Time to tune in: Latin American companies turn up the volume on global growth

Brazil highlights
About this report

Rapid-growth markets have largely been viewed and studied from the perspective of inbound investment by companies based in the West. Brazil highlights and the main global report of which it is a part, Time to tune in: Latin American companies turn up the volume on global growth, offer rare insights about the strategies of outbound investment from companies based in Latin America and provide in-depth perspectives on decision-making for companies from both mature and rapid-growth markets.

Brazil highlights draws upon a survey of 600 business executives based in Argentina, Brazil, Chile, Colombia, Mexico and Peru. The survey was conducted by Oxford Economics in November and December 2012. Among the respondents, 29% were from Brazil; 24% from Mexico; 13% each from Argentina, Chile and Colombia; and 10% from Peru. Among the companies surveyed, the reported annual revenues were: 25%, US$1 billion or more; 29%, US$250 million to US$500 million; and 46%, under US$250 million.

Brazil highlights is based on three sources of research: the survey results for Brazil (171 respondents), qualitative interviews with several Ernst & Young sector and country leaders, and the viewpoints of senior executives from companies based in Brazil. Oxford Economics provided analysis of current and predicted trade flows among Brazil and individual Latin American markets and between Brazil and the rest of the world.

Forecasting methodology

The bilateral sector export forecasts for the Latin American countries in the survey are underpinned by Oxford Economics’ Global Macroeconomic and Industry Models.

The Oxford Global Model covers 45 economies in detail, with the rest of the world economy covered in six trading blocs. Individual country models are fully linked through global assumptions about internationally traded goods and services, exchange rates, competitiveness, capital markets, interest rates and commodity prices. The forecasts for bilateral export flows are constructed as a function of final demand in each country, using input/output tables to estimate the share of domestic expenditure satisfied by imports. The forecasts for total export flows are then disaggregated by sector, using Oxford Economics’ industry forecasts to inform future demand and production trends.

The historical data on bilateral flows of merchandise exports was sourced from the UNComtrade database, which classifies sectors according to the Standard International Trade Classification (SITC) system. Historical data on exports of services was sourced from the International Monetary Fund (IMF).
Introduction

With growth still weak in most parts of the world and sluggish even in the key Asian growth markets, Latin America is looming larger now on the global business agenda.

Although the attention is new, most of the reasons for the resurgent interest are not. Abundant natural resources, growing consumer markets and a talented workforce have long made Latin American countries a destination of choice for mature-market multinationals. Beyond those advantages, another factor is making Latin markets even more attractive and more intimidating: the Latin American multinational.

This may be particularly true of Brazil, which has a growing roster of companies that have much more experience than their years in business might indicate. Over the years, Brazilian businesses have faced many challenges and crises: currency instability, policy uncertainties, tax issues, volatile interest rates and heavy competition. They’ve had to be innovative survivors.

Thanks in part to the Brazilian multinationals’ performance, turbocharged by a succession of business-friendly governments, no Latin country has seen its global reputation climb as far and as fast as Brazil, which in just 20 years has emerged on the world stage not only on account of its future promise but for its present capabilities.

Whereas even 10 years ago, a conversation with a foreigner about Brazil would have to do with where Brazil was going and what it was like to do business there, today the questions are more likely to turn on what Brazilian companies are going to do next. They are a growing force in global business.

This report focuses on these new champions: the rising cohort of strong and sophisticated Brazilian companies that is looking beyond the big Brazilian market toward opportunities elsewhere in Latin America and other rapid-growth markets and the developed world. It explores Brazilian companies’ increasing engagement with external markets, including their goals in growing their business abroad, the strategies they are using to expand and the challenges they face. Whether yours is a foreign company looking to partner with one of Brazil’s new champions or a Brazilian business looking for cross-border opportunities, we hope you find this report useful.

Jorge Menegassi
CEO
Ernst & Young Brazil & South America

Brazil highlights and Time to tune in: Latin American companies turn up the volume on global growth are part of Growing Beyond, our flagship program that explores how companies can grow faster by expanding into new markets, finding new ways to innovate and implementing new approaches to talent management.
Fast facts: Brazil

- Brazil is now the world’s sixth-largest economy, with a gross domestic product of US$2.47 trillion. Only the United States, China, Japan, Germany and France are larger. (“Brazil becomes sixth biggest economy,” Financial Times, 6 March 2012)

- Brazil’s domestic market is bigger than that of Mexico, Argentina, Colombia, Chile and Peru combined. (Oxford Economics)

- Fifty-three percent of Brazilians – 104 million – are now middle class. (Brazil Presidential Office of Strategic Affairs study, September 2012)

- Yet Brazil has some catching up to do. Its GDP per capita is US$10,299 in purchasing power parity terms, according to Oxford Economics, significantly less than that of Chile (US$16,019), Argentina (US$15,629) and Mexico (US$13,095).

- Brazil ranks in the bottom third on the Ernst & Young 2012 Globalization Index, which measures the top 60 countries by GDP in terms of their openness to trade capital flows, exchange of technology and ideas, labor movements, and cultural integration. (Looking beyond the obvious, Ernst & Young, 2012)

- Brazil is one of the most closed economies in the world, with merchandise trade accounting for less than 20% of GDP, compared with 62% for Chile and Mexico and 48% for Peru. (World Bank, World Development Indicators)

- Over the next 10 years, Brazilian trade flows are expected to rise by 50% to 100% or more, depending on the market. (Oxford Economics)

- Brazil’s auto market is the biggest in Latin America and the fourth biggest in the world. (Ernst & Young’s 2012 Brazil attractiveness survey)
Brazil is gaining a major position in the global economy. Seventy-eight percent of the respondents to Ernst & Young’s 2012 Brazil attractiveness survey (Capturing the momentum) named Brazil as the most attractive place in Latin America to set up business operations. And growth is expected to accelerate in Brazil over the next few years, propelling more Brazilian companies to invest abroad as they look for ways to leverage their experience and domestic profits. The results of the Ernst & Young 2013 Latin America outbound expansion survey and our qualitative research show that Brazilian companies are poised to gain international stature but are likely to face stiff challenges along the way. The following are our key findings:

- Like their counterparts in the rest of Latin America, Brazilian companies export or sell extensively to international markets both within and outside the Latin American region, although merchandise trade still accounts for only a low percentage of total GDP. Only 35% of our Brazilian respondents, however, have brick-and-mortar operations through direct investment in one or more markets outside Latin America.

- Fifty percent of our Brazilian respondents conduct most of their international business in North America, and 40% expect their best opportunities to come from this region in the next three years.

- Most of Brazilian companies’ international revenues (68%) are generated from rapid-growth markets.

- Not surprisingly, reaching new customers and increasing sales are the main reason Brazilian companies venture into new markets both within and outside Latin America.

- Brazilian firms’ top three concerns when selecting a new market are macroeconomic stability (69%), quality of infrastructure (56%) and political stability (51%).

Brazilian companies are poised to gain international stature but are likely to face stiff challenges along the way.

- Sixty-one percent of our respondents say that identifying reliable business partners is the biggest challenge for a Brazil-based company planning to expand internationally.

- A majority of Brazilian companies (66%) believe that making their boards more representative of global markets is the most important change they will need to make to succeed in new markets; second on the list is making their corporate culture more international (55%).

- Respondents cite sales and marketing (61%) and information technology (49%) as the functional areas that will require the most significant changes to ensure the success of their international expansion plans.
Business implications and recommendations

These opportunities and challenges require several strategic responses from Brazilian companies that wish to succeed in international markets. We recommend the following actions:

**Take advantage of national Government incentives.** One advantage for Brazilian companies looking to compete abroad is they already have a partner back home: the national Government not only tries to shelter Brazilian companies from foreign competition domestically but also gives some a helping hand overseas through such measures as extending help to the development of agreements that would foster this process,” says Tatiana Prazeres, Foreign Trade Secretary with Brazil’s Ministry of Development, Industry and Foreign Trade. “And there is support in terms of providing information for assisting these companies to go global” (see sidebar on page 13).

**Prepare for more stringent regulatory environments.** The application of regulations in international markets – particularly in the developed economies – may be more rigorous than what Brazilian companies are used to. “One of the barriers mentioned by clients who are expanding into developed markets like the US is that sometimes there’s a much stricter regulatory environment and de facto enforcement of standards, be they health, safety or environmental,” says Fiona Araujo, South America Advisory Accounts Leader at Ernst & Young Terco. Also the judicial process aimed at deterring violations of standards is often slow, drawn out and cumbersome,” Araujo says.

“What can take a few months in developed markets often takes years if not decades in Brazil.” The exception, Araujo points out, relates to labor matters in the country, which predominantly seek to protect workers. The courts do process cases relatively quickly, all too often not in the employers’ favor. Developed markets generally address such labor-related matters in a more balanced manner, which tends to be more equitable toward employers in comparison with Brazil.

**Pick and choose markets carefully.** Our respondents say that direct exporting will be their most important international expansion method in the next three years, but companies will need to analyze each market opportunity individually. For example, Brazil-based refractory materials producer Magnesita Refratários does not have a single overarching strategy for expansion. Otto Alexandre Levy Reis, Global Commercial Vice President of Steel, says the company doesn’t try to force the market to fit the strategy, but analyzes the market opportunity first, deciding on whether to form a partnership with a local company or make a direct investment (see sidebar on page 12).

**Explore the vast Chinese market – now.** China is already an enormously important trading partner for Brazil, and by 2021 it will be a larger market for Brazil than the US and Latin America combined. Therefore, given that bureaucratic formalities can be slow in China, Brazilian companies would be well advised to begin investigating the Chinese market immediately to position themselves for future growth opportunities.
Anticipate some cultural differences. Variations in corporate culture and work habits can sometimes make it difficult for Brazilian companies to expand abroad. But it’s important to try to bridge these differences, says Araujo. For instance, she explains, the Brazilian custom of engaging in social conversation before a business meeting might seem like “wasted” time to executives from other cultures, but it’s actually an important way to build trust and get to know one another. “It often translates into relationships, into rapport, and a number of other things.”

Develop an international outlook. For our respondents, making boards more representative of global markets and making their corporate culture more international are the two changes that they see as most essential going to require, I think, a very much more sophisticated generation of managers, and a much more internationally minded generation of managers,” says Paulo Bilyk, CIO and Co-founder of Rio Bravo, a leading hedge fund. “They will have to be better educated. They will have to speak other languages. They will have to be better managers.”

Strive to balance flexibility and structure. Brazilian managers tend to be highly versatile, according to Antonio Uras, an Advisory services partner for Ernst & Young in Brazil.

“Competitiveness and competition help the internationalization processes of companies as market trends reach a global scale, therefore creating the need for national enterprises to gain strength and become more competitive. In this scenario, it can be noticed that the Brazilian Government has created specific programs to encourage entrepreneurship and foment technological development, with the purpose of improving the competitiveness of Brazilian enterprises. As this is a one-way ticket, we hope these programs gain strength and create the necessary conditions for our enterprises to conquer their terrain in the market.”

Liliana Junqueira, Brazil Government and Public Sector Leader, Ernst & Young Terco

“ Brazilians are very used to scenarios that are very, very volatile,” he says. As a result, they have learned to be flexible and adapt quickly to changing circumstances, but this flexibility can be a drawback when expanding internationally. “The great challenge is how to develop the governance you need to work in a multinational world,” Uras says.

Flexibility is an advantage in an opportunistic expansion, says Marcus Schreiner, a senior manager for Ernst & Young in Brazil, but it creates challenges of its own when the company grows to a point where it needs more structure.
Brazil is the second-largest economy in the Americas and the sixth largest in the world; the Ernst & Young Rapid-Growth Markets Forecast (January 2013) predicts that it will become the fifth-largest economy by 2013. A multi-ethnic nation of more than 200 million people, it is rich in natural resources. Brazil has more successful multinational companies than any other Latin American country. Thirty-three of the Forbes Global 2000 are Brazilian, three times as many as Mexico (11), nine times as many as Colombia (4), and 11 times as many as Chile (3).

Brazil also has a compelling growth story. Although Brazil's growth slowed to 2.7% in 2012 (GDP growth in Brazil for 2012 was actually 1%), the country will experience some of the strongest growth in the Americas over the next four years: 3.9% in 2013, 4.9% in 2014, and more than 4% in 2015 and 2016, according to the Ernst & Young Rapid-Growth Markets Forecast.

Not surprisingly, many global companies are now looking to Brazil for growth. “Four years after a crisis that has shaken economies that are traditionally stronger, Brazil is one of the few countries with real growth prospects,” says Cledorvino Belini, Chairman of Fiat Brazil and Head of the National Association of Automobile Manufacturers (ANFIA). “As a market with potential for vehicle sales expansion, we lag behind only the US and China.” (Quoted in Ernst & Young's 2012 Brazil attractiveness survey)

Vast and vibrant, Brazil has a number of important advantages – all of which seem likely to grow in value over the rest of the decade:

**A major middle-class consumer market, 100 million strong – and counting.**
Between 2002 and 2012, median annual household income increased by an average of 2.4% a year in inflation-adjusted terms. (Brazil Presidential Office of Strategic Affairs)

**A young population and growing workforce.** Nearly a third of Brazil's population is under the age of 20. The total number of working-age people (15-64) is expected to grow by 15m by 2020, an increase of 11%. (Brazil Demographics Primer, Country Overview, Bank of America 2010; quoted in Ernst & Young 2010 attractiveness survey)

**A hot investment destination.** Foreign direct investment reached US$63 billion in 2011, according to our attractiveness survey, the highest level in five years.

**Diversified and plentiful sources of energy.** Brazil's energy supplies are unusually diversified, and nearly half are renewable (hydro-power and ethanol supplied 50% of Brazil's energy in 2010, according to the 2012 Country Analysis presented by the US Energy Information Administration). In addition, the recent discovery of vast deposits of offshore oil and gas may turn Brazil into an energy superpower over the next decade. The country also has extensive agricultural resources, with about 50 million hectares under cultivation today. This could be increased to as much as 400 million hectares, according to estimates of the international Food and Agriculture Organization – at which point Brazil would have twice the level under cultivation today in the United States. (“Brazilian agriculture: The Miracle of the cerrado,” The Economist, 26 August 2010)

**Growing international credibility.** By hosting a succession of high-profile global events over the next three years, Brazil will enhance its standing in the international arena. Major events include the FIFA Confederations Cup in 2013, the FIFA World Cup a year later, and, finally, the Olympic Games 2016 in Rio de Janeiro.
As with respondents from other Latin American countries, the overwhelming majority of Brazilian respondents to our survey told us they have exports or sales within Latin America. Over half have financial investments elsewhere in Latin America, and just under half have investments outside Latin America. North America — the US, Canada and Mexico — is a focus, though slightly less so than elsewhere in Latin America. Argentina, Brazil’s traditional sister market, is served by 47% of respondents (see Figure 1). Over the next three years, survey respondents expect the US and Canada will be their primary source of growth, followed by China.

South-South investment is another important focus. Brazilian construction companies, for instance, are doing well in Africa, and not only in former Portuguese colonies such as Angola and Mozambique but other markets as well, where not being a former colonial power and having a left-leaning government are viewed as positive, according to Antonio Uras, Advisory Partner at Ernst & Young Terco.

**Figure 1: Brazilian companies conduct most of their international business in North America**

*In which of the following countries and/or regions do you conduct a significant amount of business (excluding your company’s home country)? Select all that apply.*

<table>
<thead>
<tr>
<th>Country</th>
<th>Brazil</th>
<th>Latin America (excluding Brazil)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States or Canada</td>
<td>50</td>
<td>54</td>
</tr>
<tr>
<td>Argentina</td>
<td>27</td>
<td>47</td>
</tr>
<tr>
<td>Mexico</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>Latin America (excluding Brazil)</td>
<td>24</td>
<td>30</td>
</tr>
<tr>
<td>Chile</td>
<td>21</td>
<td>29</td>
</tr>
<tr>
<td>China</td>
<td>22</td>
<td>28</td>
</tr>
<tr>
<td>Western Europe</td>
<td>20</td>
<td>26</td>
</tr>
<tr>
<td>Colombia</td>
<td>19</td>
<td>26</td>
</tr>
<tr>
<td>Venezuela</td>
<td>18</td>
<td>15</td>
</tr>
<tr>
<td>Peru</td>
<td>16</td>
<td>17</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>11</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Ernst & Young 2013 Latin America outbound expansion survey
Base: Latin America = 600 (Brazil, 171); shown = percentage of respondents
But they are ready for the challenge of expanding into these markets. Flavio Kosminsky, Ernst & Young’s Business Development Leader for Brazilian-owned Groups, says that the biggest Brazilian companies are prepared for the global growth ahead. “I think Brazilian executives in Brazilian companies have a sense that they can manage foreign subsidiaries pretty well,” he says.

In the past, the world beyond Brazil was distant to most Brazilian businesses, which remained occupied with challenges at home. “Because it was a country that was emerging for so long, we didn’t have the self-confidence to see ourselves as global players in anything,” says Rio Bravo’s Paulo Bilyk. He adds that this legacy of insecurity still persists: “Brazilian industry is oftentimes scared of international competition and prefers ways to be protected. They would rather forgo exports if they could forbid imports or tax imports,” he says.

“Brazil was a closed economy for a very long time, and it was a very complex place to do business,” says Kosminsky. “There was a lot of regulatory and government interference and high inflation, and you could not rely on debt to grow because interest rates were very high.” But thanks to these conditions, he adds, “Brazilian executives became very, very well prepared to deal with adversarial environments.”

For the tough, hard-charging companies that top today’s league tables, the time might seem right to look beyond national borders. Indeed, the biggest companies in Brazil are all looking abroad, according to Fiona Araujo, South America Advisory Accounts Leader at Ernst & Young. “When we look at all the largest national Brazilian companies, I would say the top 20 are either already operating cross-border or actively looking at an international expansion or footprint.”

Oxford Economics predicts that between now and 2021, Brazilian regional goods and services exports will surge in virtually all of Brazil’s export markets (see map, “Brazil regional goods exports by US$b, 2011-21,” page 9). Most markets will see growth of between 50% and 100%, and some will grow even more. China will emerge as an exceptionally important trading partner and see trade nearly triple in value, from US$44 billion in 2011 to US$125 billion in 2021 — at which point, Oxford Economics analysts predict, it will be a larger market for Brazil than the US and Latin America combined. The three sectors experiencing the largest increases in volume will be metals, crude ex fuels and mineral fuels.

Our respondents, however, see assets other than commodity-driven sales as their most important contribution to the market. They view the quality of their workforce (62%), the ability to leverage technology (50%) and the competitiveness of their workforce (47%) as their strong suit.

Main expansion methods are direct exports, partnerships and joint ventures

When evaluating a new market, macroeconomic stability, infrastructure and political stability are Brazilians’ top concerns, to a greater degree than the Latin American average. Brazilians are more focused on the cost of capital as well.

André Ferreira, Brazil Strategic Growth Markets Leader, Ernst & Young Terco
Macroeconomic stability is the most important factor for Brazilian companies. A total of 69% of executives surveyed say it is the quality they care about most, a reflection perhaps of deep memories of past market turmoil in the 1980s and 1990s. This concern is followed by infrastructure (56%) and political stability (52%) – other concerns that make perfect sense for companies that have come of age in a country where neither attribute could be taken for granted (see Figure 3).

The cost of capital is also of slightly stronger interest (31%) than to other Latin American executives surveyed, a reflection perhaps of the high capital costs faced by Brazilian companies. Indeed, the United Nation’s report “Foreign Direct Investment in Latin America and the Caribbean” (June 2012) noted that in 2011 a total of US$21.163 billion in capital reaching Brazilian companies were loans channeled through foreign subsidiaries that had access to cheaper capital, an increase of 39% over 2010.

Figure 3: Companies consider macroeconomic stability first when targeting international markets

Which aspects of the business environment do you assess most carefully when targeting an international market for sales and investment? Select up to five.

- Macroeconomic stability
- Quality of infrastructure (roads, ports, electrical grid, telecommunications, etc.)
- Political stability
- Size of potential customer base
- Exchange rate stability
- Local trade barriers or protectionism
- Cost of capital
- Legal or regulatory environment
- Geographic proximity
- Tax policy and environment
- Access to sophisticated/educated workforce

Source: Ernst & Young 2013 Latin America outbound expansion survey
Base: Latin America = 600 (Brazil, 171); shown = percentage of respondents
Globally, Brazilian executives say, they plan on expanding through direct exports, partnerships with local suppliers, and joint ventures or acquisitions. Within Latin America, they are most likely to create an in-country distribution hub, export directly or look for an acquisition. “By buying companies you can get your business going much more quickly, and start generating returns on your investment much more quickly, than if you start a greenfield operation,” says Evaldo Dreher, CEO of Tigre Tubos, a Brazil-based company that provides building solutions for construction engineering applications. Tigre has acquired 15 companies in the last decade and a half, in Latin America and elsewhere.

“Our preference is for a takeover,” continues Dreher. “Because with a greenfield, when you go into a country, you have competitors who have already been in a strong position for a long time - when they know that there is a new company coming in, their strategy is to do everything they can to make it harder for us to do what we want. So the return on this kind of greenfield investment takes longer.”

But expansion, whether it is by acquisition or some other method, presents a unique set of challenges. Our Brazilian respondents worry about whether they can identify reliable business partners (61%), find the right blend of skills in their headquarters management team to handle the expansion (46%) and hire the right managers at the country level (44%) (see Figure 4). Also on their to-do list: building a board that is more representative of global markets, a more international corporate culture and less centralized decision-making (see Figure 5). They also feel that their sales and marketing teams, their IT systems and their risk management systems need to be improved if they are going to reach the next level (see Figure 6).

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**Figure 3:** Finding reliable business partners is the biggest challenge when expanding internationally

*Overall, what do you see as the biggest challenges for a Latin American company planning international expansion? Select up to three.*

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Brazil</th>
<th>Latin America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifying reliable business partners</td>
<td>54</td>
<td>61</td>
</tr>
<tr>
<td>Getting the right blend of skills</td>
<td>37</td>
<td>46</td>
</tr>
<tr>
<td>Getting the right managers at the</td>
<td>37</td>
<td>44</td>
</tr>
<tr>
<td>country level</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gaining detailed market understanding</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td>Integrating products and brands</td>
<td>28</td>
<td>25</td>
</tr>
<tr>
<td>Cultural compatibility</td>
<td>21</td>
<td>21</td>
</tr>
</tbody>
</table>

Source: Ernst & Young 2013 Latin America outbound expansion survey
Base: Latin America = 600 (Brazil, 171); shown = percentage of respondents

**Figure 4:** Making boards more representative of global markets is the most important change needed to expand successfully

*Which of the following changes will be most important for your business to succeed with its international expansion plans? Select up to three.*

<table>
<thead>
<tr>
<th>Change</th>
<th>Brazil</th>
<th>Latin America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Making our board more representative of global markets</td>
<td>55</td>
<td>66</td>
</tr>
<tr>
<td>Making our corporate culture more international</td>
<td>49</td>
<td>55</td>
</tr>
<tr>
<td>Decentralizing decision-making</td>
<td>36</td>
<td>30</td>
</tr>
<tr>
<td>Entering new market segments</td>
<td>33</td>
<td>35</td>
</tr>
<tr>
<td>Getting the right local partners</td>
<td>28</td>
<td>25</td>
</tr>
<tr>
<td>Developing new distribution channels</td>
<td>22</td>
<td>28</td>
</tr>
<tr>
<td>Strengthening corporate governance</td>
<td>21</td>
<td>17</td>
</tr>
<tr>
<td>Altering the value proposition for customers</td>
<td>17</td>
<td>22</td>
</tr>
<tr>
<td>Changing our organizational structure</td>
<td>13</td>
<td>13</td>
</tr>
</tbody>
</table>

Source: Ernst & Young 2013 Latin America outbound expansion survey
Base: Latin America = 600 (Brazil, 171); shown = percentage of respondents
“Brazil keeps a positive perspective for investments in the upcoming years. A more stable economic scenario, with a 'new nation of consumers,' and real interest rates at lowest levels ever create favorable conditions for long-term investments, where infrastructure is a bottleneck to country's development. For this, [the] Brazilian Government, including states and municipalities, has been promoting PPPs [private-public partnerships] and concession processes as one of the ways to booster our economic growth.”

Luiz Claudio Campos, Infrastructure Advisory Leader for Ernst & Young Terco

Attractive cross-border acquisitions are a key reason for leap into new markets

Although Brazilian companies’ destinations for cross-border expansion vary, “they’re all considering or already engaged in international activity, without exception,” Fiona Araujo says. A key reason for this is that for many Brazilian companies interested in pursuing an inorganic growth path, cross-border acquisition is often the only viable option. Many companies are beginning to find themselves constrained from growing at home because of antitrust considerations. Others think the prices are too high. “Acquisitions have become pretty expensive here in Brazil, so if you want to grow by acquisitions, you won’t find lots of good deals,” Kosminsky says.

But the outlook is brighter overseas. “The valuations of foreign companies are low by historical standards, which means you can leverage capital flows in Brazil to finance acquisitions and expansion abroad,” explains Antonio Uras, Advisory Partner, Ernst & Young Terco.

Careful targeting leads to better deals

Growing inorganically is not easy, particularly in a business as tough as the steel sector. But Magnesita Refratários, a Brazil-based holding company involved in the production and supply of refractory products, seems to have mastered the task, having grown to become a global player in just five years.

Magnesita doesn’t seem to have a single overarching strategy. For success, Otto Alexandre Levy Reis, the company’s Global Commercial Vice President of Steel, says the company doesn’t try to force the market to fit the strategy but analyzes the market opportunity first.

“We have to analyze the culture of the company and the opportunities. It could be through a distributor, it could be opening a new office or new offices, or establishing a partnership with a local producer,” he explains. “In some countries here in Latin America, we established a partnership with a local company; in others we opened an office. It depends really on the opportunity that we find in each country. For other regions, we are studying more and spending more time in the planning before putting in practice our movements outside Latin America. This means that on our planning phase now for these new markets we are spending double the time that we spent to expand for Latin America.”
Marco Stefanini, CEO of Stefanini IT Solutions, a global provider of IT services, says that for his business, mature markets tend to be the most lucrative because they're more inclined to buy services rather than hardware. The US, for instance, is a tough market, but the returns make the effort worthwhile. “It's not an easy market, but we can have a better return in that one country than in Latin America, where we spread our efforts in four, five or six different countries,” he explains.

The US has traditionally been an important destination for many Brazilian companies, Ernst & Young’s Fiona Araujo says, and remains so. However, as familiar as the US is for many of Brazil's business leaders, entry into the market is not always an easy jump. For one thing, products don't always travel well. “Multinationals that have been operating internationally are very good at this, but a lot of the big Brazilian multinationals are new at working on the global scene, and adapting products internationally is something many of them are learning,” Araujo says.

For another, regulations may be more burdensome than what they've seen before. “One of the barriers we’ve heard about from clients who are expanding into developed markets like the US is that sometimes there’s a much stricter regulatory environment and de facto enforcement of standards, be they health, safety or environmental standards,” Araujo says.

But that difficulty is also a motivation for entry into foreign markets. If Brazilian companies acquire “a company that is already doing business on the ground and has all the required licenses and is already operating locally, those are things that an outbound Brazilian company doesn’t need to go through,” Araujo explains. Buyers gain the “speed of getting to the market and being able to reach the consumer quickly with people that are on the ground and who know the local environment.”

For some companies, the strength of the internal market acts as a kind of obstacle to going abroad. Sidney Chameh, CEO of DGF Investimentos, a leading Brazilian private equity firm, isn’t in a rush. “We believe that we have a great market here in Brazil to explore and think that we have good opportunities that will generate good returns to our investors,” he says. “Although we foresee good returns on other Latin markets, we don’t believe it’s needed or it’s the time to go directly abroad.”

Make that a great market: Chameh estimates that small- and mid-cap companies may grow as much as 20% to 30% a year in the near term, and in every sector.

And he is not alone in his optimism. “A kind of barrier that stops more of our companies from going abroad is the strength of our internal market, because in the last eight years we gained more than 40 million consumers,” says Jorge Menegassi, CEO for Ernst & Young in Brazil.

The financial sector in particular is keeping its eyes focused on the prize right at home, according to Menegassi. “This is the main reason banks are not abroad -- if family consumption is growing at 4% to 5% each year, it doesn’t matter if GDP is growing at 1% to 2%. That still leaves banks with a lot of opportunities to explore,” he adds.

Public-private teamwork pays off

Private capital may sometimes be difficult to access in Brazil, but Government help is frequently available for Brazilian companies wishing to go global. Perhaps the most important assistance comes through direct investments in both debt and equity. Tatiana Prazeres, Foreign Trade Secretary at Brazil’s Ministry of Development, Industry and Foreign Trade, explains the role of the Brazilian Development Bank (BNDES). “Through BNDES, we have two different means through which the Brazilian Government can support the expansion of Brazilian companies abroad.” She says that there is a credit line for investment abroad as well as a company within BNDES that can make equity investments in a company interested in investing abroad.

The companies that take advantage of the credit line are most often from the construction sector, according to Prazeres, but this is not a criterion. “There is no limitation regarding the areas or companies or sectors that we are willing to support abroad,” she says.

Beyond these facilities, the trade ministry is also actively looking for new ways to help, declares Prazeres. “Our secretariat has worked this year with CNI [the National Confederation of Industry] and FIESP [the São Paulo Industry Federation] to conduct research surveys with companies to identify the reasons that they go global, the obstacles that they find and the tools that would be most suitable for them for Government support in this direction,” says Prazeres.

“The outlook for Brazil is robust and the possibilities for overseas business expansion virtually limitless. But challenges still exist: the task ahead for Brazilian companies entering a global environment is to adapt to the demands of international customers, prepare for a wide variety of regulatory regimes and develop a global outlook.”

Antonio Vita, South America Advisory Brazil Managing Partner, Ernst & Young Terco
To prepare for successful expansion abroad, Brazilian companies must ensure that their own operations are secure, smooth and transparent. International tax regimes can be highly complex, particularly when it comes to joint ventures and acquisitions, and Brazilian businesses will need to be forthcoming and open when it comes to providing information about their own operations.”

Eliezer Serafini, Brazil Tax Managing Partner, Ernst & Young Terco

However, Andre Ferreira, Brazil Strategic Growth Markets Leader, Ernst & Young Terco notes that some companies are now looking to expand precisely because the domestic market is so strong: making an acquisition to gain a new source of competitive advantage not just for growth, it’s a way to become more competitive, more quality oriented and increase your competitiveness in Brazil.

Certainly some recent high-profile cross-border deals have had major domestic drivers. In 2011, the two biggest Brazilian cross-border acquisitions were both motivated largely by domestic considerations, according to the United Nations’ report “Foreign Direct Investment in Latin America and the Caribbean” (June 2012): CPFL bought Spain’s Jantus, whose only assets were Brazilian wind farms in Brazil, for US$987 million, and TLNP acquired 10% of Portugal Telecom, a component of the domestic telecom market.

One welcome advantage for Brazilian companies looking to compete abroad is that the national Government not only sometimes tries to shelter Brazilian companies from foreign competition at home but also gives them a helping hand overseas – for example, extending financing to prospective customers of massive infrastructure projects. “What’s interesting about economic models like Brazil and Colombia is the way the Government participates in some of the major businesses,” says Sam Fouad, Americas Emerging Markets Leader at Ernst & Young. “It may not be direct in terms of ownership interest, but more through providing financing or governance and oversight; however, the role of Government in these economies and some of these businesses is an important dimension of their success, and it’s a little different from some of the other models we see.”

Focus on institutional investors: perspectives from Paulo Bilyk, CIO and Co-founder, Rio Bravo

Can Brazilian investors keep up with rapidly changing conditions? Paulo Bilyk, CIO and Co-founder of Rio Bravo, a leading hedge fund and private equity firm in Brazil, sizes up the outlook:

› On the consequences of falling interest rates: “Institutions that used to invest almost exclusively in government bonds – when interest rates were 15% to 20% are reallocating their portfolios.”

› On Brazilian institutional investors in the era of the single-digit interest rate: “They’ll have to actually work for their money and make allocations to private equity, income-generating real estate, specialized strategies and public equities, and to credit, private credit and infrastructure as well.”

› On outward-bound Brazilian money: “These institutions are going to be looking beyond Brazil necessarily as we move in the direction of what’s happened in Chile, where the large institutions have become so big that they end up overflowing the size of the country. We’re nowhere close to that now, however, and Brazil’s is a much larger economy than Chile’s. But eventually it will happen.”

Looking ahead: bright prospects for growth

Over the next decade, the prospects for Brazilian businesses are among the strongest in the Western hemisphere. Few companies are better positioned for long-term success. However, this success will not be captured evenly. Brazil’s new champions will have to adapt to a changed world in which Brazilian companies are competing not only in fiercely contested home markets but even more intensely contested markets abroad. The transition to global status is likely to be challenging, demanding wrenching cultural changes for many companies.

Policy changes and reversals are still possible, although perhaps the only serious threat at present relates to a sharp rise in the number of inbound tariffs, such as the recent 40% surcharge slapped on foreign car imports. Yet it is unlikely that the rising protectionism signals a return to the anti-market-economy policies that often choked Latin American growth in the past. Brazil’s bright prospects lessen the odds of major policy reversals. As Sidney Chameh, CEO of DGF Investimentos, a leading Brazilian private equity firm, says, “I really don’t think that this is going to be a kind of bubble and that is going to be worse in five years’ time. I think in five years, Brazil will be much stronger than it is today. It could be even better if the Government helps with the infrastructure. We have passed a point of no return.”

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