detailed analysis would be carried out – with a final decision from the Cade likely to take at least two years.

National market share isn't the issue. Carrefour has pointed out that the merged Novo Pão de Açúcar would only have 32% of national supermarket sales. That is far less than other merged companies: Ambev (AMBV4:SAO) has 70% of the beer market; Brasil Foods (BRFS3:SAO) has 82% of pasta sales; and Nestlé (NESN:VTX) and Garoto are reported to have around 90% of the market for certain types of confectionary. But the supermarket industry is much more local: people don't travel to do their shopping, and the best store locations may be taken.

Local competition concerns centre on the south-east. Pão de Açúcar and Carrefour are both focused on the region, helping to explain why they estimate yearly synergies of €600m (R$1.3bn, $860m, £537m) to €800m from their merger (2-2.8% of last year's sales). There are 26 Carrefour stores in the city of São Paulo: 13 of these are within a 10-minute drive (roughly 4km) of a Pão de Açúcar store, according to the latter's online store locator. This does not take into account CBD's other chains, such as Extra.

The competition analysis would be highly complex: the authorities would have to decide how to divide São Paulo into local markets, and whether small convenience stores count as viable competition to big players. Are consumers so loyal to Pão de Açúcar that they would keep shopping there even if prices shot up? It's not just about physical products, says Ademir Pereira, a partner with Advocacia José Del Chiaro: will the merger affect how poor consumers (C and D class) buy on credit?

Likely sanctions are divestment of assets and the protection of separate brands. Carrefour and CBD could be forced to sell off not just stores, but also distribution centres, client portfolios, and even one of their chains (such as Extra), says Mr Dias. Ambev, for example, sold off its Bavária brand and several factories as part of its settlement. The Cade can order full divestiture, when the merged company ends up with a similar market share, albeit with a different mix of stores and other assets.

The decision will not necessarily be tougher if a freeze has been applied. The Cade allowed CBD's purchase of Sé Supermercados, and ordered only one store to be sold off as a condition for approving ▶

Where Brazil's biggest retailers are focused

Carrefour and Pão de Açúcar have around two-thirds of their stores in the south-east, while Walmart is more dependent on the south and north-east.

Carrefour
Total stores: 236 (excluding Dia discount chain)

	No. of stores	% of total
São Paulo	106	44.9
Minas Gerais	26	11.0
Goiás/Brasília	19	8.1
Rio de Janeiro	13	5.5
Rio Grande do Sul	11	4.7
Others	61	25.8

Grupo Pão de Açúcar
Total stores: 1,592 (all chains)

	No. of stores	% of total
São Paulo	851	53.5
Rio de Janeiro	288	18.1
Minas Gerais	128	8.0
Goiás/Brasília	82	5.2
Paraná	53	3.3
Other	190	11.9

Walmart
Total stores: 487

	No. of stores	% of total
Rio Grande do Sul	111	22.8
São Paulo	79	16.2
Bahia	73	15.0
Pernambuco	53	10.9
Paraná	50	10.3
Others	121	24.8

Sources: Companies, Brazil Confidential

CBD's purchase of Rio de Janeiro chain Sendas (both cases were subject to a freeze). Detailed analysis would come after the merger, first by the Secretary of Economic Monitoring (SEAE), linked to the Treasury, then by the SDE, linked the Ministry of Justice, then finally by the Cade. Carrefour has not yet confirmed whether Dia (DIS:MCE), the discount chain which has listed separately in Madrid, will form part of the merger.

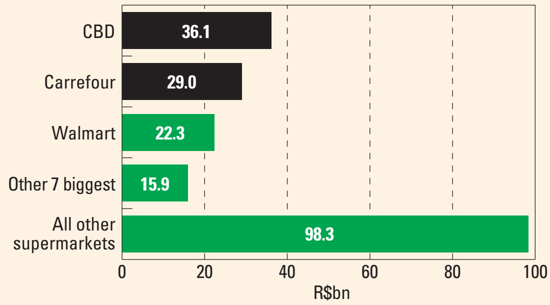
Forced spin-offs could open the door to other retailers. Last year Chilean group Cencosud (CENCOCUD:SGO) bought Super Família (based in Ceará), Perini (Bahia) and Bretas (Minas Gerais and Goiás); it has also owned Sergipe's biggest retailer GBarbosa since 2007. Cencosud's owner, Horst Paulmann, is also said to have met with executives from France's Carrefour last month to discuss acquiring some of its Brazilian assets. Currently, Brazil has only three supermarket chains with national coverage: CBD, Carrefour and Walmart (WMT:NYSE). If Cencosud can gain a significant foothold in the south and south-east, it could join the ranks.

There are 26 Carrefour stores in the city of São Paulo: 13 of these are within a 10-minute drive of a Pão de Açúcar store

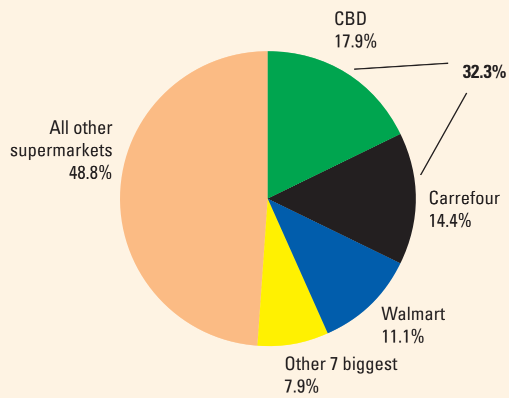
National champions don't count. Lawyers suggest that 'national champions' are highly unlikely to receive favoured treatment from the competition authorities. In any case, the context has radically changed since the Cade decided not to stop the merger of Ambev, now Brazil's dominant beer company. The idea of national champions has no legal basis. Moreover, the Cade is increasingly aware of international norms and of Brazil's more vibrant private sector. Its decision on Brasil Foods, expected by July 13, should throw further light on this issue. ■

Combining the top two

With Carrefour, CBD would strengthen its national leadership, without gaining a majority of the market



Market share, compared with other top 500 supermarkets



Notes: R$1=$0.64, £0.40, €0.44
Sources: Companies, Abras, Brazil Confidential

Local market dominance?

In the neighbourhood of Pinheiros, São Paulo (shown), Carrefour and Pão de Açúcar stores are located a few blocks from one another. The anti-trust bodies – particularly the Secretary of Economic Monitoring and the Cade – would look at the impact on prices and choice for consumers and suppliers

Sources: Brazil Confidential, Google Maps

GREEN BUILDING CLIMBS HIGHER

SUMMARY

> **Brazil's sustainable building** industry is growing quickly with projects worth about R$27.5bn under development.

> **Specialist suppliers interviewed** by Brazil Confidential report annual output rises of up to 100%, with growth stimulated by regulatory changes, client demands and tax breaks.

> **Expansion of the** supply chain is being held up by the lack of affordable credit in the domestic market.

BLOOMBERG

Growing demand from big construction companies and other clients, combined with regulatory pressures, is pushing the expansion of the sustainable supply chain in Brazil

Suppliers of eco-friendly materials are finding new demand, but little financing exists beyond the BNDES and Caixa Econômica Federal.

Demand for sustainable building products, which increase energy efficiency and reduce carbon emissions, is steadily increasing in Brazil. The country's green supply chain is smaller than that of the US or many European countries, but it is developing, thanks to annual growth of around 6% in the construction sector, together with regulatory changes and tax breaks.

Certification programmes – which register compliance with internationally-recognised environmental standards – are being widely adopted in Brazil.

By the end of this year, some 335 buildings, the equivalent of around 11m sq m, will be in the process of being certified as **LEED (Leadership in Energy and Environmental Design)** compliant. The LEED standard is issued by the US Green Building Council (USGBC), an independent entity that accredits sustainable buildings and products.

A certificate issued by the UK-based Building Research Establishment – under the so-called **BREEAM** – is also gaining ground locally.

The USGBC has ranked Brazil sixth in the world in terms of the total number of developments applying to meet its green standards, ahead of Mexico, Germany and South Korea.

These developments, which include residential, office, retail and industrial projects, represent an estimated investment of R$27.5bn ($17.6bn, £7.0bn, €7.8bn) according to the USGBC's Brazilian sister organisation GBC Brasil.

Brazil Confidential spoke with the directors of small and medium enterprises (SMEs) that manufacture the certified wood products, recycled floors and ceramics, ecological paint and "green roofs" that are currently in demand. Those surveyed attested that they are seeing annual growth rates in output of up to 100%. However, they also identified a lack of access to affordable credit in the local market and the lack of specific credit lines for the "green sector" as factors that are constraining the future growth of their businesses.

The rise in sustainable building

Sustainably-built workplaces are on the increase in Brazil because they provide "access to more external light and [improve] quality of air and acoustics" and therefore increase employee productivity, says Guilherme Soares, national director for project and development services at Jones Lang LaSalle (JLL:NYSE), the property agency.

And while the GBC calculates that adopting sustainable building practices can increase the price of construction by between 2% and 7%, this cost can be reduced by incorporating sustainable practices and materials at an earlier stage of the design process.

Furthermore, buildings, which are more efficient consumers of energy and water pay up to 9% less on utilities over their lifecycle, the organisation estimates.

There are also a host of "hard factors" – including demands from big construction companies and other clients, as well as regulatory pressures – pushing the expansion of the sustainable supply chain.

Some clients will only purchase some of their products from sustainable suppliers, since they calculate the resulting green credentials will enhance their access to capital or credit and boost their image with government and among consumers.

Two forthcoming laws are expected to create new limits on states and municipalities for emissions of greenhouse gases and the amount of waste that goes into landfills

For example, the housebuilder **Even (EVEN3:SAO)** generated major changes in its R$1m-a-year door supply chain by taking the decision in 2006 to only buy wood that is certified by the Forest Stewardship Council (FSC), which promotes managed logging.

This strategy initially led the cost of the wood it bought to increase by around 5%, says Sílvio Gava, technical and sustainability director at the developer. But he claims that the firm now pays less than it did in 2006, as a result of increased competition among the supply chain. Even buys wood from seven suppliers – Espaço da Madeira, Randa, Madepar, Lavrasul, Engeforma, Vert and 3N.

Competitor **Cyrela (CYRE3:SAO)** has for its part begun instituting some changes, such as the blanket use of low-voltage lighting. It has also established a relationship with the São Paulo Polytechnic School with a view to creating a carbon footprint ranking of the most important building materials it uses.

"It will probably lead us to substitute materials or [promote] changes in the process of construction," says Aron Zylberman, director of sustainability at Instituto Cyrela, the company's social investment arm.

Such client demands are combining with regulatory pressures to stimulate the growth of the supply chain for sustainable products. Two forthcoming laws – the National Climate Change Plan and the National Plan for Solid Waste – are expected to create new limits on states and municipalities for emissions of greenhouse gases and the amount of waste that goes into landfills. The construction industry and real estate are two of the most wasteful sectors, sending 80m tonnes of waste to landfill each year. "These are two major initiatives that will affect all businesses, including our sector," states Mr Zylberman.

In addition, central and local government incentives are encouraging the expansion of the sustainable market. Three municipalities – Guarulhos, São Carlos and Sorocaba, all located in São Paulo state – have introduced a so-called **IPTU verde (green property tax)**. This introduces a discount of up to 20% on the payment of a municipal tax for occupiers of buildings that include at least two sustainable criteria, such as solar-powered heating, rainwater capture and green roofing. The GBC Brasil is calling for this scheme to be extended out to all of Brazil's 5,565 municipalities.

The federal government has also introduced a discount on the IPI – the tariff factored into the sale of manufactured goods for more energy efficient products – which sees a reduction from 15% to 5% on the greenest products. There is also a proposal to roll out the IPI verde to manufacturers of products that comprise a minimum of 70% of recycled material.

LEED's popularity has been accompanied by the establishment a number of home-grown certification programmes including:

- **the AQUA scheme** from the Fundação Vanzolini, linked to the University of São Paulo (USP), which focuses on the entire project process;
- **Casa Selo Azul**, an initiative from the national bank Caixa Econômica Federal for the residential sector, which has so far recognised one scheme, Rôgga's Residencial Bonelli in Joinville, Santa Catarina for which Caixa provided R$8.34m in financing; and
- **PROCEL Edifica** from the federal government, which certifies the energy efficiency of products.

Such initiatives can have a significant, if intangible, impact on brand perception.

Mr Gava at Even, which is the only housebuilder to be listed in the corporate sustainability index Bovespa ISE, feels that there is anecdotal evidence to suggest that when presented with the choice consumers will opt for sustainable buildings.

"We sell a lot of apartments in relation to the competition, even though we're selling them at the same price and building in the same area," he argues.

Pioneering suppliers

Remaster: recycled flooring

One company that has been reaping the rewards of the incipient interest in sustainability is Remaster. It produces raised floors for office buildings out of 100% recycled polypropylene, allowing unseemly cables

LEED by example

Brazilian buildings applying for Leadership in Energy and Environmental Design certification

	No. of buildings	Area (million sq m)	Value of developments (R$bn)
2010	211	8.3	20.8
2011*	335	11	27.5

*Forecast

Source: Green Building Council Brasil

Tax breaks for sustainable products

Name	Detail
IPTU verde	Municipal tax reduced by up to one-fifth for buildings that fulfill two or more sustainability criteria
ITI verde	Reduction in ITI (consumer-goods tax) payable by manufacturers of energy efficient products. For the most efficient products, rate falls from 15% to 5%.

Sources: GBC Brasil

to pass hidden in cavities beneath floors.

From a factory in Bragança Paulista, on the outskirts of São Paulo, the firm has installed around 1.5m of such floor and cable packages since it launched in 2000 and now has a subsidiary in Medellín, Colombia. This year it is expecting to install a total of 200,000 sq m, generating predicted revenue growth of 43% to R$60m. Remaster has just signed an exclusive contract with Cyrela to include the Tec Garden brand in residential developments – which captures rainwater and uses it for irrigation in communal areas. Other key clients include the federal government, Odebrecht and Queiroz Galvão.

"As an SME it's impossible to get credit lines from the government, it's unjust and bureaucratic"

The business is entirely financed by the two partners, including a R$5m investment necessary for the construction of a new 4,000 sq m factory. "If I had [access to] money at a fair interest rate then I'd borrow more," says Paulo Vinícius Jubilut, Remaster's managing director. "As an SME it's impossible to get credit lines from the government, it's unjust and bureaucratic. If you want to borrow less than R$10m from the BNDES, it's through approved banks. Those banks don't have any incentive in resolving this because they have competing products that are more expensive."

Ecotelhado: green roofing

It is a similar story over at Porto Alegre-based Ecotelhado, which makes green roofs – products that lower a building's temperature and absorb rainwater through a layer of vegetation on the roof. Clients include Coca-Cola (KO:NYSE), Petrobras (PETR4:SAO) and CSN (CSNA3:SAO).

Director, João Feijó, has kept overheads down through working largely with outsourced personnel. He employs only 15 permanent staff who are mostly engaged in research and development. They have created patented modular designs, which are then planted by, and licensed to, third parties – many of them family businesses – and Mr Feijó says that since 2007, output has been growing at a rate of up to 100% per year.

The largest demand for the products is in the states of Rio de Janeiro and São Paulo, although the company has recently opened up franchises in Chile, Colombia and Mexico. "Our structure is not based on a centralised model: with two to three weeks' training, partners can replicate it," he says.

New product lines include eco-pavements, which can help to absorb rainwater and reduce the risk of flooding, "kangaroo wall gardens", which allow inhabitants of the buildings to grow vegetables on their walls in recycled plastic pouches, which Mr Feijó thinks will be of particular relevance to the fast-expanding low-income housing sector.

"We want to offer this to *Minha Casa Minha Vida* [the federal government low-income housing programme]. Often people who live in the low-income sector come from rural areas [with a history of growing their own food]," he explains.

However, the high interest rates mean that Mr Feijó has stopped taking out commerical loans and now resorts to his own capital to fuel expansion. "We're looking at new ideas [for] the expansion of the business," he comments, "[But] the culture is of high interest, when we have capital we try to reinvest it [rather than repaying interest]."

Randa: certified wood

Some businesses are turning to the external market for funding. Randa, a R$45m company with 420 employees based in Bituruna, Paraná, specialises in the production of doors, kits and plywood, all of which are FSC-certified, according to commercial director Marcelo Kochaki.

The firm currently produces around 30,000 doors per month and counts Even as one of its major clients. By January 2011, it hopes to be making around 80,000 doors per month. This is predicated on an R$10m investment in a new factory, in which all machines are computerised, compared with just 10% of the production line at present.

"There's a link between this development and the demand for sustainable development," says Mr Kochaki. "Many contractors are demanding sustainable material, we're preparing to meet their demand."

The funding for the new machinery is expectd to be entirely provided by the German export credit agency Hermes. It offered a 4.5% interest rate over five years and as the equipment was manufactured by a German firm – Homag – Randa got a 40% discount on its order through obtaining the finance with Hermes.

Randa does still use internal credit: it invested R$2m in additional equipment with funding from Bradesco and Banco do Brasil (BBAS3:SAO) and is also investing in managerial and leadership training.

Mr Kochaki still thinks that locally-based incen-

A trickle of financing

Credit lines for sustainable building

Lender	Eligibility	Funds available	Terms
BNDES	World Cup stadiums that fulfill sustainable criteria	R$4bn, with maximum of R$400m per project	6.9% annual interest, plus plus credit risk rate of 1% for public borrowers and variable for private borrowers.
BNDES	World Cup hotels that fulfill sustainable criteria. Minimum project value of R$3m in host cities and R$10m elsewhere.	R$1bn with R$343.7m committed to date	6.9%-8.8% annual interest plus credit risk rate. Tenor of up to 18 years
Caixa Econômica Federal	Retrofitting of commercial buildings with energy-efficient equipment	R$11m dispersed to date	2-60 months maturity, 6 month grace period. Rates vary between 1.29% and 1.92% per month

Sources: BNDES, CEF

tives for the sector are weak and that there is a lack of general awareness of the benefits of sustainable products. "It's necessary to change the culture. That can take two generations at least," he says.

Nanotech: insulating paints

Another sustainable product supplier that is looking outside Brazil is Santo André, São Paulo-based Nanotech, which makes paints with thermic and insulating properties for the marine, oil and gas and transport markets.

The business produced around three tonnes of paint last year for clients including Rolls Royce (RR:LSE), Telefónica and GlaxoSmithKline (GSK:LSE), with turnover of below R$10m. But new contracts with the likes of Siemens (SI:NYSE) and a pilot project with the São Paulo metro to paint 190km of tunnels in a bid to reduce sound pollution, promise future growth opportunities.

The business has been financed by a mixture of a capital injection from the chief executive José Faria, using the proceeds of the sale of another firm that he sold three years ago, and working capital facilities from Banco Bradesco (BBDC4:SAO) and Citibank. Nanotech pays 1.7% per month on Citibank loans.

"It's the best possible rate that we found, but [Citibank is] extremely selective," Mr Faria comments. Despite having a "good relationship" with Bradesco he thinks that the 3-5% monthly rate it offers him is "absurd".

"Until now money has come from the internal market but interest rates and inflation is very high, so it's more attractive going to the external market." Mr Faria says he is finalising his business plan this year and has the interest of "Canadian investors". What specific model of external investment he will go for depends on the needs of the business, he says.

Credit lines in short supply

While supply chain companies interviewed by Brazil Confidential reported dramatic increases in business, almost all of them complained about the shortage of loan finance. Rates of interest are unaffordably high and the commercial sector, quick to promote its green credentials elsewhere, has been slow to offer tailored products for the sector.

With the private sector largely absent, the main credit lines for the green sector come from the national economic and social development bank (BNDES) and the state-owned savings institution Caixa Econômica, together with a small number of federal government finance lines.

BNDES provides preferential rates for arenas and hotels for the 2014 World Cup that fulfil certain sustainability criteria. The bank has a budget of R$5.8bn in these two areas – R$4.8bn of which is available for the World Cup via the ProCopa Arenas line and the remaining R$1bn for hotels via ProCopa Turismo.

Developers of eight stadiums have applied for finance, representing a total of R$3.1bn, with half of the developers requesting the upper limit of R$400m. One – Rio de Janeiro state, which is backing the refurbishment of

MOVIMENTO TERRAS

Movimento Terras is intended to act as a blueprint for sustainable development elsewhere in Brazil

INSIGHT DESIGNING ECO-HOMES

The architect Sérgio Conde Caldas is creating opportunities for the green supply chain with his Movimento Terras eco-residential project. Located high up in the lush mountains of the Serrana region of Rio de Janeiro, this scheme, which is aiming for UK-based BREEAM certification, involves the construction of eight eco-homes in its first stage, with a view to doubling this number in the second stage.

Each of the units is to be sold at cost price of between R$900,000 and R$1m, as a result of discounts of up to 40% obtained from green suppliers, including glass manufacturer Guardian, ceramics company Portobello and Gerdau (GGBR4:SAO), which is providing recycled steel for the projects. Mr Caldas says the discounts were obtained because the companies see this as an opportunity to showcase new product lines.

"They think about the institutional visibility of the project," Mr Caldas says. He hopes that the scheme will provide a much-needed boost to a domestic market, which often loses out to foreign competition.

"We only looked at Brazilian [suppliers], it was hard for us. The supplies weren't there, we don't have so many environmentally-friendly products, but I think we're starting to improve that. Our project is very small but we're happy to see that we could [help suppliers] to be ready for the international market"

While non-profit, the venture is intended to act as a blueprint for sustainable development elsewhere in Brazil. Mr Caldas's firm of architects won a contract from Concal (which is run by his father, José Conde Caldas) to design 520 offices covering 26,000 sq m in the Rio de Janeiro neighbourhood of São Cristóvão.

But like much of the supply chain, he found a lack of attractive financing from the private sector for his eco-homes scheme. "I went to São Paulo to visit bank directors and showed them the project and they liked it. [But] when it came to the financials, they said we would have to talk to the marketing director and they put me in a hole. The private banks don't have different finance lines for ecological construction."

So instead he went to Caixa, whose response was positive. "On the first visit they said 'you're in'."

Caldas' firm is putting up 10% of the R$6.5m finance for the project, with the Caixa providing the remainder at a rate of 10.5% per year – a "good interest rate" in Caldas's eyes – to be paid in 240 monthly instalments with the amount to be paid dropping from R$8,000 in the first month to R$2,000 in the last months.

the Maracaná stadium – has been approved and a further two – the developers of the stadiums in Belo Horizonte and Natal – are currently being analysed by BNDES.

Interest on these facilities is at 6% per year plus 0.9% basic remuneration for BNDES and a credit risk rate of 1%. If funds are obtained via an agent, developers also have to factor in the price of commissions.

In order for the first tranche to be disbursed, developers must have a contract signed with an internationally-recognised environmental certification body or by the Brazilian national institute of metrology, normalisation and industrial quality (Inmetro) with a view to obtaining accreditation. This explains the relatively high number of stadiums – ten out of 12 – that are in the running for the USGBC's LEED certification.

However, delays in the schedule relating to a number of factors, including changes to Fifa demands, funding shortfalls and the lack of centralised management, have meant that the design and construction processes have been rushed in some cases in order to meet deadlines and as a result key sustainability criteria have been overlooked.

Maria Clara Coracini, executive director of GBC Brasil, admits that it is doubtful whether all ten arenas will achieve LEED rating. But she argues that the fact that the arenas had established LEED certification as an initial goal was a good step as they have "managed to reduce their [overall] environmental impact" as a result.

On the hotel front, BNDES has two programmes – ProCopa Turismo Hotel Sustentável, which finances sustainable project management and ProCopa Turismo Hotel Eficiência Energética, which focuses on energy efficiency. To qualify for the former, developers have to be certified by the system of sustainable management for hospitality – a Brazilian professional certification – and for the latter, equipment must have the highest energy efficiency level in the federal government's PROCEL Edifica system.

Both of these schemes respond to concerns in the hotels sector of short tenures and so have maturities of up to 18 years, among the highest offered by BNDES. SMEs pay a 6.9% interest rate and large businesses 8.8%, although the latter can be reduced if environmental certificates are presented. A risk spread is also factored in. As of June 2011, BNDES had R$343.7m committed under these two schemes.

Caixa Econômica Federal finances around 70% of all housing programmes in Brazil, which accounted for R$286.2bn between January 2009 and June 2011. It has supported sustainable practices by requiring all developments it funds to prove that the Brazilian wood they use is legally procured. It also subsidises solar water heating in 40,649 units with a total development value of R$1.72bn in the south, southeast and centre-west of Brazil as part of the *Minha Casa Minha Vida* programme. But specific credit lines for sustainable initiatives are thin on the ground.

It has just two products in this area and they are destined at the durable consumer-goods sector. It provides more favourable terms for businesses that wish to retrofit buildings to include more energy-efficient apparatus. Loans are for up to 100% of the value of the products and have a maturity of between two and 60 months, with a six-month grace period. Rates vary between 1.29% and 1.92% per month, compared with up to 80% financing at rates of between 1.56% and 1.96% for a traditional product. The total lent under this scheme is quite minimal though. Since it was launched in 2010, R$11m has been disbursed according to Sandra Quinto of the bank's national environment management unit.

Caixa finances around 70% of all housing programmes in Brazil, which accounted for R$286.2bn between Jan 2009 and Jun 2011

The federal government also has a number of other schemes that fund product innovation. For example, Portobello (PTBL3:SAO), a Santa Catarina-based ceramics company, financed part of a R$1.36m investment towards developing its new Extra Fino product line, as well as other products, through research body Finep.

Banco Santander (SANB4:SAO) is one of the private-sector banks that has managed to build a reputation in the sustainability field. Its subsidiary, Banco Real, was the first bank to acquire LEED certification for one of its branches in 2007 and the programme Santander Obra Sustentável recognises construction projects that adopt sustainable criteria. To date, seven projects have passed through this programme, developed by Goldsztein Cyrela, EcoEsfera, PDG Realty (PDGR3:SAO), Even, Cosil and Rodobens (RDNI3:SAO). However, Brazil Confidential is not aware of any specific financial incentives or credit lines for the sustainable sector from Santander, and the bank did not respond to a request for an interview.

A spokesperson at the IFC says that the institution had not yet got involved in the Brazilian sustainable construction market because "high liquidity in the market has not allowed us to identify projects where IFC could provide added value." The IFC is currently undertaking a project in Colombia engaging the public and private sectors on development of a sustainable construction code, which is intended to be replicated across the region.

Other bottlenecks

Leasing arrangements are another factor holding up more rapid development. So-called net leases, which pass on the cost of utilities, local taxes and condominium charges to tenants, discourage landlords from carrying out eco-retrofits because it is the occupiers rather than the landlords that will see the cost savings.

"If a landlord decides to retrofit the building, there won't be a benefit to them until they look at the lease renewal," says Mr Soares at Jones Lang LaSalle.

Another constraint is that the cost of sustainable building is artificially inflated by the fact that it is often only considered in a late stage of the construction process. Whereas the average cost of building sustainably costs between 2% and 7% more in Brazil, this can sometimes reach 10%.

"We're still at the higher end of this range because of the education of the whole supply chain," says Mr Soares. "As we start to see more institutional initiatives this will change." ■

ACTION POINTS

01 Growth of the construction sector, new federal legislation on greenhouse gas emissions and waste and the introduction of tax breaks means that recent rapid growth of the sustainable building sector should continue to see strong growth.

02 Specialist supply companies – such as Remaster, Ecotelhado, Randa and Nanotech – could use more capital and credit. Finance for the sector is dominated by BNDES and Caixa.

PRIVATE EQUITY: SERGIPE AWAITS FURTHER BOOSTS FROM PETROBRAS AND VALE

SUMMARY

> **Rising incomes in** Sergipe are spurring on cement, textiles and food producers. In some sectors, the high cost of freight limits competition from companies based in the south-east.

> **Oil production has** declined in recent years, but should rebound following offshore discoveries by Petrobras. The state government is investing oil royalties in infrastructure upgrades.

> **Vale and Canadian** miner Rio Verde are exploring potash sites in the Sergipe basin. Vale's Carnalita project will be the biggest potassium facility in the country, and is due to come online in 2014.

SEPLAG

Sergipe's consumer story is attracting multinational companies

Our state-by-state private equity series looks at the leading consumer and export businesses in Sergipe, including a one-time beer entrepreneur who is investing in long-life milk.

Sergipe – Brazil's smallest state – reflects two of the country's biggest themes: the fast growth of poor regions, and the impact of large commodity investments. The state's economy grew 10% last year, while the number of new jobs more than doubled to 23,800. Petrobras (PETR4:SAO) has made new oil and gas finds in the state, and Vale (VALE5:SAO) is planning to increase its presence with a new potash mine.

Sergipe is starting to catch multinationals' attention. Its second largest company, coffee and fruit juice producer Maratá, is said to be in talks with Sara Lee (SLE:NYSE) about a possible acquisition, although neither party will confirm the deal. If approved, the takeover could be the state's biggest – exceeding the 2007 acquisition of supermarket chain GBarbosa, Sergipe's largest company, by Chilean group Cencosud (CENCOSUD:SGO) for $430m (R$671m, £267m, €297m) including debt.

Maratá is also being pursued by three other companies, including Sara Lee's rival, NY-based food company, Bunge (BG:NYSE). "It's common for big companies to come to us for a partnership because we have a strong distribution in the north and north-east, and they're looking to expand their presence here," says Maratá's chief executive Frank Vieira.

A deal with Sara Lee, which is expected to total around R$1bn, would give the US company control of one of the group's seven factories in the city of Itaporanga d'Ajuda. Last year, coffee represented around 40% of Maratá's revenue, or some R$600m. According to Mr Vieira, the unlisted company is averaging 20% growth a year, with the biggest rise coming from new products, such as artificial sweeteners and fruit juice.

"To keep such a high growth rate we have to constantly invest in new equipment, enlarge our plants, and expand production," says Mr Vieira. By investing in its own transport fleet, Maratá has developed a strong regional distribution network, from small family retailers to large supermarket chains, such as Pão de Açúcar (PCAR3D:SAO) and GBarbosa.

Maratá is also focused on expansion, and is building a new factory and increasing its product range. It invested R$180m last year, of which R$100m came from its own capital and R$80m was lent by banks, such as the north-east development bank, BNB (BNBR4:SAO). According to Mr Vieira, the company will invest a further R$30m-40m in the second half of 2011. But it has ruled out a private equity investment.

Few of Sergipe's industrial players have warmed to the idea of private equity capital, with many sceptical of outside groups with little experience in the sector

"We don't like the philosophy of private equity firms. They buy part of your company and you end up working for them, then they sell off their share," Mr Vieira told Brazil Confidential. "We like partners that we believe can add value to our operation by creating synergy through the brand, and offer a longer-term investment."

From sugar to energy

Brazil Confidential found that few of Sergipe's industrial players have warmed to the idea of private equity capital, with many sceptical of outside groups with little experience in the sector.

One exception is Usina São José do Pinheiro (USJP) – a family-owned sugar, ethanol and renewable energy company. Its current managing director, Fernando Prado Franco, previously worked at São Paulo-based private equity firm Pátria Investimentos.

Last year, energy group Energias Renováveis (ERSA) approached USJP to partner on an investment in renewable energy from sugar cane. The offer was declined because USJP had already received R$35m financing from the BNB and the state bank of Sergipe (Banese). Yet Mr Franco says the company is open to similar deals in the future.

Sugar accounts for around 75% of USJP's revenue, with ethanol at 20% and renewable energy representing only 5%. However, the company is looking to increase its energy capacity from 3.5MW to 11MW per hour by 2012. That would bring its energy share up to around 10-15% of total revenue.

"Energy is a good investment for our free cash flow because it's very difficult to predict sugar prices," says Mr Franco. The company's margins suffered in 2008 and 2009 due to a drop in international sugar prices before picking up again last year. USJP's revenue was R$150m in 2010, up 36% from R$110m the previous year. That revenue will be reinvested in the company as USJP looks to expand its renewable energy business. It is also seeking a further R$15m for this purpose.

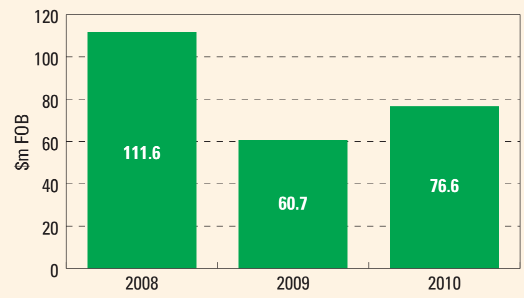
USJP hopes to capitalise on higher energy consumption in the north-east, whereas sugar has been less affected by the increase of per capita income. "If a person is receiving more money, they will not buy more sugar in the supermarket than they used to," notes Mr Franco. So USJP's best hope for increasing sugar sales is by taking advantage of its location. Its relative proximity to Europe, Asia and Africa has helped exports, which are around 20% of sugar sales. Meanwhile, in the north-eastern states of Bahia

Sergipe in figures

Population (2010)	2.1m
Share of national GDP (2007)	0.6%
GDP per capita (R$, 2007)	8,712
Minimum wage (R$)	545
Governor (party)	Marcelo Déda (PT)

Note: R$1=$0.64, £0.40, €0.44
Sources: IBGE, Sedetec, Brazil Confidential

Exports



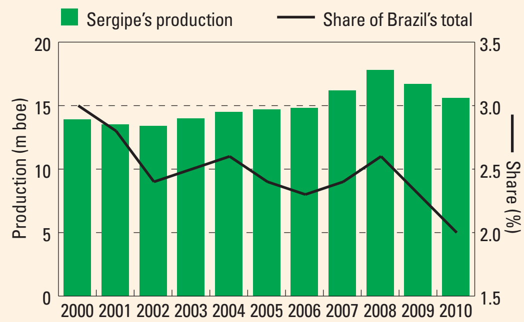
Source: MIDC

Top 5 exporting companies in 2010

	Exports ($m)	Share in total Sergipe exports (%)
Tropfruit Nordeste (citrus juices)	19.2	25.1
Maratá Sucos do Nordeste (citrus juices)	17.5	22.8
Calçados Hispana (footwear)	16.8	21.9
Usina São José do Pinheiro (sugar)	6.0	7.9
Fischer S.A. Comercio Industria E Agricultura (citrus juices)	5.5	7.2

Source: MIDC

Oil production



Source: MIDC

Recent greenfield FDI in Sergipe

Investor	Estimated investment ($m)	Activity	Announced
PetroVista Energy (US)	213	Oil and gas exploration	Dec-10
Crown Holdings (US)	640	Drinks can manufacturing	Mar-10

Source: fDi Intelligence

and Sergipe, the company has faced little competition from big players from the south-east – thanks to the high cost of freight. "We can't compete with the sugar companies in the south-east because they have soil advantages, but the freight costs and distance protects our market," explains Mr Franco. With 1m tonnes capacity, USJP is the largest sugar firm in Sergipe and a mid-sized player in the region.

Industrial growth

USJP also has the advantage of Sergipe's highly competitive tax incentive programme, which provides up to 92% off the value-added ICMS tax for ten years for companies that settle in the state, with the possibility of a five-year extension. The state government also sells land to companies at a cheaper price than the market value.

Such fiscal incentives have attracted a number of consumer-goods industries in recent years, such as beauty products maker Leite de Rosas and the Rio Grande do Sul shoe-manufacturer Dakota. Sergipe's agriculture sector is also expanding, and the real estate and cement industries are increasingly bullish.

Cement production grew by 14% last year, from 2.7m tonnes in 2009 to 3.1m tonnes in 2010. Much of this is being fuelled by a rise in demand for cement domestically, as construction surges across the country, and even more so in the north-east. Cement consumption in Sergipe grew 18% in 2010, and rose 22% in February 2011 compared to the same time last year, from 36,000 tonnes to 44,000 tonnes. Indeed, Sergipe, which is the largest cement producer in the north-east, registered zero cement exports for 2010, as cement makers such as Votorantim's Sergipe unit Cimesa focused on the north-east market. That represents a big change from the previous year when cement exports were second only to orange juice. In 2009, Sergipe exported more than $10m in cement clinker (the nodular material from which cement is made), representing 17% of exports that year.

Sergipe's agriculture sector is also expanding, and the real estate and cement industries are increasingly bullish

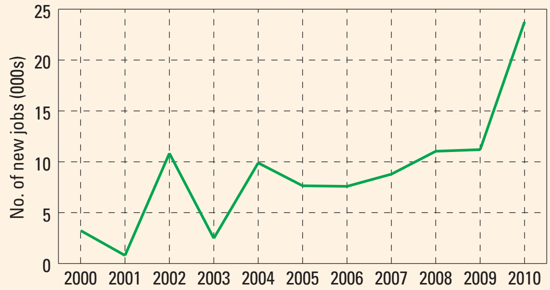
Textiles production – an industry stronghold in Sergipe – saw significant growth last year, but is now facing headwinds from the appreciation of the Real and rising cotton prices. According to Marcos Leite Franco Sobrinho, the director of one of Sergipe's largest textile manufacturers, Sergipe Industrial (SISA), local cotton prices peaked at R$7 per kilo in March this year, before falling to R$4.70 in June. That is still nearly double the price of cotton at the end of last year, when it was R$2.65 per kilo. As a result, Mr Franco is predicting only 6% growth in revenue in 2011. That comes after the firm reached 23% revenue growth in 2010, when SISA's income was R$160m, up from R$130m in 2009. The company is also facing increasing competition from China.

SISA produces bedding and bath towels, and is focused on the south-east market. But more recently, it is looking to expand its business in the north-east due to higher consumption in the region. The company is selling one of its three factories in Sergipe in the municipality of Riachuelo in a bid to reduce costs and increase production at its other factories. SISA invested R$10m last year in the expansion of its two remaining factories and the purchase of new equipment, half of which came from its own capital and the remainder from the BNB.

The sale of one of SISA's factories is also driven by high land prices in Sergipe, which have reached R$10 per square metre in the metropolitan region of the state. "The area where the factory is located has grown in value a lot, so the time is right to sell and invest in other areas of the business," notes Mr Franco.

Booming employment

New job creation in Sergipe

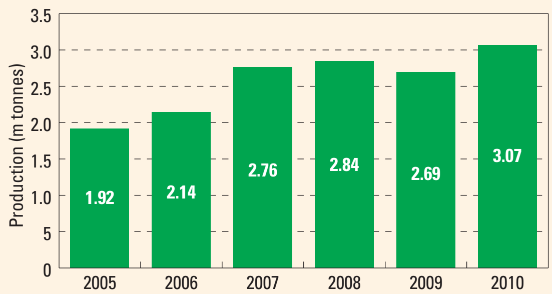


Source: MTE – RAIS/CAGED

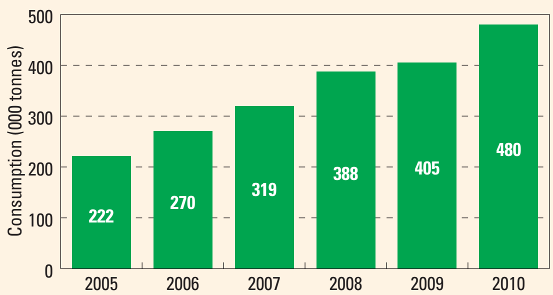
Cement on the rise

Sergipe cement production and consumption

Production



Consumption



Source: SNIC

Sergipe's real estate market is being buoyed by a rise in household per capita income that has attracted the Salvador-based land development company Max Renda, which is building the biggest urban residential complex in the state.

"We chose to build in Sergipe because we are targeting the advancing economies of the north-east, and Sergipe has one of the highest rates of per capita income in the region," notes the co-founder of Max Renda, Jerônimo Gramacho. The condominium – which is based in the municipality of Barra dos Coqueiros near the capital city of Aracaju – will house up to 50,000 people and includes a leisure centre, social club and other recreational facilities.

Sergipe is the fifth-largest oil producer in Brazil, with oil and gas production accounting for 8.8% of the state GDP

Max Renda is looking to raise up to R$120m for the project, and is in talks with a Canadian bank for a loan of C$30m, two Brazilian banks for R$5m-10m each, a US private equity fund for a further US$30m and two Brazilian private equity funds for an undecided amount. Mr Gramacho puts the minimum sales revenue from the lots at R$120m.

The complex is being developed under Max Renda's sustainable urban development brand, Reserva Adesol, and is aimed at Sergipe's emerging middle class and aspiring upper middle class. It is also strategically located to target oil and gas workers, since it is only 3km from the Sergipe port in Barra dos Coqueiros – which is used by national oil company Petrobras for its offshore oil exploration and production activities.

That will create a need for engineers in the region. Carlos Augusto Franco, founder of São Francisco Investimentos, an investment boutique focused on the north-east, estimates that Petrobras investments will attract at least 600 engineers to the region. This year alone, the oil company will spend R$1bn to develop its offshore oil fields.

Investing in infrastructure

Today Sergipe is the fifth-largest oil producer in Brazil, with oil and gas production accounting for 8.8% of the state GDP. Overall production peaked at 17.8m boe in 2008, falling to 15.6m boe in 2010. But a new discovery made by Petrobras earlier this month off the Sergipe coast is expected to boost production. At the same time, natural gas production rose by almost 30% during the period.

The state government has embarked on a number

INSIGHT
SERGIPE BUSINESS AT A GLANCE

Highlands (Alto Sertão Sergipano)

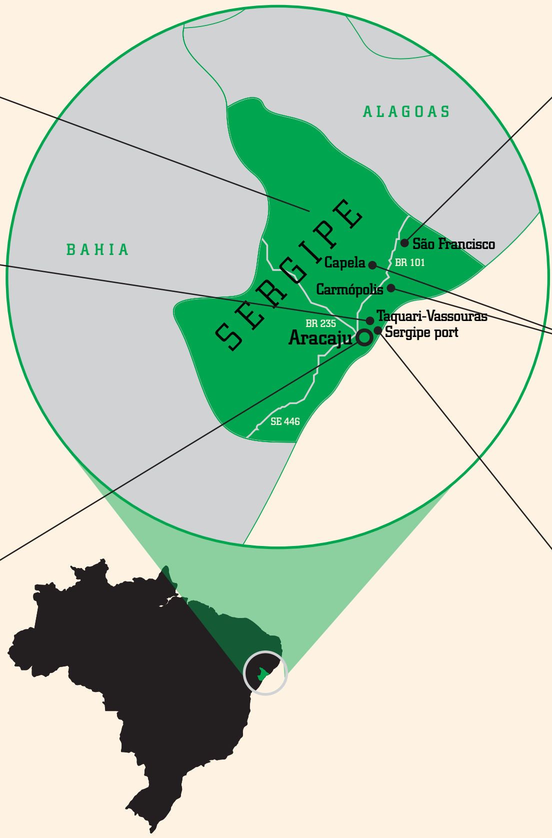
A livestock farming area, which is also strong in electricity generation.

Taquari-Vassouras

A mining area home to Vale's operations, and rich in potash, anhydrite, carnallite and other minerals. Canada's Rio Verde has started drilling for potash near the Taquari-Vassouras site, and Petrobras's active onshore oil wells are located here.

Aracaju

The area around the state capital is an oil and gas hub, as well as the centre for the bulk of the state's textile, food processing, sugar and ethanol, and real estate industries. The city of Nossa Senhora do Socorro – an industrial centre – is located here.



Lower São Francisco

The São Francisco river has made the region a centre for fruit irrigation, rice farming, and fishing. The area is also known for cement production, and has a growing ceramics industry.

East region (Leste Sergiplano)

Sugarcane production is concentrated in Capela, and the region is seeing growing renewable energy investment. Petrobras operates in Carmópolis.

Sergipe port

The Sergipe port is located 15km from the state capital Aracaju. Declared an EPZ in 2007, it is mainly used by Vale for its fertiliser operations. It's also the jumping-off point for Petrobras's activities.

of initiatives to develop the oil and gas supply sector, such as an R$8m investment in a training school for oil and gas technicians, according to the secretary of state for planning, budget and management, José de Oliveira Júnior. Last year, the state also approved a research and development programme, known as Inova-SE, to offer grants for innovative entrepreneurs through the government-funded Foundation to Support Research and Technological Innovation of the State of Sergipe, or Fapitec.

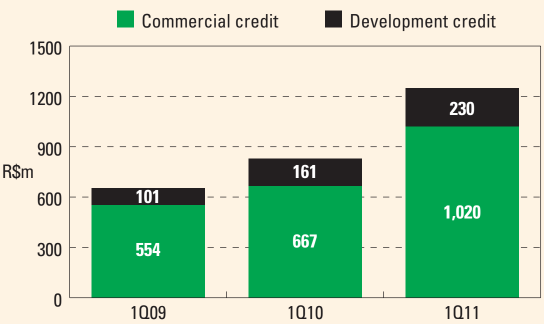
But despite these efforts, much of the market remains underdeveloped. "The development of the supply chain has been minimal. If you need something, you bring it from São Paulo," notes the state secretary of development in Sergipe, Zeca Silva.

One of the few local firms in the oil and gas sector is the Aracaju-based Engepet (Empresa de Engenharia de Petróleo/Petroleum Engineering Company), which develops technology for wellhead equipment and manages rig operations. The firm was formed in 2000 by a group of four former Petrobras engineers, and has supplied equipment and services for oil exploration and production in the Sergipe basin, Amazonas, Bahia and Petrobras's Colombia operations. In the first half of 2011, Engept received contracts totalling more than R$6.6m, with clients including oil companies OGX (OGXP3:SAO), Galp Energia (GALP:LIS), Starfish Oil & Gas and Petrobras. Today, Engepet is looking to expand the company and is seeking capital from Fapitec to do so.

The state government is also using the royalties from oil production – some R$106m in 2010 – for infrastructure works, such as the refurbishment of the BR101 highway. Another project is the renovation of two bridges that cross the Vaza Barris and Piauí rivers, with the latter expected to reduce the distance between Aracaju and Salvador by 70km.

The airport in Aracaju is also being expanded for an investment of R$240m. The engineering project is expected to be completed by September, and work is due to start in 2012. It is hoped the project will be ready in time for the 2014 World Cup – as the govern-

Lending by state bank Banese



Note: R$1=$0.64, £0.40, €0.44
Source: Company reports

SABE ALIMENTOS

A computer-generated image of Sabe Alimentos' milk products factory in Sergipe, which is under construction

INSIGHT SERGIPE'S MILK MARKET

Sergipe-born Ricardo Barreto Franco is no greenhorn in the food business. His father inherited a Coca-Cola bottling enterprise in Pernambuco in 1994 – and Mr Franco spearheaded its sale to The Coca-Cola Company (KO:NYSE) in 2001.

Five years later, Mr Franco's family launched the Indústria de Bebidas de Igarassu (IBI) brewery, which became known for its popular beer brand Nobel. But that too was sold in May 2007 – only a year after its launch – to the Schincariol beer company. "It was an opportunity and we monetised it," comments Mr Franco. "After that, we started looking for a new market."

Mr Franco founded a dairy company, Sabe Alimentos. So far, up to R$80m has been invested in the new company, most of it from the sale of the brewery to Schincariol and some R$30m from the Banco do Nordeste (BNB). The Sabe Alimentos factory – which is located in the municipality of Muribeca – is due to start production in four months, and will focus on supplying long-life milk and other milk products in Sergipe and the rest of the north-east. "Long-life milk consumption in the north-east is very low compared to the rest of Brazil, so we decided that this is where the opportunity is," says Mr Franco.

Milk production is growing in Sergipe – with 289m litres of milk produced in 2009, up 18% from 243m litres of milk the previous year. However, the small state accounts for only 8% of milk production in the north-east. Furthermore, the dairy market in the region is still underdeveloped, with companies such as Bom Gosto and Nestlé's (NESN:VTX) Brazil unit – both headquartered in São Paulo – making up the bulk of north-east milk sales.

"You don't have any first-tier dairy companies in the north-east – it's very behind in technology compared to the south and south-east, and the supply chain is completely disjointed," says Mr Franco. That has spurred Sabe Alimentos to focus its efforts on tackling the milk production chain. The company has a fleet of milk trucks, and is seeking contracts for milk production with small and medium-sized farms.

Sabe Alimentos has already signed around 100 contracts with farmers in Sergipe guaranteeing a quota of 350 or 700 litres of milk per day, depending on the size of the farm, and a further 100 contracts are being negotiated. The company is also supplying farmers with refrigerated milk storage tanks. "We intend to organise the entire milk supply chain from the farm to the consumer," says Mr Franco. "Quality is our main driver, but it is also our biggest challenge."

ment looks to increase tourism to Sergipe during the games. (For more on the problems facing Brazil's airports as they prepare for the games, see BC, Mar 31 2011, World Cup: too much spent, too little built.) Last year, 940,000 passengers came through Aracaju airport. For the first five months of 2011, the figure was 428,000 – a 17% year-on-year increase.

In recent years, Sergipe has improved its water distribution and sewage system. Up to 87.1% of households in the state had access to water in 2009, the second-best coverage in the north-east, behind Rio Grande do Norte. Last year, the World Bank's private sector arm, the International Financial Corporation (IFC), lent R$20m to the state water company Deso, and a further $117.1m is being loaned by the World Bank for a water management project in the municipalities of the Sergipe river basin.

However, infrastructure works such as the much-needed refurbishment and expansion of the Sergipe port have made little progress. "When the weather is bad the ships can't come into the port," notes Mr Franco of USJP. "That has made it cheaper for us to export by Salvador in Bahia than Sergipe, even with the high cost of freight."

Part of the problem is that there is little impetus to improve the port since exports make up only a small portion of the state GDP, and are now declining, thanks in part to the reduction in cement exports. Last year, exports accounted for only 0.39% of the GDP, at a value of $76.6m. That represents a drop of more than 30% from 2008, when exports reached $112m and accounted for 0.57% of the state GDP. Sergipe's largest exports in 2010 were orange juice at $34m and shoes at $15m.

In 2007, the port was declared an export processing zone, and today it is mostly used by Petrobras and mining company Vale, which produces potassium at its Taquari-Vassouras mine in the municipality of Rosário do Catete. Vale is also investing in the so-called Carnalita fertiliser project, which will mine carnallite rock (from which potash can be extracted) nearby the Taquari-Vassouras site. The project is expected to be the largest potassium extraction facility in Brazil, with an initial production of 1.2m metric tonnes per year of potassium chloride – which is used in fertiliser mix. It is due to start production in 2014.

Petrobras and Vale's investments are also attracting new players. "One of the most compelling reasons to be exploring in Sergipe is that there is already an existing potash mine, an environmental protocol, and the infrastructure is there," notes Stephen Keith, the chief executive of Canadian mining company Rio Verde Minerals, which last year started a potash exploration project in the state.

Rio Verde bought potash assets from the Toronto-based mining company Talon Metals (TLO:TOR) for 26.6m shares in the company – equivalent to a 44% stake. The deal gave Rio Verde more than 100,000 hectares of land in Sergipe, and in February, Rio Verde started drilling at the Serge basin, south-west of Vale's Taquari-Vassouras mine. The company expects to reach a decision on construction of a potash mine by 2014.

To finance the project, Rio Verde raised C$10m through two private transactions in December 2010 and January 2011. Of this amount, more than C$3m came from two Brazilian funds, which also contributed assets. Rio Verde has raised a further C$11m last month through an IPO on the Toronto stock exchange. The transaction will carry Rio Verde through the first 18-month phase of the project, but the final investment is expected to be in the billions of dollars. That has meant that the company is already probing for local partners, says Mr Keith. ■

ACTION POINTS

01 Coffee and juice producer Maratá, which has seen 20% annual growth, is said to be in talks with large foreign players. Its owning family would prefer an alliance to a straight buy-out – reflecting a common attitude in Sergipe.

02 The oil supply chain is limited, although Engepet, a wellhead and rig company, received R$6.6m of orders in 1H11. Property developer Max Renda is hoping to attract Petrobras engineers to its new development near the port.

Who's who in Sergipe

Organisation	Contact	Position	Telephone	Email
Banco do Nordeste	Fernando Passos	Superintendent of Financial Operations and Capital Markets	(+55) 85 3299 3022	fernandopassos@bnb.gov.br
Bank of Sergipe (Banese)	Saumíneo Nascimento	President	(+55) 79 3214 4556	–
Empresa de Engenharia de Petróleo (Engepet)	Homero Pessoa Pinto	Co-founder	(+55) 79 3246 2678	homero@engepet.com.br
Foundation for the Support of Research and Technological Innovation of the State of Sergipe (Fapitec)	Ricardo de Santana	President	(+55) 79 3259-3007	–
GBarbosa	Silvio Pedra Cruz Junior	President	(+55) 79 2107 4300	–
Maratá	Frank Vieira	Chief executive	(+55) 79 3264 2800	frank@marata.com.br
Max Renda	Jerônimo Gramacho	Co-founder	(+55) 71 3011 5528	jeronimo@maxrenda.com.br
Rio Verde Minerals	Stephen Keith	Chief executive	(+1) 416 368 1592	skeith@rvminerals.com
Sabe Alimentos	Ricardo Barreto Franco	President	(+55) 79 3225 3700	rfranco@geinvestimentos.com.br
São Francisco Investimentos	Carlos Augusto Franco	Founder	(+55) 79 8102 2188	carlos.franco@saofranciscoinvestimentos.com.br
Secretary of state for economic development and science and technology (Sedetec)	Zeca Silva	Secretary of state for development	(+55) 79 3218 1125	zeca.silva@governo.se.gov.br
Secretary of state for planning, budget and management	José de Oliveira Júnior	Secretary of state for planning, budget and management	(+55) 79 3226 2202	oliveira.junior@governo.se.gov.br
Sergipe Industrial (SISA)	Marcos Leite Franco Sobrinho	Director	(+55) 79 3218 9515	diretoria@sergipeindustrial.com.br

Source: Brazil Confidential

FUND MONITOR: REACTING TO A WEAK 1H11

SUMMARY

> **The Itaú Valor** Ações fund, which lost 13% in the 1H11, expects Chinese demand to boost Vale, while also looking for consumer-focused small caps.

> **The Argucia Income** fund has become wary of services stocks, due to labour inflation. Its best-performing stock in 2011 has been power distributor Eletropaulo.

Itaú's Valor Ações fund is sticking with Vale (VALE5:SAO), but looking for consumer-focused mid-caps, while Argucia's Income fund has pared down its services exposure.

Itaú Asset Management

Fund: Itaú Valor Ações FI
Fund type: Long-only
AUM: $199.6bn (R$311.6bn, £124.0bn, €138.0bn)
Fund AUM: $377m
Interviewed: Guilherme Rebouças Oliveira, portfolio manager

The Itaú Valor Ações FI has had a rocky first six months in 2011, down 13%. It is keeping faith with its biggest holding, Vale, but elsewhere it is looking for consumer-focused small and mid-cap companies, which portfolio manager Guilherme Rebouças Oliveira sees as an important source of alpha.

New stocks in the portfolio are Magazine Luiza (MGLU3:SAO), the household appliance retail chain, added in May after its $568m IPO in April, and property companies BR Brokers (BBRK3:SAO) and BR Properties (BRPR3:SAO), added in March and June respectively.

In the first half, Hering (LHER4:SAO) – a Brazilian clothing store that caters to social classes A to D – was the fund's best performing stock, returning 36.7% in dollar terms. However, as Hering now trades at higher multiples, the fund has reduced its holding from 6% to 3% of the portfolio.

The fund's second-best performer was Guararapes (GUAR3:SAO), a Brazilian clothing company that sells to the emerging middle-class and that has an integrated manufacturing and retail operations. The stock has a price/earnings ratio of 12 times for 2012, and makes up about 3% of the portfolio. It returned 12.2% in the first half of 2011 (again in dollar terms). Meanwhile, the worst performing position was Hypermarcas (HYPE3:SAO), the consumer goods company, down 29.6%.

Itaú Valor Ações takes a three-pronged approach at investing, says Mr Rebouças. First, it invests for the long term, holding most positions for at least a year. Second, it looks at companies' discounted cash flow and their price/earnings for the following year. And third, it focuses on those companies that capture Brazil's "mega-trends", such as commodities and the emerging middle class.

Mr Rebouças puts this year's poor performance down to the central bank's tightening measures, which undermined consumer and financial stocks. Consumer and financials are the two largest sectors in the Valor Ações's portfolio, making up around 30% and 20% respectively.

"It's complicated, but our solution is to look at our performance within the windows of three years," says Mr Rebouças, "We believe that there is a distortion in the short-term. So we just have to wait until the fund starts to pick up again." For the last twelve months as a whole, the fund is up 23.4%, thanks in part to Hering, Guararapes and shopping mall operator Aliansce (ALSC3:SAO).

Vale remains the fund's biggest position, representing 20% of holdings. "Even though Vale's stocks are down 6% this year, the Bovespa index is down 8.5%," says Mr Rebouças. "Chinese iron ore prices are flat and trading at historically high levels, so commodity prices have not been a negative issue for Vale. We believe that [new chief executive] Murilo Ferreira is a very strong name. Vale is trading at very low multiples and is one of our top picks."

Argucia Capital Management

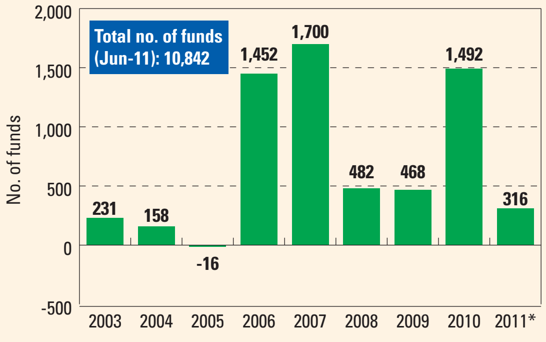
Fund: Argucia Income FIA
Fund type: Long-only
AUM: R$310m
Fund AUM: R$225m
Interviewed: Ricardo Magalhães, fund manager

The Argucia Income FIA fund is up 17% for the last 12 months, but down 4.6% in the first half of the year.

▶

Fund creation slows after 2010

Change in the number of asset management funds in Brazil



*As of end of May
Source: Economatica

Recent falls have been led by the services sector, with investors worrying about the impact of wage inflation on costs.

The fund's worst performing stock in the first half was Contax (CTAX4:SAO), Brazil's largest consumer care outsourcer, down 26.5%. A partner from Argucia is a board member at Contax. The services sector as a whole now represents 15% of Argucia Income's portfolio, down from 22% in December. This reduction in the services sector has given way to an increase in the financial holdings. The fund holds ordinary shares in Bradesco (BBDC4:SAO), with Mr Magalhães upbeat about continuing earnings growth.

The services sector as a whole now represents 15% of Argucia Income's portfolio, down from 22% in December

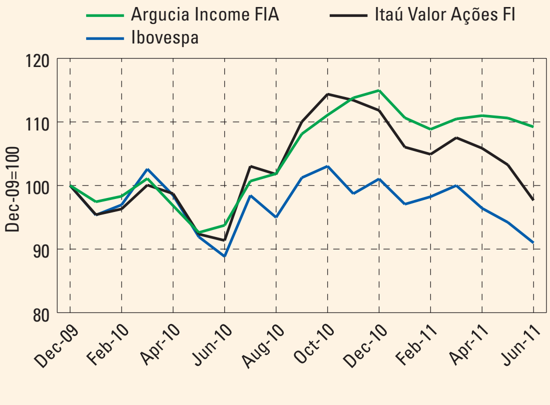
The second-worst performing stock was steelmaker CSN (CSNA3:SAO), which lost 24.1%, as competition from imports forced it to cut prices. Fund manager Ricardo Magalhães plans to hold the stock, arguing that CSN's iron ore operations should benefit from China's increasing demand for the mineral. "We believe that this company will unlock value with the mining element of the company since its iron-ore assets are some of the best in the world," he says.

The fund's best performing stock after the first half of 2011 is power distributor Eletropaulo (ELPL3:SAO). The stock, which Mr Magalhães bought back in November 2008 and currently makes up about 10% of the portfolio, rose from R$28.03 to R$33.86 in the first half of 2011. It went up to R$35.80 on July 4 on speculation that development bank BNDES would sell the 50% stake it owns in Eletropaulo through its equity arm BNDESPar.

Logistics makes up 7% of the portfolio, slightly less than at the beginning of the year. Mr Magalhães likes Tegma (TGMA3:SAO), a mid-cap logistics company that transports new vehicles throughout Brazil. That positions the stock, which trades around ten times 2012 earnings, as a play on emerging consumers.

Argucia stays ahead

Funds' performance since 2010



Source: Economatica

Brazilian funds ranked by performance

Funds averaging more than $100m in net assets, as of June 27

Name	Change in the past year (%)	Change in the past 2 years (%)	Avg. net assets in past year ($m)
Squadra Long Only FI Cotas de FIA	25.57 ▲	100.89	120.6
Squadra Long Biased FI Cotas de FIA	21.63 ▲	70.51	208.4
CSHG Beta 14 FIC FIA	21.13 ▲	53.44	504.3
Dynamo Cougar FIA	18.71 ▲	72.47	848.4
Bradesco FIA Small Cap Plus	18.68 ▲	61.16	182.3
Guepardo FIC FIA	18.55 ▲	68.07	111.2
Gap FIA	18.26 ▲	67.94	167.8
Bradesco Prime FICFIA Small Cap	16.91 ▲	56.38	112.6
Credit Suisse LS Premium FIQ FIA	16.08 ▲	45.30	125.9
BNP Paribas Long And Short FI Multimerca	15.45 ▲	29.23	200.9
Tarpon CSHG FIC FIA	15.24 ▲	89.86	198.9
Claritas LS FICFI Mult	15.17 ▲	42.44	171.4
Itaú Selecão Ações FI	14.77 ▲	73.63	263.9
Oceana Long Short FI Mult	14.50 ▲	29.02	179.7
BRZ Valor FIA	14.33 ▲	73.23	177.2
Itaú Personnalite Selecão Ações FICFI	14.32 ▲	72.28	248.0
Quest Equity Hedge FI Mult	14.08 ▲	35.83	224.6
Itaú Equity Hedge Advanced Mult FI	13.55 ▲	22.81	295.3
Itaú Personnalite Momento Ações FICFI	13.40 ▲	78.67	125.3
Quest Long Short 30 FI Mult	13.04 ▲	29.57	207.8
BNY Mellon ARX Income FIA	12.85 ▲	47.54	282.1
BBM Equity Hedge FICFI Mult	12.57 ▲	31.17	434.9
BRZ LS Advanced FICFI Mult	12.55 ▲	27.12	218.1
Vic Rv FIC FIA	12.30 ▲	51.44	134.4
BNY Mellon ARX FIA	12.20 ▲	62.38	303.6
Bradesco FIA Dividendos	11.91 ▲	33.95	251.6
Pollux Ações FIA	11.82 ▲	78.39	164.4
Argucia Income FIA	11.79 ▲	50.13	144.2
Itaú Equity Hedge Mult FI	11.73 ▲	24.06	254.4
BB Ações Dividendos FICFIA	11.48 ▲	33.19	486.3
Ip Part FIC FIA	11.32 ▲	63.46	126.0
Bradesco Prime FICFIA Dividendos	10.31 ▲	30.02	130.5
Long Brasil Ações FI	9.74 ▲	54.18	110.0
Bradesco FI Mult Long Short	9.42 ▲	17.80	109.0
Pollux Long Short FI Mult	8.11 ▲	24.69	182.3
Tempo Capital FIC FIA	7.88 ▲	30.18	399.8
Itaú Ações Dividendos FI	7.76 ▲	32.69	222.5
Patria Eq LS Fed I FICFI Mult	7.26 ▲	18.89	131.3
Mercatto Estrategia FIA	6.80 ▲	50.72	101.3
Quest Ações FIC FIA	6.49 ▲	44.03	187.0
BB Ações Multigestor Private FIC	6.33 ▲	39.83	136.3
Vinci Gas Lotus FIC de FIA	6.11 ▲	42.29	100.1
HG Top Ações FICFIA	5.90 ▲	38.16	100.5
Rio Bravo Fundamental FIA	5.45 ▲	46.31	224.4
BBM Valuation FIC FIA	5.39 ▲	58.91	202.0
Polo CSHG FICFI Ações	5.09 ▲	38.89	340.4
Santander FICFI Vale Plus Ações	4.06 ▲	43.88	106.1
BB Ações BB FI	3.74 ▲	37.15	108.5
Itaú Person Governanca Corp Ações FICFI	3.50 ▲	36.74	190.0
Santander FI Vale do Rio Doce BR Ações	3.42 ▲	44.53	317.7
BB Ações Vale do Rio Doce FI	2.83 ▲	42.63	885.3
HSBC FIA Vale do Rio Doce	2.15 ▲	42.57	156.6
Bradesco FIA Vale	2.13 ▲	41.67	460.8
Santander FI Ethical II Ações	2.10 ▲	34.61	205.2
Caixa FIA Vale do Rio Doce	1.63 ▲	40.89	780.0
Itaú Pers Ações Excelencia Social FICFI	1.01 ▲	31.39	122.4
Safra Vale do Rio Doce FIC Ações	0.87 ▲	38.49	155.0
Itaú Ações Vale FI	0.67 ▲	38.29	657.5
Unibanco Vale do Rio Doce FIA	0.58 ▲	38.12	142.4
Itaú Valor Ações FI	0.51 ▲	40.91	336.5
Itaú Personnalite Valor Ações FICFI	0.40 ▲	40.39	162.5
Santander FICFI Ethical Ações	-0.36 ▼	28.36	135.6
Xp Investor FIA	-0.93 ▼	51.29	135.9
HSBC FIA Valor	-2.13 ▼	30.03	150.1
Geracão FIA Programado	-4.41 ▼	19.56	469.9
BB Ações Ibrx Indexado FICFI	-5.53 ▼	9.95	155.8
Itaú Personnalite Ações Ibrx Ativo FICFI	-6.00 ▼	9.28	121.1
Itaú Ações FI	-6.00 ▼	9.10	529.4
Itaú Personnalite Ações Index Ibov FICFI	-6.83 ▼	15.75	148.3
Opportunity Logica II FIC FIA	-7.01 ▼	12.62	1349.6
Itaú Personnalite Ações Ibov Ativo FI	-7.44 ▼	10.50	177.0
Bradesco FICFIA	-7.49 ▼	11.74	286.7
Caixa FIA Ibovespa	-9.12 ▼	10.27	125.5
BB Ações Ibovespa Indexado FICFI	-10.16 ▼	8.02	150.9
Santander FICFI Petrobras Plus Ações	-16.78 ▼	-27.69	102.4
BB Ações Petrobras FIA	-18.03 ▼	-31.64	677.7
Santander FI Petrobras BR Ações	-18.75 ▼	-31.67	177.6
Caixa FIA Petrobras	-18.97 ▼	-33.70	620.6
Bradesco FIA Petrobras	-19.00 ▼	-33.77	302.9
Safra Petrobras FIC Ações	-19.69 ▼	-34.17	104.6
Itaú Ações Petrobras FI	-20.04 ▼	-35.60	449.8
BB Ações Siderurgia FICFI	-33.82 ▼	-16.80	100.7

Source: Economatica

STRUCTURING BRAZILIAN PRIVATE EQUITY

By Peter A. Furci, tax partner, Debevoise & Plimpton LLP, New York

Brazil is an increasingly popular destination for foreign private equity investment. Established Brazilian sponsors such as Gávea, GP and Patria have been joined by new Brazil-based managers such as Vinci and US-based sponsors including Carlyle.

Several factors have driven that interest, highlighted in the last few weeks by the closure of two $1bn-plus funds – one by Vinci, the other by Carlyle – focused on Brazil.

Economic growth, social change – including the rapid growth of Brazil's consumer classes – and a developed institutional framework surrounding private equity have been important. The relative maturity of the country's capital markets is viewed as allowing those pumping money into the sector to realise the value of their investments through IPOs.

However, Brazil's relatively high levels of inflation and rapidly appreciating currency – which has gained around 40% against the dollar in the last two and a half years – have given cause for concern for private equity players.

Last year, government moves to stem currency appreciation through the increase in the rate of tax on capital inflows also caused some alarm in the sector. The increased rate (6%, up from 2% earlier in the year) was meant to apply to speculative short-term investments, but also applied to private equity investments made through Investment Share Funds (known as FIPs). The FIP structure is widely used by private equity funds in Brazil and permits foreign investors to exit investments in Brazilian companies without paying capital gains taxes, so long as certain requirements are met.

Worries about the tax, known as the IOF, were significantly eased by the decision last December to reduce the rate applicable to FIP investments from 6% to 2%. That reduction was welcomed by investors, who generally do not view a 2% rate of tax as an obstacle to investing in Brazil, especially bearing in mind the attractive returns available in the country.

Despite this, inflation and currency appreciation remain issues for private equity investors. The appreciation of the Real – which last week traded at its highest level against the dollar since 1999 – has been a particular concern for foreigners investing in private equity funds, who generally express and fund their commitments in dollars. Meanwhile, with 12-month inflation around 6.5%, some investors are debating the appropriate "hurdle rate" – the typical return offered to investors in funds before carried interest is calculated – for Brazil-focused funds.

The terms of private equity funds are evolving in a way that reflects concerns over inflation and the Real

The continued financial torpor and low yields in developed economies and the relatively high level of overnight rates in Brazil mean that inflation and currency are likely to remain issues for the foreseeable future. Unsurprisingly, the terms of private equity funds are evolving in a way that reflects these concerns.

Currency movements can have an important impact on the returns available to the sponsors of and investors in private equity funds. If contributions and distributions under the "waterfall" – the private equity term which refers to the order of distribution of the proceeds from the sale of an investment – are typically measured in one currency whilst investments are typically denominated in another, distortions can be created. In these cases the carried interest – the share of profits (usually 20%) distributed to the sponsor – will be affected by exchange rate fluctuations between the time of acquisition and disposition of investments.

In a Brazilian-focused fund where contributions and distributions are measured in dollars, this means that the carried interest effectively contains a long position in Reais. Some investors feel that sponsors should not benefit from currency appreciation. Others worry that the possible devaluation of the Brazilian currency may make sponsors less likely to want to maximise portfolio returns. In response, a growing number of investors are asking fund managers to compute the carried interest by calculating both contributions and distributions in Reais, thereby reducing the impact of currency movements on sponsor incentives.

Inflation impacts fund structures differently. Fund investors usually receive a "hurdle" return on invested capital prior to the sponsor receiving their carried interest. However, investors have questioned whether the typical 8-9% hurdle rate seen in non-Brazilian focused funds should be adjusted to reflect the higher inflation in Brazil as compared to developed economies. Again, the concern relates to whether sponsors are being rewarded for investment performance as opposed to benefiting from inflationary value increases.

A number of variations have been seen to address this concern. A higher fixed rate could be used, or a fixed rate could be increased by a variable amount tied to the rate of inflation in Brazil (usually, above a target level) measured over the fund's term.

Investor enthusiasm for Brazilian private equity is set to continue. However, the strong Real and higher inflation mean the debate about funds terms and structures will remain lively. ■

The press has criticised the role of the development bank in the supermarkets proposal coming after official assurances that it would play a lesser role in the economy. Other themes include tax reform and the problems of the PMDB party.

BNDES: FAVOURING BIG PLAYERS

Editorial in O Estado de S. Paulo: Yet again, the state development bank BNDES is ready to set off on a dangerous adventure that is unjustifiable, unusual and against the public interest. The institution could invest up to R$4bn ($2.6bn, £1.6bn, €1.8bn) in the proposed merger between Pão de Açúcar (PCAR3D:SAO) and Carrefour (CA:PAR) [announced officially on Wednesday June 30].

The merger would allow Brazilian groups to sell more products abroad, BNDES said in a press release. That weak justification is almost as absurd as the reasons the bank has put forward for getting involved before, for example in the international expansion of meatpacking group JBS (JBSS3:SAO).

But there are new problems. If it goes ahead, the BNDES would pave the way for a merger that could damage consumers and lead to an anti-trust inquiry.

As a lender, BNDES has neglected many small and medium-sized businesses, preferring the bigger and least-needy borrowers, such as Petrobras (PETR4:SAO). Between January and April this year, big companies took 55% of the money it disbursed, even though those operations accounted for only 6% of the total.

The deal involves another risk as well. According to Casino (CO:PAR), the merger would violate an agreement made with Brazilian shareholders of Pão de Açúcar. Nothing justifies the involvement of a state bank and it is difficult to understand the interest of its bosses. Have they acted on their own account or were they obeying orders? A response from President Dilma Rousseff would be opportune.

CONFUSING PRIVATE AND PUBLIC INTERESTS

Editorial in O Estado de S. Paulo: "Public money hasn't been used," says Gleisi Hoffmann, the chief of staff, of BNDES's involvement in the proposed merger. But all the bank's resources are public, whether they come from the treasury, the labour support fund, international sources or profits.

Development minister Fernando Pimentel slipped up as well by criticising private banks for failing to offer support. According to this argument, the BNDES was simply playing a role that has been neglected by the private sector. This simply doesn't apply to many of the operations conducted by the BNDES in the last few years.

Moreover, it's not the government's role to look after the business interests of Abílio Diniz in his disputes with the Casino Group. That is strictly a private matter. The national interest is about preserving healthy competition in a sector that is hugely important for the welfare of the population.

AN INSULT TO THE INTELLIGENCE

Elio Gaspari in O Globo: Abílio Diniz, the presidency and Fernando Pimentel all insist that a Carrefour-PDA merger would be good because it would avoid the de-Brazilianisation of the retail sector. This is offensive to people's intelligence. The person who de-Brazilianised Pão de Açúcar was Mr Diniz, when he sold 36.9% of the company [to Casino], along with the promise of ceding control to the French next year. It is just that now he doesn't want to give up what he sold.

TAX REFORM: JUST POETIC LICENCE?

Mailson da Nóbrega, Felipe Salto and Rafael Cortez in Valor Econômico: Like the road to hell, the government's tax reform is paved with good intentions. One of its four aims is to unify the rate of the ICMS, Brazil's tax on added value. It would be better to create a Brazilian VAT, but this would involve complex negotiations with the states for which we are still not sufficiently mature politically.

The government's proposal on ICMS simply seeks to end the fiscal war between states. At present businesses in the south and south-east charge a 7% ICMS tax on all products "exported" to states in the north, north-east and centre-west. Goods travelling in the opposite direction pay a higher rate of 12%. The government aims to reduce the rate charged on all inter-state transactions to a flat 2% by 2016. The changes can be achieved simply by the senate approving an agreement between the states.

The government is leaving untouched some really knotty issues, including the rates for different products. But the biggest problem with the ICMS reform is the price the states will demand for supporting it. The states seem to have four demands: i) increases in the annual compensation paid to them for lost revenues as a result of the 1996 Kandir law (which exempted exports from ICMS) from $3bn-4bn to R$24bn; ii) a R$20bn regional development fund; iii) a new formula to index the debt they build up with the central government; and iv) a separate compensation fund for revenue lost as a result of the new changes.

Difficult, isn't it? As the governor of Sergipe has declared, "the government has a proposal to reform the ICMS. But to speak of tax reform is poetic licence." At the very least the ICMS reform will entail a tremendous fiscal cost, without contributing in any important way to simplify the system.

A NEW LEAF FOR THE PMDB?

Rosângela Bittar in Valor Econômico: The Brazilian Democratic Movement Party (PMDB) – the governing Workers' Party's main ally – is as fragmented as ever. But there is a new development. Two movements of PMDB parliamentarians have become stronger.

First, in the senate, the old guard may still be in control but an independent group has become much strengthened. Jarbas Vasconcelos (of Pernambuco), Pedro Simon (Rio Grande do Sul), Luiz Henrique (Santa Catarina) and other PMDB senators are seeking to improve the party's image. They aren't necessarily dissidents, nor are they all taking an independent stance in relation to the administration. But they do want to pull the party out of the gutter into which it has fallen through its blatant pursuit of self-interest. They want to be free from the pseudo-leadership of José Sarney, Renan Calheiros and Romero Juca.

A similar movement has emerged in the lower house, with 12 deputies aiming to break with the Rio de Janeiro deputy Eduardo Cunha. The group wants to get away from an approach that simply talks about power for power's sake.

KEY DATES

> July 7:
June IPCA inflation: Consumer price inflation, which fell to 0.47% MoM in May, should slow further.

> July 7-9:
ExpoFarma: The pharmaceutical fair takes place in the Expo Center Norte in São Paulo.

> July 12:
May retail sales: Sales grew 10.0% YoY in April, although they fell 0.2% MoM, the only decrease of 2011.

> July 13:
Cade/Brasil Foods: The anti-trust agency, the Cade, is due to rule on the Brasil Foods (BRFS3:SAO) merger. Commissioner Carlos Ragazzo has argued that the company's market dominance could push prices for some products up by around 40%.

> July 19-20:
Monetary policy committee meeting: The Copom has already raised the Selic rate four times this year, from 10.75% to 12.25%.

Recent data:

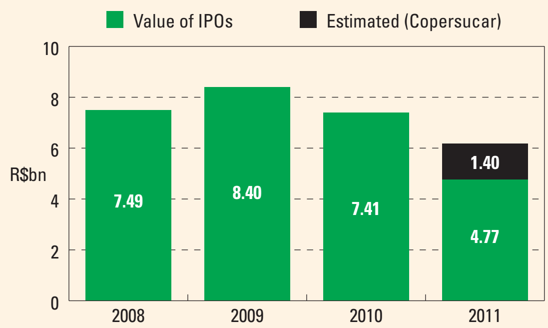
Industrial output increased 1.7% in May YoY and 1.3% MoM. April's YoY figure was revised up to -1.2%, from -2.1%. The preliminary figure for June's trade surplus was $4.4bn, the highest monthly figure so far this year.

Copersucar IPO:

The Bovespa's IPO scene has been downbeat, with many foreign investors unwilling to commit new funds to Brazilian stocks. It's "harder to get deals through" and it's "quasi-impossible" for untested companies to come to market, says Jean-Marc Etlin, investment banking vice-president at Itaú BBA. Copersucar – the well-established sugar and ethanol company, whose offering is being led by Itaú BBA – should be the biggest offering of the year so far. It is due to price on July 19, and could raise up to R$2.7bn including additional share sales, surpassing the R$1.5bn raised by oil and gas company QGep (QGEP3:SAO) in February.

Many offerings, underwhelming value

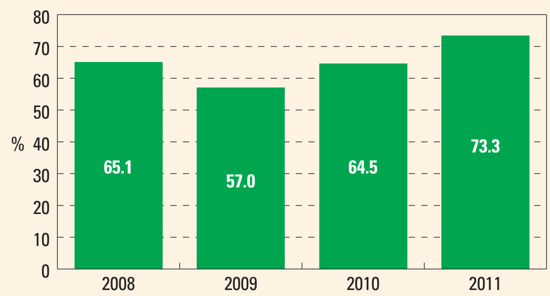
IPOs on Bovespa, January-to-August only



Source: Bovespa

Foreigners continue to take strain

Foreign investors' participation in Bovespa IPOs (weighted)



Note: 2011 figures exclude IPOs of Magazine Luiza and Perenco.
Source: Bovespa

RESOURCE BRAZIL: THE COMMODITY OUTLOOK

	2006	2007	2008	2009	2010	2011 forecast
Production						
Iron ore (m tonnes)	317.0	355.0	351.0	310.0	370*	450.0*
Soy complex (m tonnes)	55.0	58.4	60.0	57.2	68.7	74.99*
Chicken (m tonnes)	9.4	10.3	11.0	11.0	12.3	12.9*
Beef (m tonnes)	9.1	10.1	8.8	8.5	8.92*	9.2*
Sugarcane (for industrial use) (m tonnes)	387.4	425.5	495.7	569.0	623.9	642.0*
Orange production in São Paulo state (m 40.8kg boxes)	348.4	365.8	354.7	355.1	322.2	355.0*
Coffee (m 60kg bags)	42.5	36.1	46.0	39.5	48.1	43.5
Crude oil** (m barrels)	650.9	660.4	683.5	736.9	776.3	–
Corn (m tonnes)	42.5	51.4	58.7	51.0	56.1	56.3*
Exports						
Minerals and ores ($m)	9,757	12,026	18,727	14,453	30,839	38,000*
Oil and derivatives ($m)	13,005	16,042	23,047	14,947	23,348	–
Soy complex ($m)	9,283	11,323	17,986	17,240	17,216	22,067*
Meats ($m)	8,510	11,095	14,283	11,471	13,292	–
Sugar and cane ethanol ($m)	7,771	6,578	7,873	9,716	13,776	–
Paper and pulp^ ($m)	4,007	4,726	5,834	5,001	6,769	–
Coffee (in grain) ($m)	3,311	3,829	4,733	4,251	5,739	6,000-6,400*
Corn ($m)	481	1,918	1,405	1,302	2,215	–
Orange juice ($m)	1,043	1,543	1,997	1,619	1,775	–

*Estimate. **Figures for barrels of oil equivalent. Do not include Liquified Natural Gas. ^Brazilian Paper and Pulp Association (BRACELPA) forecast exports of $20 billion by 2020 on investments.
Sources: Brazilian Iron Ore and Base Metals Extraction Association (Sinferbase), US Geological Survey, National Mineral Production Department (DNPM), National Food Supply (CONAB), Brazilian Association Of Chicken Farmers (APINCO), Brazilian Census Bureau (IBGE), São Paulo State Agricultural Research Institute (IEA), National Petroleoum Agency (ANP), Brazilian Development, Trade and Industry Ministry, Brazilian Exporters Association (AEB), Brazilian Vegetable Oil Producers' Association (ABIOVE), Brazilian Paper and Pulp Association (BRACELPA), Brazilian Coffee Exporters Council (CECAFE)

BULLS AND BEARS

FORTNIGHTLY COMMENT ON THE TRENDS AMONG THE FORECASTERS

THE BANK RECOVERS SOME LOST CREDIBILITY

Inflation expectations are stabilising, as the authorities put renewed emphasis on interest rates.

The central bank has raised its forecast for credit growth to 15% this year, from 13% in March. But don't expect a new wave of macro-prudential measures to stem the flow. In the eyes of many, the last set of restrictions did its job, reducing loans for consumer purchases of cars and other items, and neither the authorities nor private-sector economists seem overly concerned by the recent uptick. After all, with such a strong labour market, it's no wonder banks are happy to lend to consumers via credit cards and overdrafts, argues Jankiel Santos of Espírito Santo Investment Bank.

Instead, the central bank is focused on using the Selic rate to control inflation. Its quarterly inflation report, published on June 30, was further evidence of the shift away from macro-prudential measures. Like recent minutes of the monetary-policy committee, it stated that small rate rises should continue for a "sufficiently prolonged" period. That hawkish tone has gone down well.

There's consensus that the Selic rate will be raised by 25bp on July 20, and a minority of forecasters also expect a further 25bp on August 31, taking the rate to 12.75%. The August decision will depend on whether upcoming data shows an economic slowdown, says Carlos Kawall, chief economist at Banco J. Safra. A few forecasters think the bank will go further, to 13%.

Other factors are working in favour of the central bank. As expected, headline inflation has calmed in recent weeks, reflecting seasonal factors and falling commodity prices. Mid-month IPCA inflation for June came in at 0.23%, and the end-of-month number, released on Thursday July 7, is expected to show price rises of around 0.05%. The consensus puts inflation around 6.15% this year, down from a median forecast of 6.37% in late April.

Inflation pessimists point to core prices. Excluding foods and fuel, mid-month inflation was 0.60% in June, up from 0.50% in May. So Tendências, a consultancy, has left its forecast for 2011 consumer inflation unchanged at 6.6%, with services inflation ending the year above 8%.

Indeed, there are good reasons to expect high services inflation to continue. Matheus Cavallari of hedge fund Claritas describes the slightly slower pace of job creation as a move from a "superheated" market to an "overheated" one. He believes unemployment will continue to fall, albeit marginally. With capacity utilisation at domestically-focused companies at near all-time highs, Claritas expects overall inflation of 6.3% this year. And the continuing strength of the Real can do little to slow non-tradeable inflation.

Perhaps more important, however, is how this plays out in 2012. Getting to the middle of the central bank's target (4.5%) would require a slump in the economy, probably induced by a global crisis, or a dramatic fall in commodity prices. The bank itself forecasts 4.8%, while the median private-sector forecast has returned to 5.10%, from 5.18%. Mr Kawall predicts 5%, which he says would be a "good result" for authorities. Mr Cavallari argues that the central bank will still tolerate higher inflation – nearer 5.5%. Indeed, he sees the risk of the central bank going soft too soon. The authorities' hawkish charm offensive has only been partially successful. ■

Monthly key indicators

	Mar-11	Apr-11	May-11	Jun-11
IPCA: Consumer price index (YoY % change)	6.29	6.51	6.55	–
IPA-DI: Wholesale price index (YoY % change)	13.8	13.3	10.3	–
Unemployment (%)	6.5	6.4	6.4	–
Total formal jobs created (000s)	92.7	272.2	252.1	–
Metropolitan formal jobs created (000s)	42.1	99.9	65.1	–
Retail sales (YoY % change)	4.0	10.0	–	–
Industrial output (YoY % change)	1.1	-0.3	1.7	–
Exports ($bn)	19.3	20.2	23.2	23.7
Export growth (YoY % change)	22.6	33.1	31.1	38.6
Imports ($bn)	17.7	18.3	19.7	19.3
Import growth (YoY % change)	17.8	31.9	38.1	30.0
Trade balance ($bn)	1.6	1.9	3.5	4.4
Current account balance ($bn)	-5.7	-3.5	-4.1	–
International reserves, Liquidity Concept ($bn)	317.1	328.1	333	–
FDI into Brazil ($bn)	6.8	5.5	4.0	–
Brazilian FDI overseas ($bn)	1.5	-1.2	1.6	–

Quarterly GDP

	Q110	Q210	Q310	Q410	Q111
Real GDP growth (YoY % change)	9.3	9.1	6.8	5.0	4.2

Equities

	5-Jul 11	2 wk prev	Change (%)	Change YTD (%)
Bovespa	63,038.81	61,423.61	2.6	-9.0
Petrobras	23.56	23.24	1.4	-13.7
Vale	46.33	43.65	6.1	-4.5

Currencies

	5-Jul-11	2 wk prev	Change (%)	Change YTD (%)
BRL per USD	1.57	1.59	-1.6	-5.7
BRL per EUR	2.26	2.29	-1.0	2.5

Government bonds

	5-Jul 11	2 wk prev	Change	Change YTD
Yield on 10-year USD-denominated bonds	4.06	4.17	-0.11	-0.56
Spread over US Treasuries	0.93	1.21	-0.27	-0.39

Yearly key indicators

	2008	2009	2010
Real GDP (% change)	5.2	-0.6	7.5
Industrial output (% change)	2.9	-7.2	10.5
Retail sales (% change)	9.1	5.9	10.9
Consumer price index (end-period; %)	5.9	4.3	5.9
Unemployment (%)	7.9	8.1	6.7
Total formal jobs created (000s)	1,452.2	995.1	2,524.7
Metropolitan formal jobs created (000s)	679.2	463.6	1,105.8
General Government Net Debt (% of GDP)	37.9	42.3	36.7
Trade balance ($bn)	24.8	25.3	20.3
FDI into Brazil ($bn)	45.0	25.9	48.5
Brazilian investment overseas ($bn)	-20.5	10.1	-11.5
Gross fixed investment (% real change)	13.6	10.4	22.5
Selic Rate (end of year; %)	13.8	8.8	10.8

Sources: IBGE, BCB, FGV/IBRE, IMF, Datastream, Bloomberg