FINANCE 7386

Fall 1998

COUNTRY REPORT

BRAZIL

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October 29, 1998

Brazil, with a GDP of 820 billion USD in 1997, is the seventh largest economy in the world. It represents 42% of the total GDP of Latin America. Recently, the country has suffered as a result of the Asian economic recession and the crisis in Russia. This report analyzes the economic and financial environment of Brazil for the purpose of aiding investment decisions.

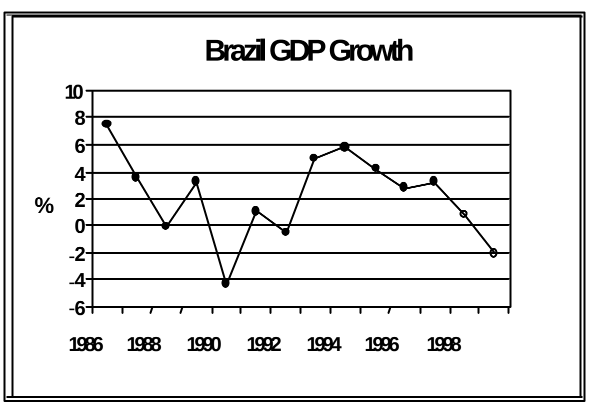
Political and Social Environment
Brazil is a democracy with three independent branches of government, similar to the United States. Foreign ownership is legal in most businesses, with the exception of banking. The recent re-election of the pro-business and reformist President Cardoso should please the international investment community. Mr. Cardoso has been a stabilizing force of the Brazilian leadership because of his free-market advocacy and commitment to low inflation.

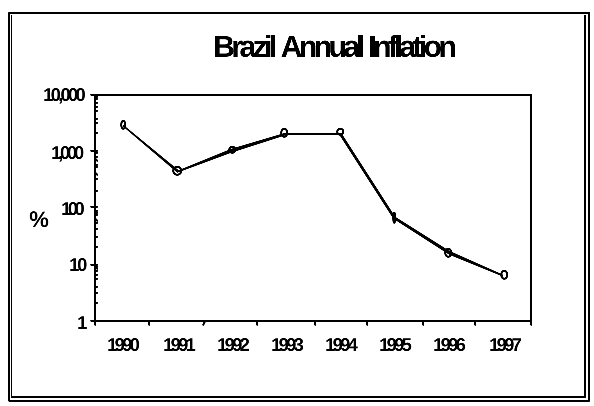
Unlike some of its Latin American neighbors, Brazil does not have any major problems with terrorist organizations or extreme militant groups. There is no recent record of politically motivated property damage or expropriations. Brazil enjoys good relations with the United States.

However corruption is still a problem in Brazil. There is no better testimony to the prevalence of corruption than the Sao Paulo mayor's (unofficial) re-election campaign slogan: "He may steal, but he gets the job done". In this year's report by Transparency International, (an anti-corruption organization based in Berlin) Brazil was ranked the 14th most corrupt of 85 countries studied. Regionally, Venezuela, Argentina and Mexico were ranked higher (more corrupt) than Brazil.

Brazil also has a number of social problems. Brazil's poverty level is 17%. In addition, the income distribution in Brazil is one of the most unequal in the world. Brazilians are also poorly educated, with a illiteracy rate of 17% and high dropout rates. The national language of Brazil is Portuguese and Brazilian's English language skills are poor on average. These factors may restrain long-term growth prospects for the country.

Macroeconomic Environment
GDP Growth
The graph below demonstrates the volatility of Brazil's economic growth over the past ten years. Since 1994, the GDP growth rate has declined from 6% to an anticipated 1% for 1998. Brazil is heading towards a recession, with GDP growth for 1999 expected to be –2%, due to the current world economic crisis that has hit Brazil particularly hard.



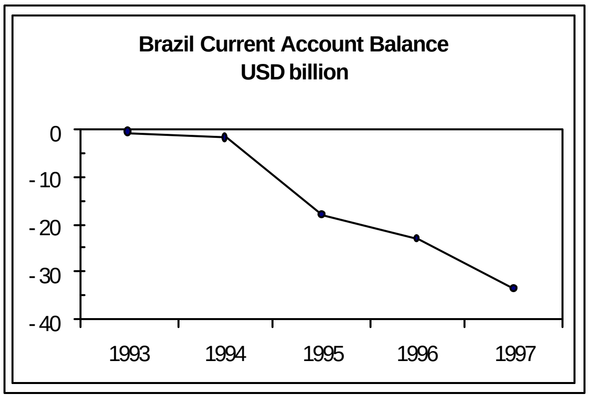


Inflation

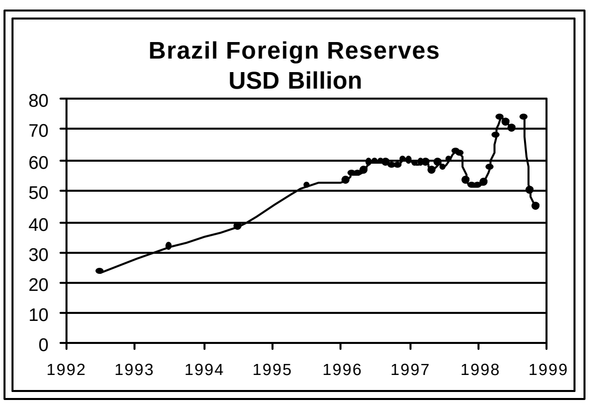
The Real Plan was implemented in July 1994 by Mr. Cardoso, while he was Brazil's finance minister. The program instituted a tighter monetary policy and introduced a new currency, the Real, that was floated with an adjustable target band set against the U.S. dollar. As shown in the preceding graph, the program has been overwhelmingly successful in bringing down Brazil's historical hyperinflation to single digit levels. The period of monetary stability has, in no small part, contributed to the popularity of Mr. Cardoso as Brazilians citizens have benefited from a stable currency. Inflation rates are expected to remain at single digit levels.

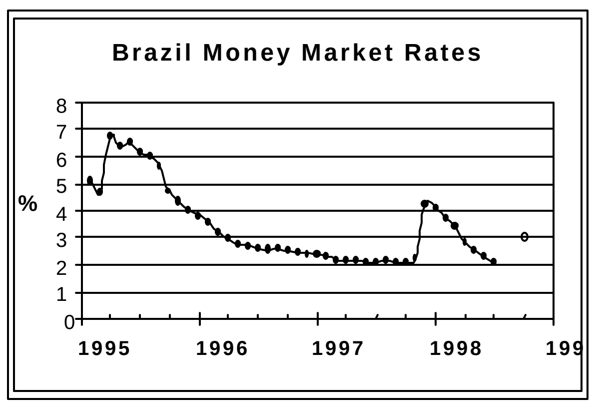
Government Fiscal and Current Accounts

The charts below show Brazil's historical current account balance and foreign reserve levels. Last year, Brazil reported a current account deficit of roughly 33.4 billion USD. Approximately 8.4 billion of this deficit is composed of a trade deficit, which arose out of Brazilians' increased buying power due to the low inflation.

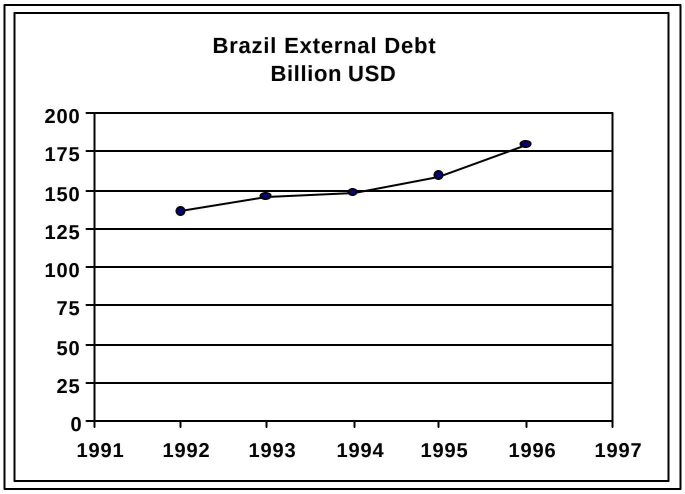


The flow of capital out of the country has caused a decline in foreign reserves. Since this past spring, foreign reserves have dropped from 74 billion USD to the current level of 45 billion USD, causing tremendous concern that a devaluation may occur. In an effort to stem the capital flight, the government has responded aggressively by raising short-term interest rates to 30%.



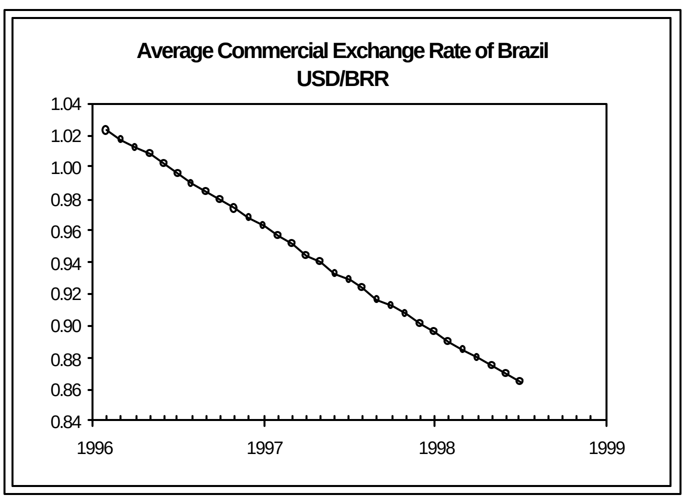


The Cardoso administration faces the daunting task the reducing the huge fiscal deficit, which has recently exceeded 60 billion USD, an alarming 7% of GDP. The high deficit is primarily the result of bloated pensions for civil workers and social benefits. In addition, the higher interest rates have raised Brazil's debt servicing costs, further exacerbating the problem. In addition to fiscal debt, the chart below shows that Brazil's external debt has risen steadily to 180 million USD in 1996 (the latest figures available).

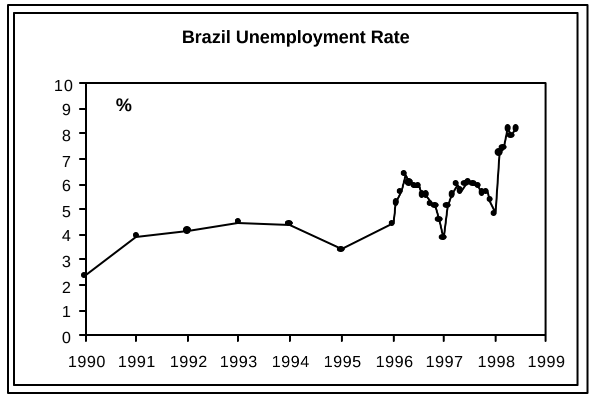


Brazilian government officials are currently holding discussions with the IMF and global banks concerning a 30 billion USD support package. Part of the package may come from issuing bonds backed by the future sale of state assets. The IMF is expected to link any loan package to badly needed fiscal reforms. In order to accomplish the necessary spending cuts, Mr. Cardoso will require the cooperation of Congress and the powerful state governors. Roughly half of the governorships are currently up for grabs in runoff elections. The fate of Mr. Cardoso's planned budget cuts rests on his ability to garner support from these groups.

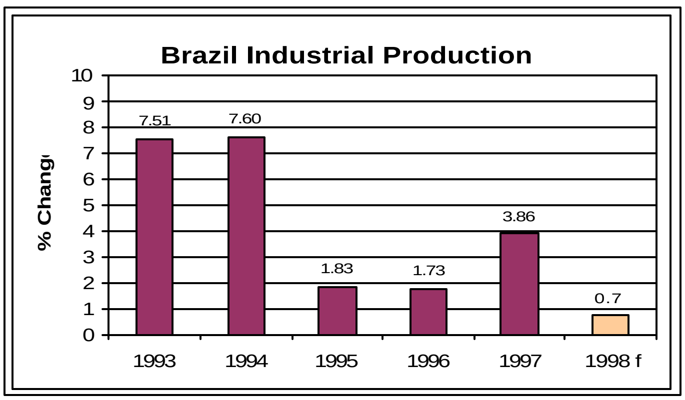
Exchange Rate
The graph below shows that the exchange rate, under the Real Plan, has undergone a slow, controlled devaluation. Because of the foreign reserve problem that Brazil currently faces, there is a risk that the central bank will not be able to continue to support the real, resulting in a major devaluation--a possibility that investors fear the most.



Labor Markets
Labor unions represent approximately 10-15% of the workforce. The civil sector workers are likely to oppose Mr. Cardoso's budget cuts that target the excessive civil pensions and benefits. However, their power is likely to be limited due to the rising level of unemployment, as shown in the graph below. Real average income of employed people has been increasing since 1993. However, the pending budget cuts may suppress future wage growth, at least in the near-term.



The chart below shows Brazil's industrial production growth over the past few years. In general, the lower production levels since 1995 stems from reduced investment due to the austerity measures during the Cardoso administration. High interest rates during 1998 further suppressed production.



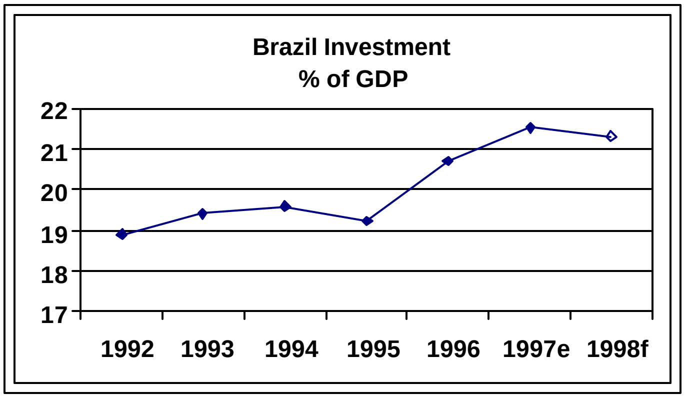
The table below shows Brazil's productivity level, relative to the United States, by sector. While all sectors show less productivity than the U.S., the steel industry is Brazil's most productive.

Sector	Relative Productivity (U.S. =1.0)
Steel	0.68
Telecoms	0.48
Automotive manufacturing	0.38
Housing construction	0.37
Food processing	0.18
Food retailing`	0.15

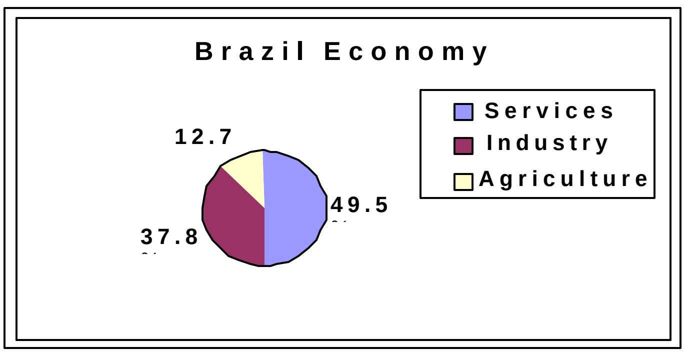
Investment and Privatization

Investment, relative to GDP, has experienced strong growth since 1995, as shown in the chart below. Foreign direct investment in Brazil totaled 16.3 billion USD in 1997. This figure may rise to 25 billion USD by the end of this year due to privatization.

Brazil launched a massive privatization program in the early 1990's. To date, the government has raised a total of 80 billion USD, of which 35% is from foreign participation. Industries such as steel, mining, electrical power, and petrochemicals have been the primary focus. This year, the focus is on telecommunications. The recent auction of Telebras raised an incredible sum of 19 billion USD. While the government has yet to put the State Oil Company Petrobras on the blocks, they have introduced competition into the energy industry by offering exploration and production licenses to international oil companies. It seems likely that eventually, the government will sell off at least part of Petrobras, as it has been doing with other state assets.

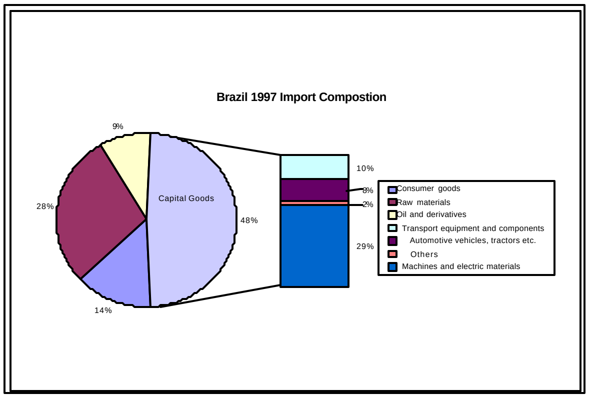


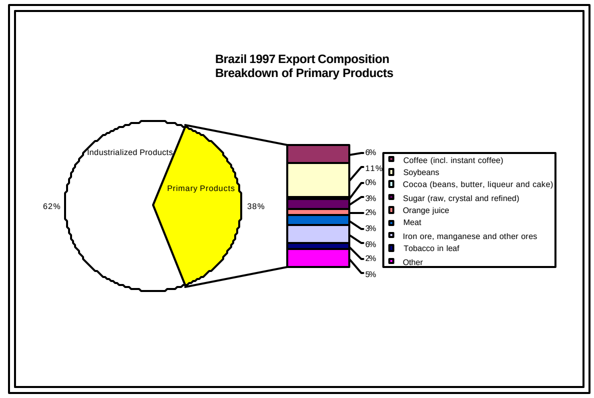
Sectorial Analysis
The economy of Brazil is dominated by the service sector and the industrial sector. Brazil's main trading partners, as shown in the table below, are the European Union, the United States, Mercosur countries, and Asia.

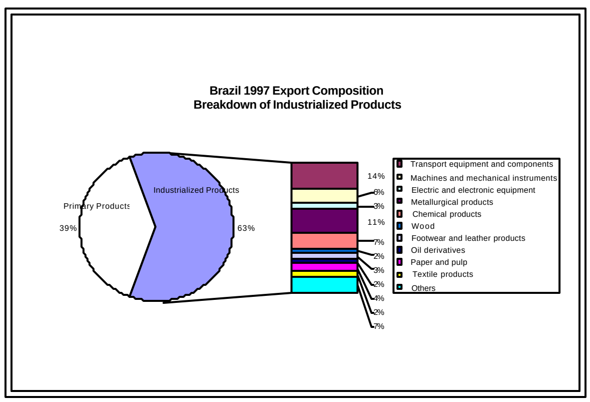


	Exports	Imports
European Union	27.4%	26.6%
USA	17.8%	23.4%
Mercosur	17.1%	15.8%
Asia	14.6%	14.5%
Others	6.8%	2.9%
OPEC	5.0%	6.7%
Other Latin America	3.3%	0.8%
Central and Eastern Europe	2.5%	1.5%
Chile	2.3%	1.6%
Mexico	1.6%	1.9%
Canada	1.1%	2.4%
EFTA	0.7%	1.9%

The charts below show a breakdown of Brazil's imports and exports. The exports are subdivided into industrialized products and primary products. Major exports include transport equipment and components, metallurgical products (steel), soybeans, and coffee. Imports are primarily composed of raw materials, machines and electric materials, and consumer goods.







Taxes
Brazil's tax system is extremely complex, with a wide range of income, consumption, and payroll taxes levied at the federal, state and municipal levels. Because of difficulties in passing comprehensive tax reform through Congress, the government has focused on limited revisions by executive order. The government has announced plans to transform the current system into one where a federal value-added tax, state and city sales taxes, and a selective excise tax would replace the current system of multiple taxation.

Corporate taxes include, in general, 8% social contribution tax in addition to 12-15% corporate tax. Other investment taxes include 15% capital gains tax and 15% withholding tax on dividends and royalties. Base income tax rate is 10-15%. In addition to taxes and base wages, businesses are required to pay compulsory benefits that add an additional 50-80% to base wages.

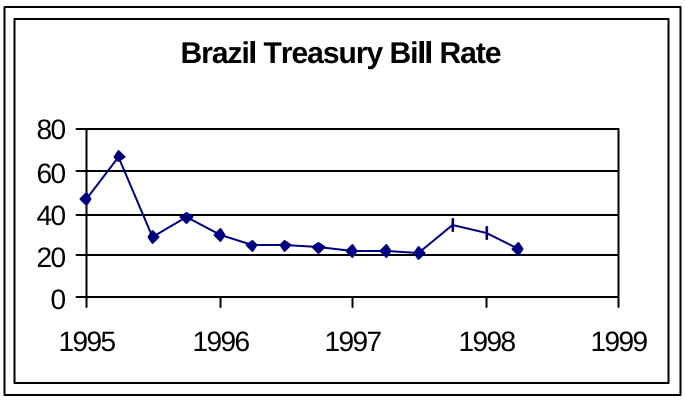
The only tax incentives offered by the government are for investments in the remote areas of Brazil, rather than the major urban areas where most of the population resides.

Country Risk
In a report published in March of this year, The Economist Intellegence Unit gave Brazil a risk rating of 56 (on a scale of 0-100, where 100 is the lowest score), or a C rating. Since that time, President Cardoso has been re-elected, which would tend to raise the rating. However, Brazil's

fiscal deficit and debt servicing problem have deteriorated, which would lower its score. This is somewhat cushioned by the prospects of an international aid package. In general, a current rating of C would still be appropriate, for the short-term prospects (1-2 years). For longer term investments, Brazil presents an attractive seems an attractive prospect, considering its size and growth potential, the current administration's reform plans, and the aggressive privatization progress.

Market Indicators and Stocks
This section examines Brazil's investment performance, as indicated by government bond yields, stock market indexes, and stocks.

Government Bond Yields



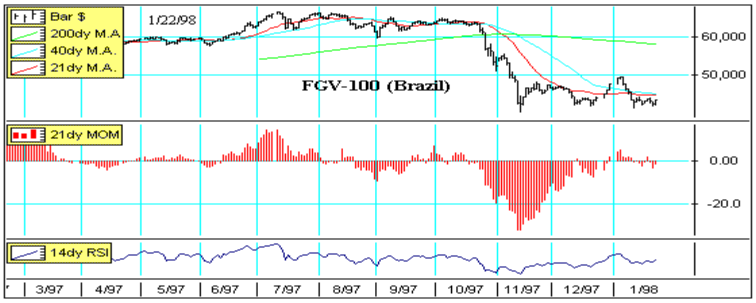
Stocks

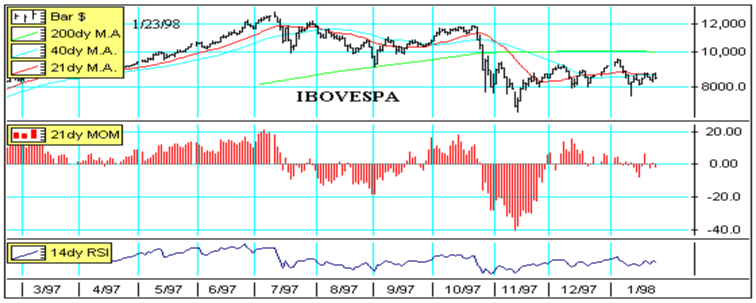
Summary of Selected Stocks

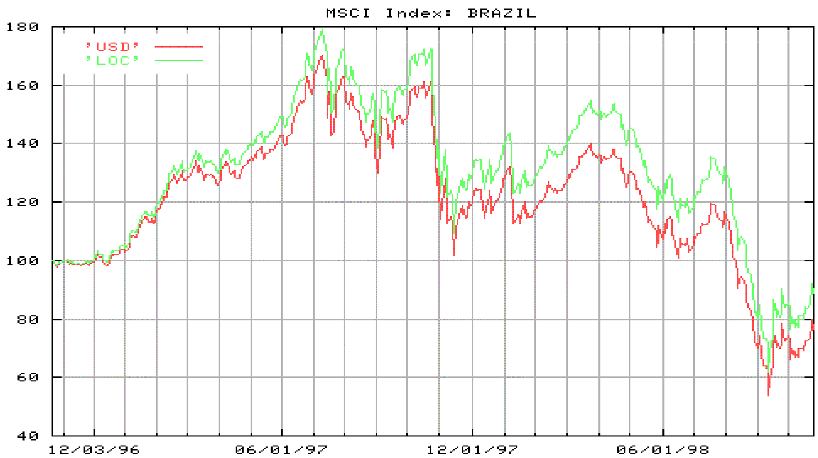
Company	Industry	Stock	Volume	P/E Ratio	Yield	EPS
Telebras	Telecomunications	TBR	3,040,300	5.13	4.7	0
Unibanco Uniao de Banco	Banking	UBB	215,800	4.18	7.4	4.59
Aracruz Celulose SA	Pulp	ARA	140,100	79.17	1.7	0.12
Companhia Cervejaria Brah	Alcoholic beverages	BRH	80,000	26.51	2.9	0.84
Companhia Parana de Energy	Electricity	ELP	313,500	0	6.2	0
Cemig Companhia Energetics	Electricity			NA	NA	NA

All of the above stocks are available as ADR's. The following graphs show each stock and stock index performance. Prior to 1998, most of these stocks and indexes followed the general trend of the S&P 500 index. However, most stocks have experienced a significant drop due to the economic factors described early. Most stocks are showing signs of recovering in the past couple of weeks. Interestingly, most of these stocks and stock funds behaved very similarly suggesting that performance is driven by national factors, and less by specific company performance.

Brazil Indexes







Valuation of Brazilian Index

Assume that real economic (long-run) trend growth (g) is 4% a year. That is, corporate earnings (E), in the steady state, are growing at 4% a year. Assume that the real bond yield is 6% and the risk premium is 5%. Thus, the discount rate, r, is equal to 11%. The steady state P/E ratio is:

$$P/E = 2/3\ [1.04/1.11]/[1 - 1.04/1.11] = 11.67.$$

The Brazilian economy is expected to have a negative growth rate in 1999 (-2%). This will significantly decrease corporate earnings. The P/E ratio should be adjusted downward by 25%, giving a P/E ratio for 1999 equal to 8.75. According to the Dow Jones Global Index Quarterly Review (Summer 1998), Brazil's P/E ratio is 8.52. Based on these numbers, I find the Brazilian stock market fairly valued (or a bit undervalued).

Conclusions and Recommendations

Because of the current world economic crisis that as hit Brazil particularly hard, the short-term outlook looks pretty bleak as the country is facing negative growth rates for 1999. However, the country's long term prospects are more promising as the current administration is committed to reforming the fiscal accounts as well as aggressively breaking up and selling off state assets. This will present opportunities for foreign investment and the increased competition will serve to improve productivity.

Growth in Brazil will likely be in the areas of electric power and telecommunications. Brazil is currently undergoing a significant modernization in these sectors, which are the current focus of government privatization. The forecasted demand for electrical energy is expected to surpass current capacity. Brazil's demand for energy is growing at a rapid pace (3,000 MW per year). With Brazil's population of 163 million, the 5th largest in the world, this could represent tremendous growth potential.

In line with this assessment, I recommend two stocks—a telecommunication company such as Telebras and an electrical power generation/distribution company, such as Cemig Companhis Energetics. The information in the report pertains to Telebras as a single company, whose ADR's trade on the NYSE. However, based on recent news articles, Telebras was broken into 12 separate companies so the selection of companies would require further research.

Cemig (Companhia Energetica de Minas Gerais), one of Brazil's largest energy companies, trades on the NASDAQ exchange. Cemig services the large, industrial state of Minas Gerais. Some of the performance statistics, such as P/E ratio, were not available. However, in a recent financial press release, the company reports that 1998 second quarter net income gained 66.3 percent to R$103.6 million in non-adjusted currency, or R$0.65 per lot of 1,000 shares, compared with R$0.48 per lot of 1,000 shares for the 1997 second quarter. Revenues were up 9.3 percent to R$ 601.1 million from R$549.9 million.

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