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Investing for a world of change

Notes from the road: Brazil's corporate credit market

On-the-ground insights from leading companies in a fast-evolving economic landscape

POST CARD

From trade tariffs to government intervention, corporate bond issuers in Brazil face a shifting backdrop and careful bottom-up selection is becoming increasingly key. However, opportunities abound for active investors, not least in the field of green commodities.

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Introduction

Despite its well-developed nature – as outlined below – Brazil's corporate debt market is an increasingly diverse investment universe.

My recent field trip confirmed the importance of active selection in this market, especially in the context of dynamics that are reshaping the corporate landscape – grouped into four themes in this piece. It also supported our view that Brazil is home to some compelling long-term opportunities for global investors.

A key market for EM credit investors

The Brazilian corporate credit market is one of the largest in the world, and the biggest in Latin America. Within the JP Morgan CEMBI Broad Diversified Index (CEMBI), Brazilian corporates account for US$28 billion of the market capitalisation across 60 issuers from a wide variety of sectors.

Despite the various tailwinds boosting Brazil's economy – from rising offshore oil production to credible monetary policymaking, as noted by my colleague earlier this year – Brazil's corporate credit market has only delivered a slight outperformance of the broader EM corporate credit market (CEMBI) year to date. Yet within this, there is significant variation in the performance of Brazilian corporates, which highlights the need for a selective approach. As an illustration, the Brazilian industrial sector has returned c.9 % year-to-date to the end of August, while the domestic technology, media and telecoms (TMT) sector is down c.1.1% for the same period.[1]

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1. The Brazilian portion of the JPM CEMBI has outperformed the overall JPM CEMBI by +0.4% through the year-to-date to end 31 August 2024.

1 The varied impact of tariffs on corporate profitability

One particular issue that was raised by a number of companies, particularly commodity exporters, was the negative impact of subsidised manufacturing exports from China, with the steel industry a notable example.

Chinese steel producers have suffered from overcapacity following the collapse of the domestic property market, and government subsidies have allowed them to export rather than shutdown otherwise unprofitable overcapacity. This 'dumping' of cheap supply is clearly having a negative impact on the profitability of Brazil's local corporates, prompting calls for an increase in tariffs to reduce imports from China. However, Brazil's authorities appear reluctant to take any action that may put upward pressure on local inflation.

However, some companies have been more successful than others at pleading their case, with one example being petrochemical company Braskem. Tariffs on resin imports were cut from 20% to 12.6% in 2022 by then-President Bolsonaro, but this had a huge impact on Braskem's revenue when a cyclical downturn in the petrochemical sector occurred shortly thereafter. Braskem made a strong technical case that a reversion of tariffs to 20% would not result in an increase in cost for the consumer, and if implemented this would lead to a material improvement in profitability for Brazilian producers. Estimates from management are that the tariff change, even if partially passed through to consumers, would result in a meaningful increase in EBITDA and lead to a significant deleveraging at the company by over 1x turn. The company confirmed these estimates after the tariff reversion was announced by the Brazilian regulatory body in mid-September.

2 Cheap local financing is reshaping the market

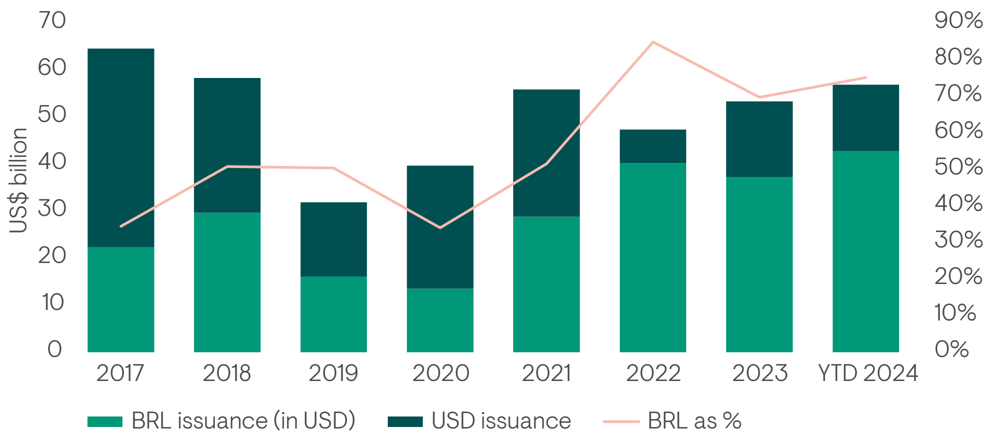
Another theme that emerged from my meetings in the country is that Brazil's local currency debt market is in high demand from local investors. Distress has largely been contained, with default rates remaining low outside of the retail sector, and this has boosted domestic demand.

Large, blue-chip companies have been able to get cheaper financing in local currency compared to global dollar markets on a FX-hedged (i.e. Brazilian real-equivalent) basis – local currency financing is estimated to be 40-50bps cheaper on average, with some corporates able to achieve a discount of 200bps or more.

As a result, US dollar-denominated issuance has fallen from over US$20 million per year in 2019-2021 to around US$10 million year to date, with Q4 expected to continue to be tepid at best. Consequently, we expect that companies issuing foreign debt in the primary market are likely to be increasingly bifurcated into two categories. The first is large companies with US dollar-denominated revenues looking for size or duration that local markets cannot absorb – a recent example includes the issue of a floating production storage and offloading (FPSO) business with a high-quality offtake contract with Petrobras, which has since performed well. The second group are potentially vulnerable companies that locals have been unwilling to fund, forcing them resort to issuing expensive US dollar-denominated debt.

This polarisation in credit quality of issuers emphasises the need for strong credit underwriting and selectivity when considering the new issue pipeline from Brazilian corporates.

Figure 1: Brazilian corporate and financials supply



Source: Ninety One, Bloomberg, September 2024.

3 Concerns around government intervention

Government intervention is not a new issue in Brazil. In a year of municipal elections, there has been growing concern among locals that President Lula da Silva's administration may once again look to apply political pressure, with state-owned oil company Petrobras considered a likely vehicle for this. Given Petrobras' huge market presence, it will be important to monitor the situation closely given the potential for second-order effects on other issuers in the sector.

With the government discussing a potential increase in its stake of both public and private companies in other key sectors, investors should seek to identify investment opportunities that are not reliant on domestic industries at risk of political interference, or those that could potentially benefit from the government's support.

4 The potential to be a sustainability hub

A confluence of factors has helped Brazil to establish itself as the world's largest and lowest cost sugar producer. Consequently, it is also the world's second largest and lowest cost ethanol producer, making Brazil a key producer of sustainable fuels, and with hydroelectricity representing a significant portion of Brazil's grid, Brazilian corporates benefit from a high share of sustainable power generation to power their activities.

Discussions with company management reaffirmed my view that Brazil has the potential to be the hub for the next generation of green commodities.

Raizen Fuels is an example of a company that looks set to benefit from this theme given its position as the largest cellulosic ethanol producer globally. Raizen's ethanol production via its cutting-edge E2G process (second generation ethanol made from sugar cane waste) has reached commercial scale, with its second plant opening earlier in 2024. Over the next four years, Raizen will scale up to producing nearly 700k cubic metres of E2G ethanol, all of which can be sold at a premium as a 100% green biofuel.

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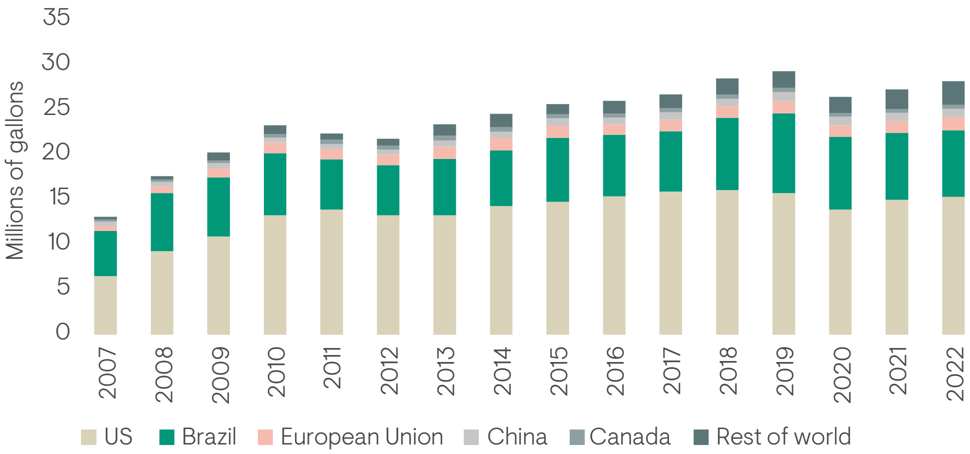
This is not a buy, sell or hold recommendation for any particular security.

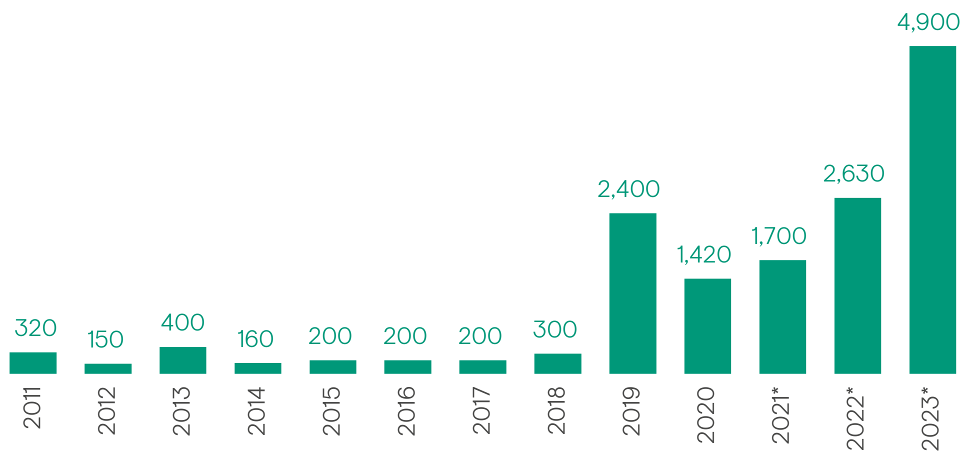
Figure 2: Brazil is a key producer of ethanol globally



Source: Renewable Fuels Association, January 2024.

A further theme that was discussed during this trip was the export of lithium – an essential component in batteries for electric vehicles (EVs).

Figure 3: Brazil's lithium production has surged



Source: US Geological Survey. *denotes an estimate.

Prior to 2022, exports of Brazilian lithium were restricted by regulations imposed in the late 1990s to protect the domestic nuclear power industry (lithium was used in the reactors). Post the removal of this regulation, mining companies have been able to increase exploration and lithium production has risen.

Crucially, lithium production costs in Brazil are highly competitive on the global stage – typically ranging between US$400-500/T compared to over US$700/T in other regions, and the quality of the ore in Brazil potentially avoids the need for chemicals and tailings that other methods rely on and can create environmental concerns for investors. For example, Brazil's South-Eastern state of Minas Gerais potentially offers one of the highest quality deposits of lithium ore on the planet.

The Brazilian lithium opportunity set currently represents one of the few possibilities for integration into global supply chains outside of China, and as such there is significant Western demand. We already see an opportunity in Brazil to finance the production of the greenest high-quality lithium for EVs.

Conclusion

As bottom-up fundamentally-based investors, field research and regular on-the-ground visits are a key element of our analysis and underwriting of investments. My recent visit to Brazil underscored the importance of understanding the dynamics of local markets when assessing the future prospects of domestic corporates. Current considerations vary from the impact of tariffs on the profitability of companies, the potential for government interference or support, and the demand for green commodities produced in the country in the context of global supply-chain shifts. There will be winners and losers, and a rigorous assessment of underlying fundamentals is imperative.

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