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Bancos do basis points

It is writ: Never reach for yield in a short-term credit instrument. Cash is cash, an investment is an investment and never the twain shall meet. That is, unless you, the qualified investor, need the income.

Short-dated, speculative-grade, U.S. dollar-denominated Brazilian corporate notes are the securities under the *Grant's* lens. They are not for everybody—for one thing, they come in minimum denominations of $100,000 and $150,000—but they could be for somebody.

To start with, the notes are rated junk because they can't be rated higher; they are tarred with the brush of the Brazilian state's double-B-minus rating (it constitutes a credit-quality ceiling for rated Brazilian financial-institution debt).

Dollar investors have only so many income options. The Bloomberg Barclays U.S. Corporate High Yield index comes with a 6.3% in yield to maturity, along with credit risk and duration risk. As to the latter, a 100 basis-point rise in rates would take the prices of the component bonds down by almost 4%.

The Bloomberg Barclays U.S. Corporate Investment Grade index, which yields 3.98% to maturity, or 111 basis points over Treasurys, likewise holds credit risk (a plethora of triple-Bs, junk bonds in waiting) and duration risk: a 100 basis-point rise in market yields would lop more than 7% off the prices of the indexed securities.

Which leads us to Brazilian short-duration dollar-pay notes from high-quality corporate issuers whose merits are obscured by the low-rated home government. This publication remains bearish on Brazil's currency (*Grant's*, Jan. 12), but the Great Green Country is in a strong position to pay its foreign creditors. Brazil holds international reserves of $382 billion versus $34 billion in external federal debt (1.8% of GDP) and another $35.5 billion for state and local governments and enterprises. It registered an average external account deficit of $55.5 billion in the past 10 years—the shortfall reached a high of $104 billion in 2014 but subsided to $10 billion in 2017.

The sovereign's dollar-denominated bonds due January 2021 yield just 88 basis points more than Treasurys. Better, we think, the short-dated paper of three prospering financial institutions. Creditors draw comfort from the law that holds officers, directors and managers of Brazilian financial institutions personally responsible for the solvency of the institutions they oversee (*Grant's*, April 2, 2010). The risk that one's net worth may be frozen—one's passport seized—pending the outcome of years-long court proceedings helps to instill an extra measure of care into the management style of Brazilian bankers.

"Consider, first," proposes colleague Fabiano Santin, "the awkwardly named B3 S.A.—Brasil, Bolsa, Balcão 5½s of July 2020 (rated Ba1/double-B-minus, $612 million outstanding). The bonds trade at 102½ to yield 4.3% to maturity, or 170 basis points over Treasurys, with a duration of two years. On March 31, cash and equivalents (net of collateral deposits) footed to $1.4 billion compared to total debt of $1.6 billion. Total debt stands at two times adjusted earnings before interest, tax, depreciation and amortization (EBITDA); there is $14 billion in equity market cap."

B3 has the effective monopoly on Brazil's securities trading and custody market. It furnishes the exchange, settlement and registration platforms for listed and over-the-counter equities, fixed-income and derivatives and bank-funding instruments. The company is the product of the 2017 merger between BM&FBOVESPA S.A. and CETIP S.A. Management says it aims to pay down transaction-related borrowings next year to the point at which the ratio of debt to adjusted EBITDA is sawed in half, to 1:1.

The merger makes a hash of year-over-year comparisons, but here are the figures (on a currency-neutral basis): free cash flow of $116 million in the first quarter, up from $75 million in the first quarter of 2017; net income of $90 million, up from $60 million in the same period of last year. The market projects that net income margin will top 50% this year.

"Another option," Santin proceeds, "is the Banco Bradesco S.A.'s 6¾s of September 2019 (rated double-B-minus, $750 million outstanding) quoted at 104 to yield 3.67% or 138 basis points over Treasurys. The bond is subordinated and the company may elect to defer interest and payment, but interest would accrue at an additional percentage point from the coupon."

Bradesco is the second-largest publicly owned retail bank in the country, the third-largest asset manager and the owner of the largest life-and-health and property-and-casualty insurance business with 25% market share.

Brazilian banks have historically enjoyed some of the fattest net interest margins in the world, according to the World Bank. They averaged 31% in the last decade, nearly 10 times the level achieved in Mexico, Canada and the United States. Returns on equity are commensurately high, even given the Brazilians' relatively low leverage. Nonperformers, too, are sizable, though well-covered.

Since 2007, Bradesco's ROE has averaged 21.5% (the low, 17.7%, was registered in the fourth quarter of 2012). Over the same stretch, nonperforming loans have averaged 4.9% of the loan book, topping 6.7% in the first quarter of 2017; 155% of NPLs is the average loan loss reserve for that bad debt. On March 31, Bradesco showed $370 billion in assets and $32.5 billion in common equity (valued at $57.6 billion by the stock market) above $6.2 billion in subordinated debt; the tier-1 ratio was 12.4%, compared with the minimum requirement of 8.4%.

"Option No. 3," Santin winds up, "is the Banco Daycoval S.A.'s 5¾s of March 2019 (rated double-B-minus, $500 million outstanding) that trades at 101¼ to yield 4.2% to maturity, or 194 basis points over Treasurys. The bank was founded in 1968 by members of the Dayan family. In June 2007, as the previous stock bubble inflated, the Dayans sold about 30% of their shares in the bank through an initial public offering for R$17 per share, or 2.5 times book value. As Brazil's stock market, represented by the Ibovespa index, headed towards its lows in January 2016, the Dayans were buying back the stock for R$9.08 per share, or 0.7 times book value.

"Banco Daycoval focuses on the middle market (two-thirds of loans outstanding) and payroll advances (personal loans secured by the borrower's wages or salary). On March 31, assets footed to $6.9 billion with a $4.2 billion loan book, $900 million in equity and a 16.1% tier-1 capital ratio. Nonperformers amounted to 3.3% of the loan book; they were 201% covered by loan loss reserve. ROE averaged 14.4% in the past decade with the worst result in 2013 at 10%. The return has since improved to 21.8% in the first quarter, higher than the 18.3% in the first quarter of 2017."

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