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SectorNote
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Getting to Know Brazil's Fin System

#5: Digging deeper into Brazilian companies' debt levels

Eduardo Rosman
Brazil – Banco BTG Pactual S.A.
eduardo.rosman@btgpactual.com
+55 11 3383 2772

Gustavo Lobo
Brazil – Banco BTG Pactual S.A.
gustavo.lobo@btgpactual.com
+55 11 3383 2516

Jose Luis Rizzardo
Brazil – Banco BTG Pactual S.A.
jose.rizzardo@btgpactual.com
+55 11 3383 2984

Central Bank report offers interesting insight into corporate debt levels

In report #5 of our "*Getting to Know Brazil's Financial System*" series, we discuss current debt levels of Brazilian companies and credit to SMEs. The abundant liquidity that predominated globally after the '08 financial crisis enabled companies, in general, to increase their leverage and improve their funding conditions. And in Brazil it was no different. With a vastly broader array of funding instruments (including much cheaper BNDES/earmarked lending), Brazilian companies' debt levels have tripled since June 2008. So, while the market usually focus more on monitoring household indebtedness in order to anticipate NPLs, we believe it is also crucial to track companies' leverage. In that sense, the latest Financial Stability Report (FSR), published this month by the Central Bank (CB), contains some fresh and very interesting data on the theme.

Corporate debt has tripled in Brazil since '08, but quality has also improved

In recent years, Brazilian companies' leverage has soared to 49% of GDP vs. 30% in 2008. While this jump may raise some eyebrows, the CB doesn't see it as cause for concern (at least not yet) since (i) leverage isn't high by international standards; (ii) with a bigger role from earmarked lending, companies have lengthened their debt and lowered the average interest rate paid; (iii) lower interest rate risk: earmarked rates have very low sensitivity to interest rate ups-and-downs; and (iv) FX risk mitigated: un-hedged exposure is very limited and the market no longer works with the exotic derivatives that caused a "problem" the last time the BRL depreciated significantly.

But loan growth profile has changed markedly, with SMEs losing a lot of room

While banking credit to large non-financial companies ("corporates") has been growing at double digits, SME loans have slowed sharply and are now growing only single digits (and below inflation). We see this as bad news as we consider the SME segment a good proxy for the performance of the overall economy. And in a still challenging macro environment (low GDP, high inflation/interest rates), banks are scaling back their SME exposure – including the smaller banks whose main focus used to be SME loans.

If rollover conditions worsen, SMEs' NPLs may pick up

Besides a weak economy, deteriorating confidence levels and lower credit demand should continue to strangle loan growth, which – with most private banks in risk-off mode – should remain under pressure. As a result, banks have, in general, been focusing their growth on credit lines with lower risks/stronger collateral. According to the CB, lower credit supply could affect the rollover conditions of SMEs' funding needs, which would ultimately drive up NPLs. To avoid the potential side-effects of lower credit supply, the FSR states that the CB acted preemptively. In August, it announced a set of pro-credit market measures aimed at "freeing up" some cash for banks and improving the rules of the collection of past-due loans. But our fear is what could happen to SMEs NPLs if the current economic weakness drags out for longer…

Companies are more indebted, but with better quality; sluggish SME portfolio growth looks set to continue

Brazil's Central Bank (CB) publishes its Financial Stability Report (FSR) twice a year. In addition to assessing the stability of the local financial system, it stress tests financial institutions and presents select granular system data, making it a useful resource for investors tracking the market. The CB published its 1H14 edition last week, prompting us to reinstate our "Getting to Know Brazil's Financial System" series.

In this report, the fifth in the series, we discuss the debt levels of Brazilian companies and credit to SMEs (small and mid-sized enterprises). Although the market tends to focus a lot more on monitoring household indebtedness, we believe it is also crucial to track companies' leverage - a theme on which the latest FSR offered fresh insights.

Brazilian companies have, today, access to a much broader array of funding instruments than in the past, and their leverage has increased in recent years (it has tripled since 2008). But as per the CB's report, indebtedness isn't high by international standards and debt profiles are improving, meaning there is no cause for concern.

Growth in loans (both corporate and individual) has been led by BNDES/earmarked (i.e. regulated) loans, which tend to have longer maturities and lower interest rates (regardless of ups and downs in the Selic rate). As a result, higher indebtedness has failed to translate into higher commitment of income to debt servicing (though it remains at a very high ~90%).

FX exposure also doesn't seem to be a big problem in Brazil (unlike other global markets). The bulk of FX exposure lies with exporters, companies with international and/or hedged operations, meaning that actual un-hedged exposure is very limited. The local market also no longer (at least much less than in the past) works with the exotic derivatives that caused a crash in some companies the last time the BRL depreciated significantly.

But while, from a broader perspective, companies' debt portfolios look healthy, the dynamics of large companies ("corporate") and SMEs differ materially: while corporate portfolios are growing double digits, SME loans are growing less than inflation. This situation reflects a combination of banks' risk-off mode and poor demand amid a weak economy, in our view, and deterioration in rollover conditions could represent another headwind, as per the FSR.

We have flagged in past reports that rollover conditions were/are, in our view, one of the main threats to NPLs (for companies and individuals), even more so than unemployment/income commitment, so it's interesting to see that the FSR also claims that rollover is a risk for SMEs.

On that front, the FSR affirms that in order to prevent rollover conditions from worsening, the CB implemented measures to improve credit supply. While clearly positive news, we believe it won't be able to help much if the economy and/or confidence levels fails to improve…

Companies are becoming more leveraged, but debt is higher-quality

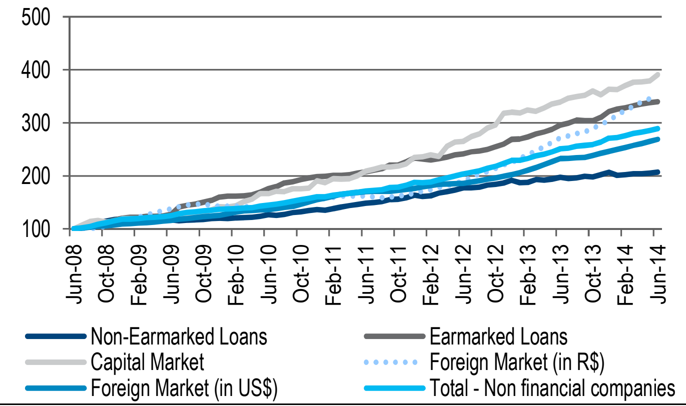
After the 2008 financial crisis, the international market saw sustained low interest rates and, after rounds of monetary easing, abundant liquidity in global financial markets. In general, companies took advantage of these more favorable financing conditions to increase leverage and improve their funding conditions.

Globally speaking, this movement has been raising some concerns about its possible impacts on financial stability. Indeed, the increase in indebtedness and reliance on international debt instruments usually leave companies more susceptible to swings in the economic environment.

With a broader array of funding instruments, Bz companies' debt have tripled since 2008

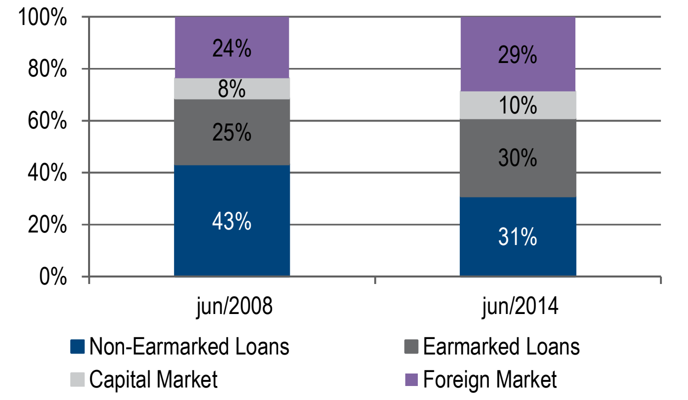
In Brazil, we saw a similar movement: the indebtedness of non-financial corporations tripled between 2008 and June/14. Unlike what occurred abroad, in Brazil, the increase in indebtedness was mainly due to earmarked/regulated banking loans, but non-earmarked/non-regulated banking loans remain the main source of funding.

Chart 1: Company indebtedness has been increasing in Brazil, especially in capital markets and earmarked loans…



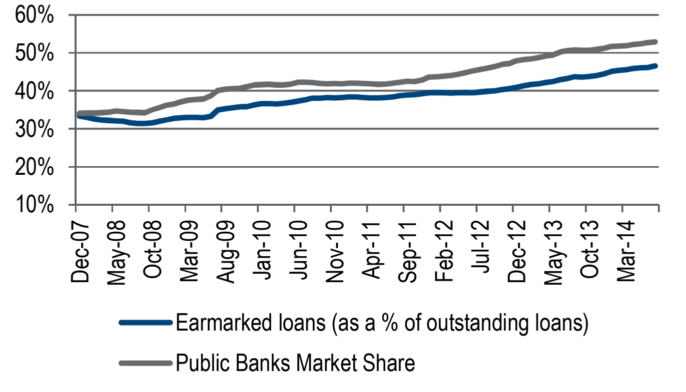
Source: Brazilian Central Bank and CETIP

Chart 2: …that now represents 30% of total vs. 25% in 2008



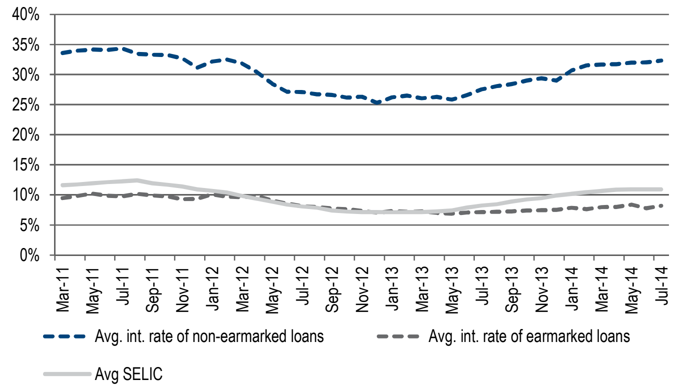
Source: Brazilian Central Bank and CETIP

Chart 3: Since 2008, credit growth in Brazil has been led by public banks and earmarked loans



Source: Central Bank

Chart 4: Interest rates charged in earmarked loans are much lower and less susceptible to changes in the SELIC rate than non-earmarked



Source: Central Bank

The difference is important because earmarked loans tend to have much lower spreads, though delinquency is also lower. Furthermore, the interest rates charged on such operations are less susceptible to the ups and downs of the SELIC rate.

All-in, the CB still believes that Brazil's financial system remains solid

In its Financial Stability Report (FSR), the Brazilian Central Bank assessed the potential risk of this surge in indebtedness in more detail. The CB still believes that Brazil's financial system remains solid and that, even in a hypothetical scenario assuming a deterioration on the international front, the possible risks from it would be controlled. Why? Because Brazilian companies (on average) are still working with:

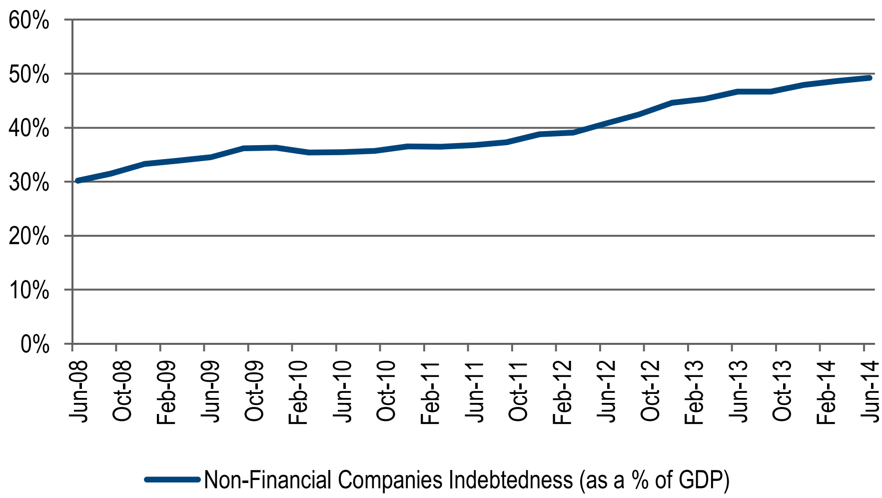
1. Comfortable leverage rates (despite the recent increase);
2. Stable debt service commitment levels; and
3. Proportionally low borrowing in international currencies.

Below, we discuss each of these topics in more detail:

1. Leverage: increasing but in line with peers

In the past few years, leverage at Brazilian companies (measured by the ratio of company loans to GDP) increased to 49.2% (vs. 30.2% in 2008). Although this jump might raise some eyebrows at first, the CB does not see it as a cause for concern (at least not yet). We flag that this measure takes into account not only banking credit, but also bonds and other instruments.

Chart 5: Company indebtedness as a % of GDP has been growing steadily



Source: Central Bank

According to the IMF, current leverage at Bz companies is around the median of emerging countries

According to the most recent Global Financial Stability Report, published by the IMF, this ratio is currently around the median of emerging countries, while the leverage ratio for Brazilian companies is below the median of developed countries. Hence, Brazilian companies don't seem to be overleveraged by international standards.

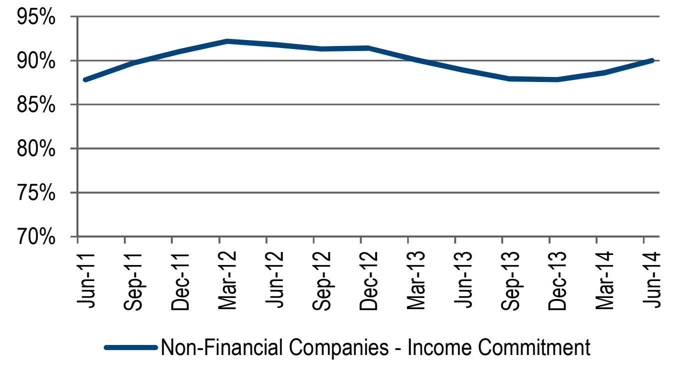
Note that for individuals the picture is similar: households are getting increasingly indebted, but by international standards, they still have a lot of headroom (mainly due to the low penetration of mortgages in Brazil) – *see chart 7 on next page*.

2. Income commitment to debt service: lower rates and longer maturities have allowed companies to leverage up

Despite the rise in the ratio of loans to GDP, the income commitment for Brazilian companies hasn't significantly changed – a reflection of the improvement in company debt profiles. With the increase in earmarked loans (lower spreads), businesses were able to lengthen their debt and lower the average interest rate charged. Thanks to this new debt profile, potential interest rate fluctuations should have a milder impact on the income commitment of Brazilian companies (though the ratio remains at a high ~90%).

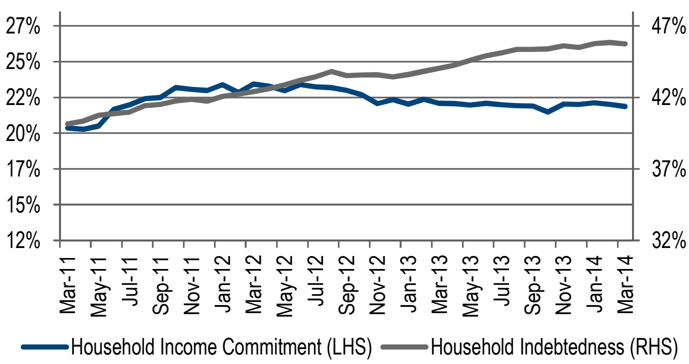
With a bigger role from earmarked lending, companies have lengthened their debt and lowered the average interest rate charged

Chart 6: The recent increase in the indebtedness ratio has not significantly changed income commitment from Brazilian companies



Source: Central Bank; *Companies' income commitment defined by the CB as the ratio between: debt service (comprised of the following debts: banking, securities issued in capital markets and foreign debt) and IBGE's gross operating surplus ("excedente operacional bruto"), as a proxy for companies' income.

Chart 7: For the sake of comparison, the same happened with Brazilian households



Source: Central Bank

Currently, almost 30% of loans to non-financial corporations are originated with earmarked loans and thus have regulated rates and indices and are less sensitive to interest rate movements.

The risk we see here is if earmarked loans start to decelerate, potentially leading to a decline in the average maturity and a jump in the average interest rate due to a mix effect. At this point, we don't see such risk materializing, but if it happens, some companies might have a hard time to make the transition…

3. FX Risk: un-hedged exposure is very limited

In the past few years, the array and complexity of debt instruments has broadened while debt instruments in other currencies have become more accessible to more companies. As a result, companies have increased their borrowing in foreign markets.

At first glance, this development could (once again) become cause for concern, since it would make Brazilian companies more vulnerable to FX variations. However, despite the recent increase, foreign debt represents roughly the same share of the pie of Brazilian companies' debt as before.

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What's more, the Central Bank highlights that one should also take into account other important factors when analyzing risks stemming from the increase in foreign currency debt:

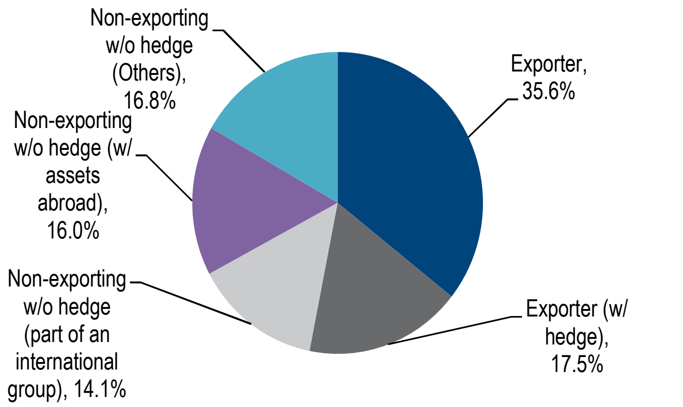
(i) Exporting companies usually have natural hedges to debt in foreign currencies;

(ii) Being part of an international group (based abroad) also reduces the risks, as it increases the possibility of intergroup financial support;

(iii) Owning assets abroad could offset possible losses; and

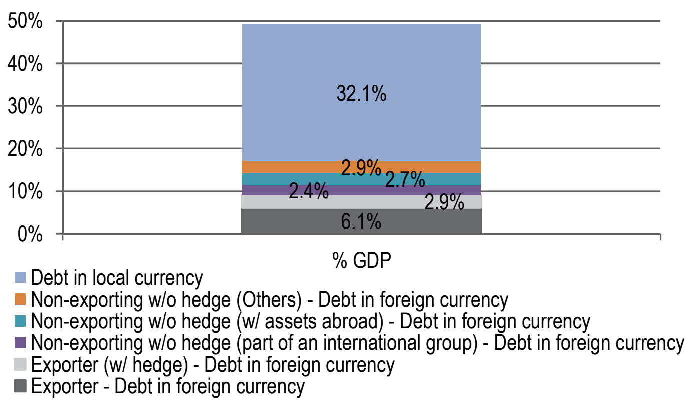
(iv) Businesses often have FX-hedge products.

Chart 8: Foreign debt by type of borrower



Source: Central Bank

Chart 9: Total company debt breakdown (as % of GDP)



Source: Central Bank

According to the CB, debt at companies that do not avail themselves of any of the factors above represents only ~5% of the total debt owed by Brazilian companies.

In short, exposure to debt in foreign currencies is very limited

In short, exposure to debt in foreign currencies is very limited. Many Brazilian companies have some kind of hedge, making the impact of a stress scenario on the FX front somewhat controllable.

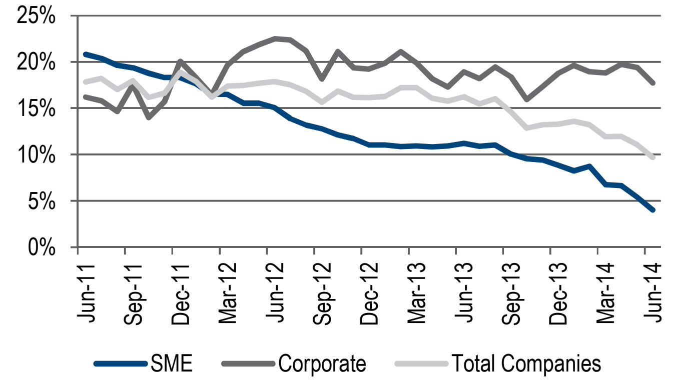
The only caveat, in our view, is the potential impact of derivatives (which were a major headwind in the 2008 crisis). However, we do not think that risk is significant. In our view, after the problems faced in the previous crisis – when large corporations nearly went bust due to a fast swing in the FX rate – banks/companies aren't as exposed to toxic derivatives.

The growth in loans to companies has been focused on the corporate segment – loans to SMEs remain lackluster

As shown above, in the last few years, loans to non-financial companies grew at a faster rate than Brazil's GDP (i.e. penetration increased). However, it is worth highlighting that growth rates are materially different across the various lines. While banking credit to large non-financial companies ("corporate") grew at a double-digit pace, loans to SMEs have been decelerating and are now growing at single-digit rates, below inflation (and thus losing share).

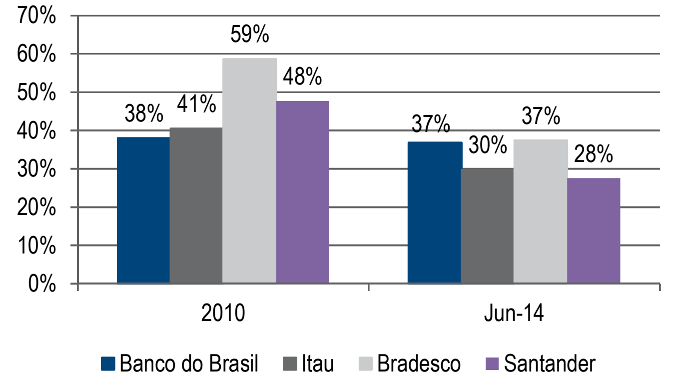
While banking credit to large non-financial companies grew at a double-digit pace, SME loans have slowed sharply

Chart 10: Loan growth (y/y) at non-financial companies was mainly led by corporate loans; SME is losing ground



Source: Central Bank

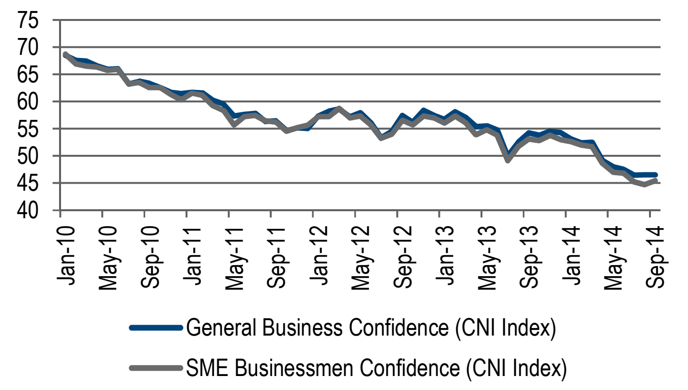
Chart 11: SME loans are losing share of loan portfolios at banks (SME loans as a % of companies' loan portfolio)*



Source: Company reports and BTG Pactual estimates; *Due to different criteria, ratios aren't 100% comparable between banks

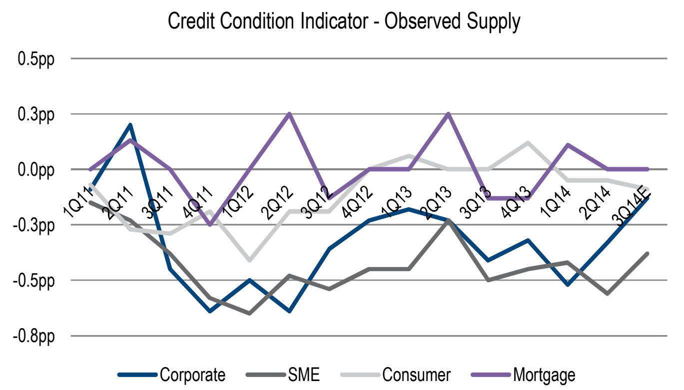
In our view, the performance of the SME segment is a good proxy for the performance of the economy. These companies are often the ones that benefit most when the economy is doing well and suffer most when things are not working out. In other words, they are the most cyclical – so it is clearly bad news to see SME lending losing ground…

Chart 12: Business confidence remains very low



Source: CNI

Chart 13: Banks are not keen on resuming growth in the SME segment



Source: Central Bank

Against the still challenging macro environment (low GDP growth, high inflation rates), Brazilian banks have been scaling back their exposure to the segment – including smaller banks that once focused primarily on SME loans.

Brazilian banks have been scaling back their exposure to the SME segment…

We don't see this shift reversing in the short term. Confidence levels are at historical lows, and the outcome of elections is uncertain, preventing an improvement in demand. What's more, on the supply side, banks are in risk-off mode, focusing on the corporate segment and raising the bar for SMEs (our view here). Indeed, the CB's latest credit survey showed that banks are not keen to resume growth to this segment.

...and we don't this shift reversing in the ST

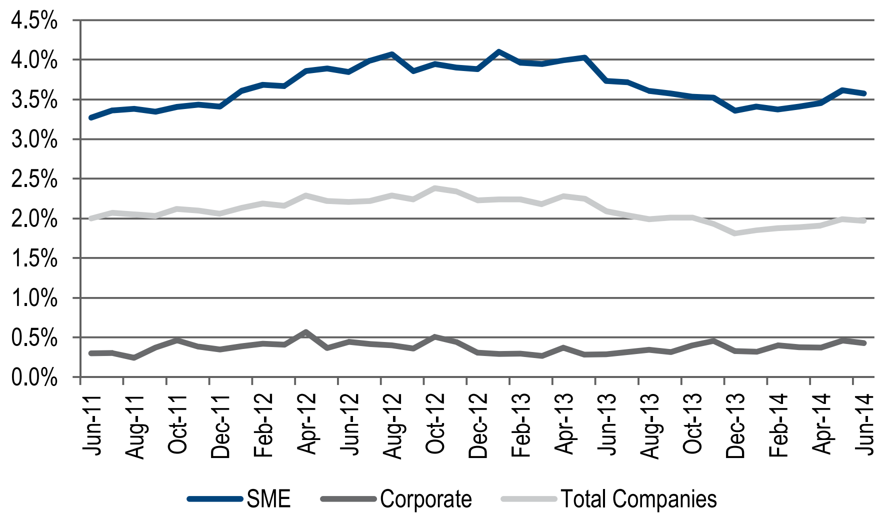
Not only are loans to SMEs decelerating, that portfolio is also vulnerable to a deterioration in rollover conditions, as per the FSR

In a previous report, we argued that the "rollover rate" was a main risk to NPLs, partly based on our macro team's model, in which rollover plays an important part in forecasting delinquency. And now in the FSR, the CB also flagged that "rollover conditions" are extremely important to the financial soundness of businesses (especially SMEs).

As per the CB, lower credit supply could affect the rollover conditions of SMEs' funding needs, which could ultimately drive up NPLs

According to the CB, a reduction in credit supply could hamper the rollover conditions of SMEs' funding needs, which would ultimately lead to an increase in delinquency ratios and represent a potential threat to those portfolios (where NPLs are already higher than for the corporate segment).

Chart 14: NPLs for SME portfolios are already higher than for the corporate segment



Source: Central Bank

To avoid the potential side effects of a reduction in credit supply, the FSR stated that the CB acted preemptively. Back in August, it announced a set of measures to stimulate the credit market that were aimed at both "freeing up" some cash for banks and improving the rules and processes to simplify the collection of past-due loans and streamline the execution of collateral.

Although we welcomed these measures, we believe they are only marginally positive. In our view, banks are not accelerating, due to: (i) their current risk appetite, which is not enough to resume growth in the current environment; and (ii) lack of demand amid stubbornly weak confidence levels. We believe that for most players these issues are much more relevant than any funding constraint.

That said, loans to SMEs have been decelerating – a reflection, in our view, of the current economic environment, in which (i) low investments by large companies are leading to poor demand for credit from SMEs and (ii) the risk-off mode at banks is translating into some supply constraints. A deterioration in market conditions (including rollover conditions) could lead to a further worsening of the prospects for this segment.

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Company Disclosures

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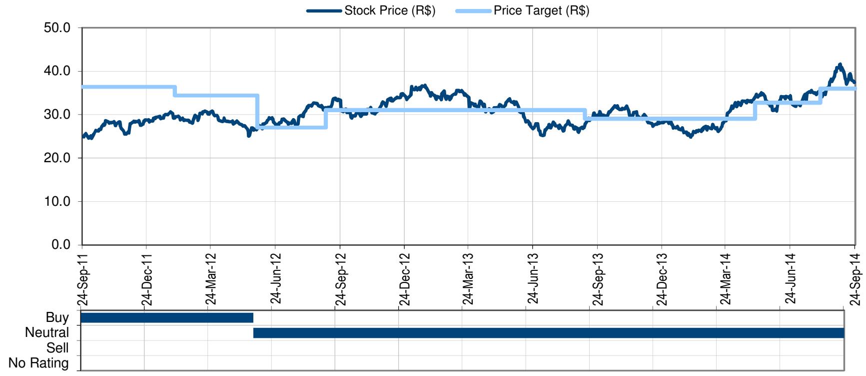

Source: BTG Pactual and Economatica. Prices as of 23 September 2014

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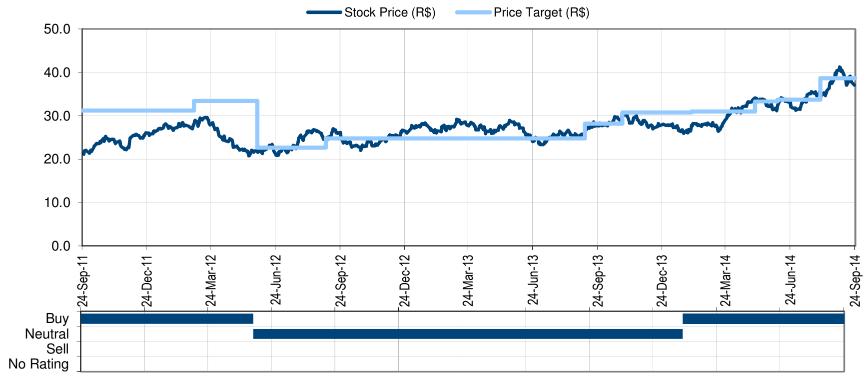

Source: BTG Pactual and Economatica. Prices as of 23 September 2014

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