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CAPITAL

Global Emerging Markets

A letter from São Paolo…

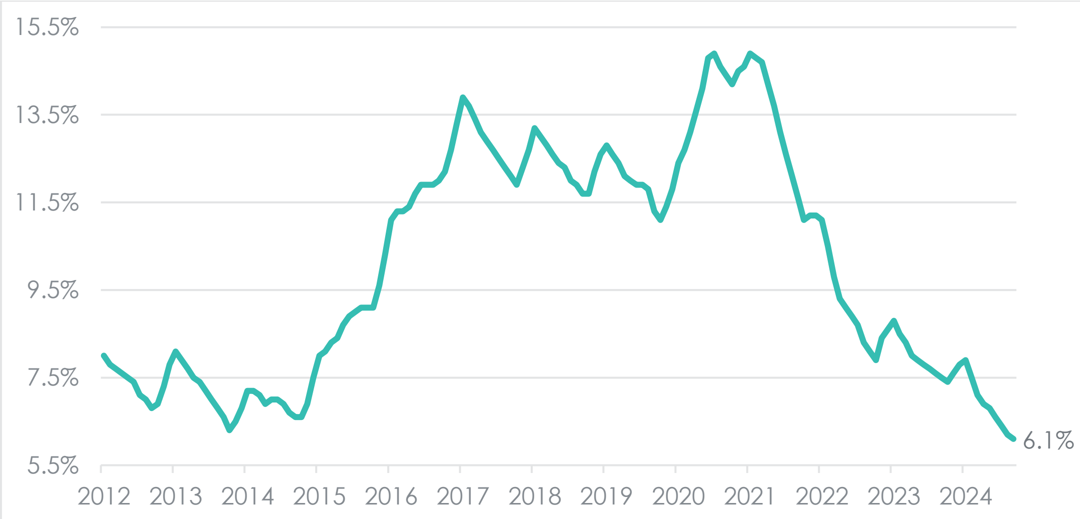
In this report we discuss the current economic environment in Brazil, following a week on the ground in São Paolo. Historically low unemployment and improved potential GDP growth due to reforms have improved economic conditions in Brazil. But the challenge of inflation and high government debt remains a key consideration. Incorporating Northcape's proprietary sovereign risk discount factor, healthcare companies Rede D'or and Raia Drogasil have been identified as key stock specific opportunities to include in the Approval List.

"*Things are actually pretty good right now*". So went the surprising refrain, heard again and again, from São Paolo's elite during a week of meetings in Brazil's leading metropolis. The comment comes as a surprise to non-Brazilians accustomed to reading pessimistic articles in the international press, where the more likely description of the country's economy is "basket case". Spend some time on the ground, however, and the cheerfulness starts to make sense. Whilst the government debt dynamics remain troubling (more on that later), Brazil's economy is currently in rude health and the near-term outlook is robust.

Exhibit 1: Villa Olimpia in downtown Sao Paolo (Source: author photograph)

First, as shown in Exhibit 2 below, Brazil's unemployment rate is currently at an all-time low. Rather than simply an aberration caused by a pandemic-related decline in the participation rate, this instead reflects a structural increase in the country's potential GDP growth rate. Most economists now believe that a number of important reforms introduced by Michel Temer, and his successor Jair Bolsonaro, structurally increased the rate at which Brazil's economy can grow without 'overheating' (i.e. without pushing inflation too high). Temer supported the privatization of inefficient state-owned assets, such as Electrobras, the country's leading electricity generation and transmission company, and major reductions in bureaucratic red-tape; in particular, significantly simplifying the process for companies to access loans from the National Bank for Economic and Social Development (BNDES). Bolsonaro's key victory was pension reform; a critical area in which no president in the previous thirty years had succeeded, introducing reasonable retirement ages and increasing mandatory pension contributions. Bradesco's Chief Brazil Economist believes that the main economic result of the various reforms has been a roughly 150 basis point increase in the country's potential GDP growth rate, from 1.5% to 3% (see Exhibit 3).

Exhibit 2: Brazil unemployment rate (Source: FactSet)



It takes time for economists and forecasters to adjust for changes in potential GDP growth, and a consequence of the recent structural changes has been a Brazilian economy that has consistently outperformed expectations. Exhibit 4 shows actual Brazilian real GDP growth per year (in turquoise) compared with the average forecast for that year 12 months' prior (in grey).

Exhibit 3: Brazil annual Real GDP Growth (Source: Bradesco)

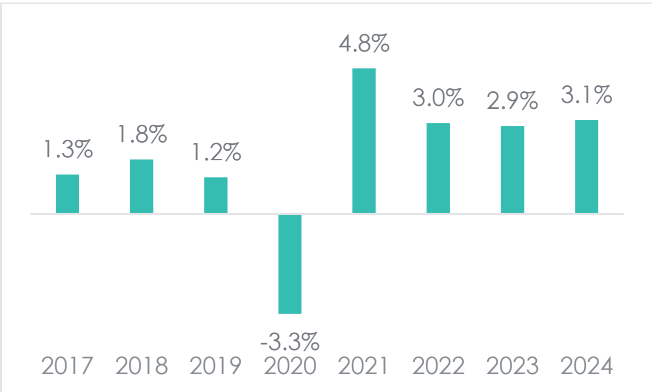
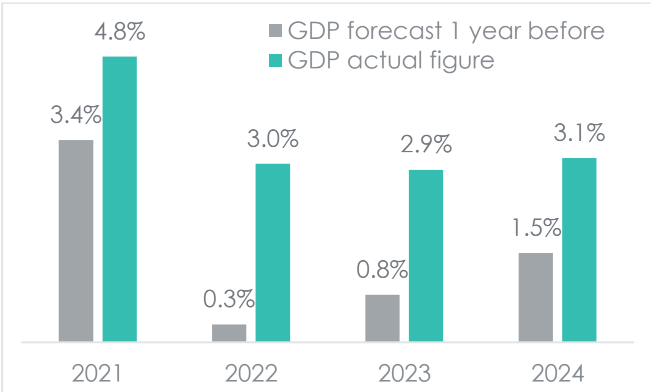


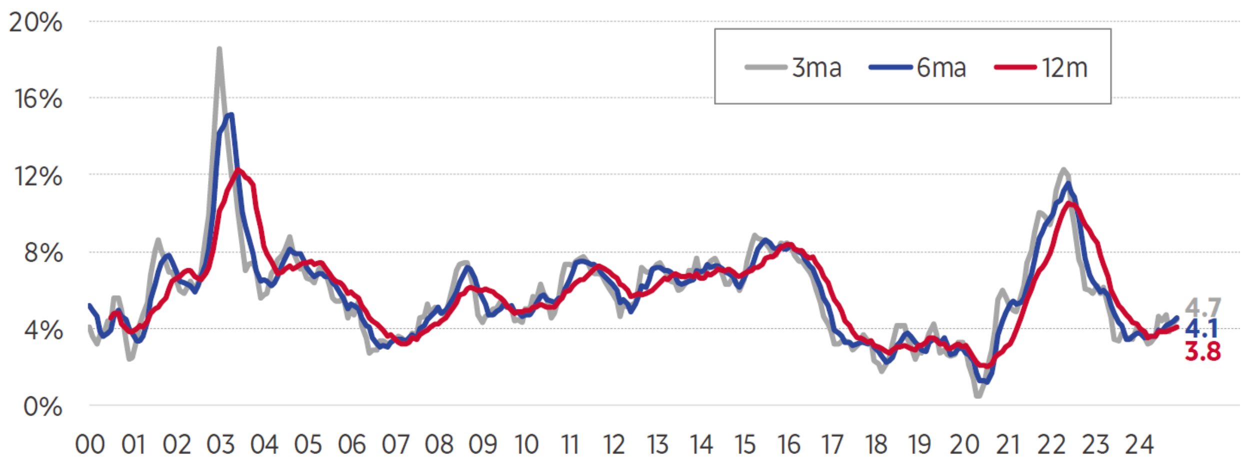
Exhibit 4: Brazil's GDP forecasts vs actual figures. Recent economic growth has consistently exceeded expectations (Source: Bloomberg)



The Brazilian economy has a history of high inflation and remains prone to inflationary pressures due to a combination of regulated prices and widespread indexation. According to the Bank of International Settlements (BIS), almost a quarter of Brazil's CPI basket is composed of prices with fixed increases set by contract which do not respond to actual supply and demand conditions. The country's history of high inflation means that the contractual price increases are often higher than is warranted by prevailing economic conditions, creating "inflation inertia" in the words of the BIS. Another source of this inertia is wage indexation; the minimum wage in Brazil and other wages that are linked to the legal minimum, which combined account for almost half of workers in the country, are indexed to past inflation. The latter, in addition to contributing to inflationary pressures, has resulted in a consistent dynamic in the country where productivity growth has lagged wage growth.

With this backdrop, the country's choice of central bank governor is hence very important. It is reassuring that Roberto Campos Neto, the current governor, appears to be serious about containing inflation. Since assuming the position in February 2019, Neto has overseen a Selic rate (Brazil's central bank target rate) that has increased from 6.5% to 12.25% currently, with expectations of further hikes. According to the minutes of a recent Copom (the monetary policy committee of Brazil's central bank), Neto said the bank will do "whatever it takes" to keep inflation under control. As shown in Exhibit 5, following a pandemic-related price spike seen in many countries, the results so far have been reassuring.

Exhibit 5: Key measures of inflation are benign, particularly relative to historic levels (Source: IBGE, Bradesco)



The one major dark cloud on the horizon which threatens to spoil Brazil's otherwise sunny economic outlook is of course government debt. Gross government debt to GDP in the country is currently around 80% and is expected to reach 100% by the end of the current decade. The main issue is the high cost of this debt: at the time of writing, the yield on ten-year Brazilian government bonds was some 14.8%. This means that the Brazilian government pays 8% of GDP in interest payments according to the International Monetary Fund, amongst the highest in the world. The situation is likely to deteriorate in the near-term as almost half of Brazilian government bonds are linked to the Selic rate, which is expected to be hiked at least another 200 basis points (i.e. 2%) over the next 12 months. Brazil's nominal budget deficit, including interest payments on public debt, has already climbed to 9.5% of GDP, from 4.6% when President Lula took office just two years ago.

The main manifestation of the country's troubling debt dynamic has been the currency, which hit an all-time low in December. USD denominated investors into Brazil lost -20% on currency alone in 2024, one of the reasons that the Northcape EM strategy maintained an underweight exposure relative to the benchmark throughout the year.

Exhibit 6: USD-BRL exchange rate: An *Annus Horribilis* in 2024 (Source: FactSet)

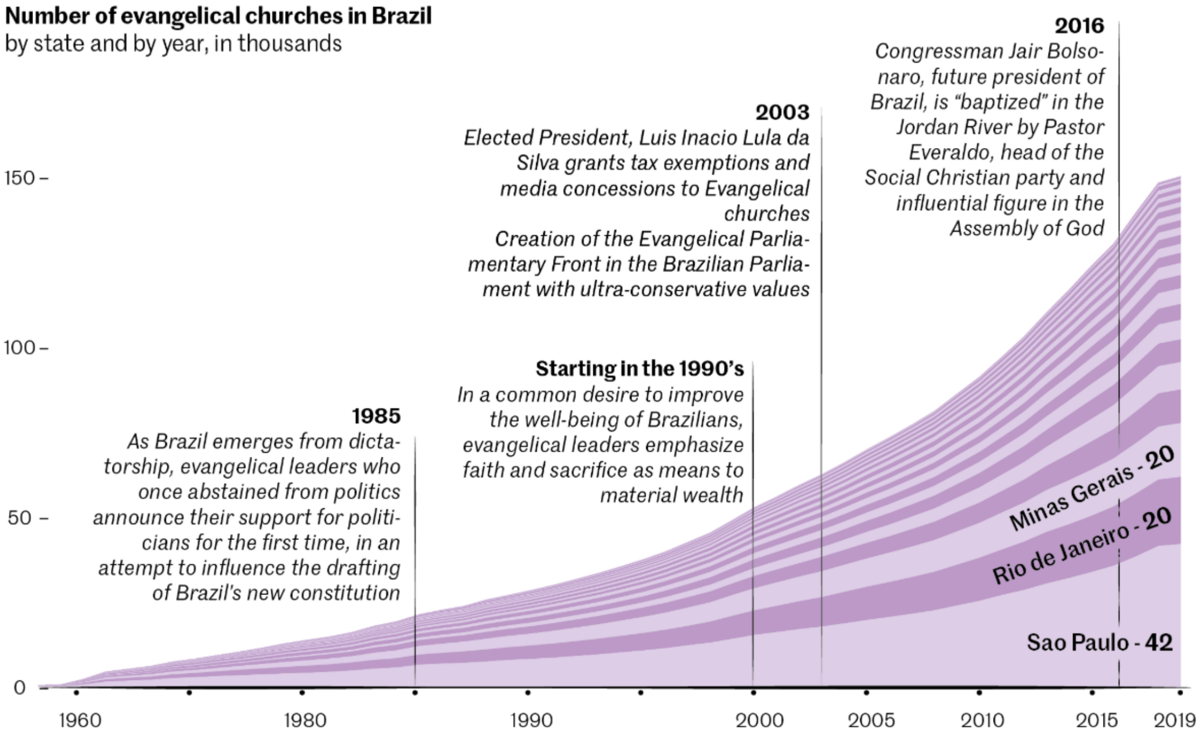
Importantly, the Centre for Economic and Policy Research (CEPR) argues that "Brazil's exorbitantly high interest rates are a policy choice, rather than a result of structural factors such as chronically low savings rates…the persistent high interest rates on Brazil's debt cannot be explained by a risk of default, inflation risks, or the risk of balance of payments crises. About 95% of Brazil's public debt is in domestic currency". Indeed, the poor performance of the currency has been directly influenced by policy decisions made by the left-leaning president, particularly the announcement in late November that the government will raise the tax-free threshold for workers to 5,000 reais (USD $842) per month from 2,824 reais per month. The effect, according to Thomas Traumann, a noted economist and journalist who Northcape met in São Paolo, is that less than 10% of the population will pay income tax – a dangerously narrow tax base. The negative impact on the budget of the changes should be offset by a bill approved by the Brazilian Congress' lower house on December 17, which will simplify and increase consumption tax to an overall level of 26.5%, with higher rates on products considered harmful such as tobacco and alcohol, but the problem is very much one of 'one step forward, one step backward' for Brazil's public finances under the current administration.

The hope for investors then is a potential change of government, away from the current leftwing *Partido dos Trabalhadores* (PT or Worker's Party) towards a more reform focused administration as the country saw under Temer and Bolsonaro. The good news here is that Lula's approval rating remains low (around 35%) and there will be an election next year, in 2026. More broadly, the expert meetings Northcape conducted on the ground in Brazil suggest that there are structural changes happening in the country which should fundamentally reduce the appeal of the PT to voters.

The most important perhaps is the rapid rise of evangelicals in Brazil, surprising in a nation known for having the most Catholics of any country in the world. In the 1970s, Brazil was still 91% Catholic and 5% Protestant. Five decades later, the ratio is 50% to 31%, or 66 million Protestants, with the biggest growth coming from evangelicals, according to the Datafolha Institute. At this rate, the Roman Catholic Church could find itself in the minority as early as 2032: "a religious transition of unprecedented speed" according to *Le Monde*.

Relative to Catholic voters in the country, Brazilian evangelicals tend to be more socially conservative on issues such as abortion, gender roles and crime. Surveys suggest that they also tend to be more comfortable with material wealth as an aspiration and correspondingly tend to support market friendly economic policies. According to *Al Jazeera*, "while the majority of the prominent left-wing movements in Brazil appear to be – much like their US counterparts – stuck in their own identity-based agendas and immersed in so-called 'culture wars', the evangelicals are actually doing the leg work and changing the lives of Brazilians living in poverty for the better".

Exhibit 7: The surprising rise of Evangelical churches in Brazil (Source: Le Monde)



This religious and cultural shift is diminishing the PT's core support base in the north of Brazil, the poorest region of the country where more than three-quarters of the population depend on fiscal transfers. Given that the wealthier southeast of the country is invariably voting for a right-of-centre candidate, this trend presents a serious challenge for Brazil's left wing such as the PT. Further most pundits believe the "cult of Lula" is worth at least a few points in an election, with no other left-of-centre candidate close to matching the charisma and popularity of the two-time president. Given the recent news of emergency brain surgery in December, following a severe fall in his residence in October, it looks increasingly unlikely that the 79-year-old will run again in 2026.

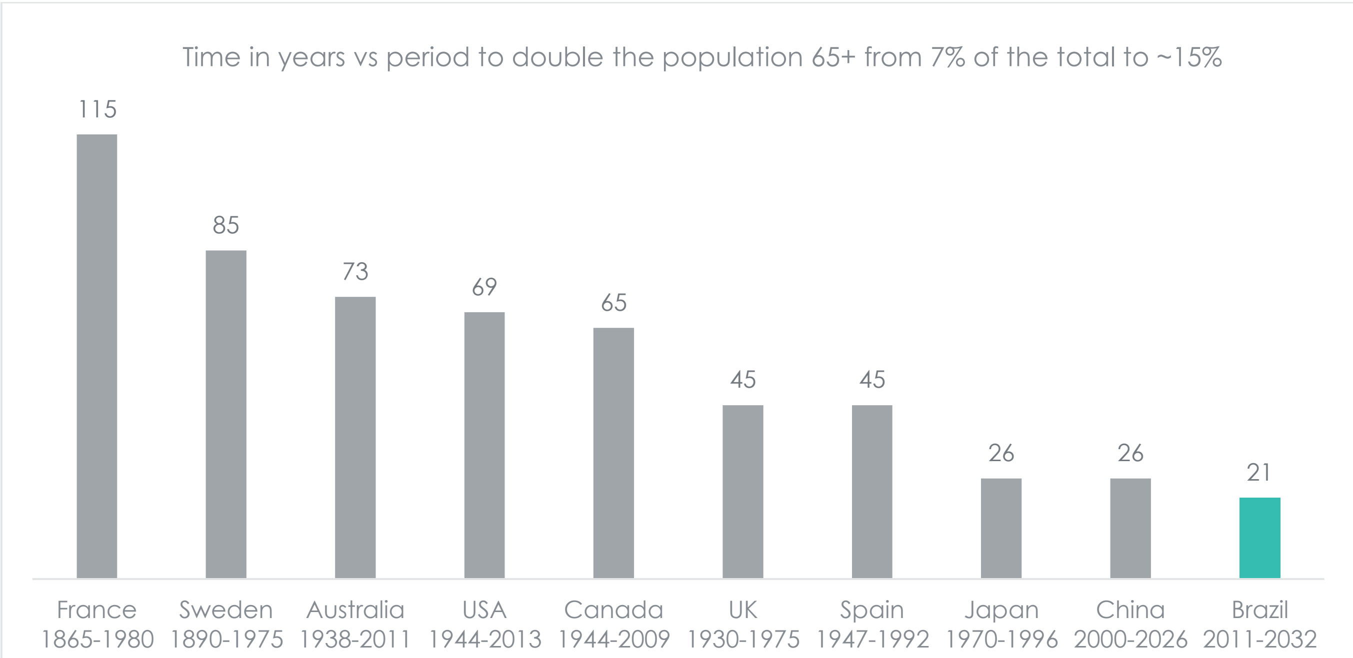
In addition to laying the foundation for a market-friendly reform-focused candidate win in the 2026 election, the continued decline in Lula's approval rating could constrain the current government in its final 18 months in power, as should the severe underperformance of Brazil's currency in recent months.

In the meantime, how should investors approach Brazilian equities? First, a high discount rate is certainly warranted, not just because of the high government bond yield but because of the broader sovereign risks arising from the country's unsustainable debt dynamic and the current political obstacles. This is why Northcape's proprietary sovereign risk discount factor takes into account both quantitative and qualitative factors to estimate the *true* cost of capital for international investors in any particular emerging market.

Even with an appropriately high discount rate, there are pockets of the Brazilian market that still look attractive to long-term investors. In particular, the health care sector currently looks to be underappreciated relative to the significant growth opportunities.

The first important point for healthcare expenditure in the country is that surprisingly, by some measures, Brazil is the fastest aging country in the world (see Exhibit 8). The proportion of Brazilians over the age of 65 is expected to reach 15% by 2030, double the proportion two decades ago and a faster speed than has ever been recorded historically. This is a consequence of expanding life expectancy and a declining birth rate, the latter a consequence of improved access to contraception, which is causing the population pyramid to rapidly mature.

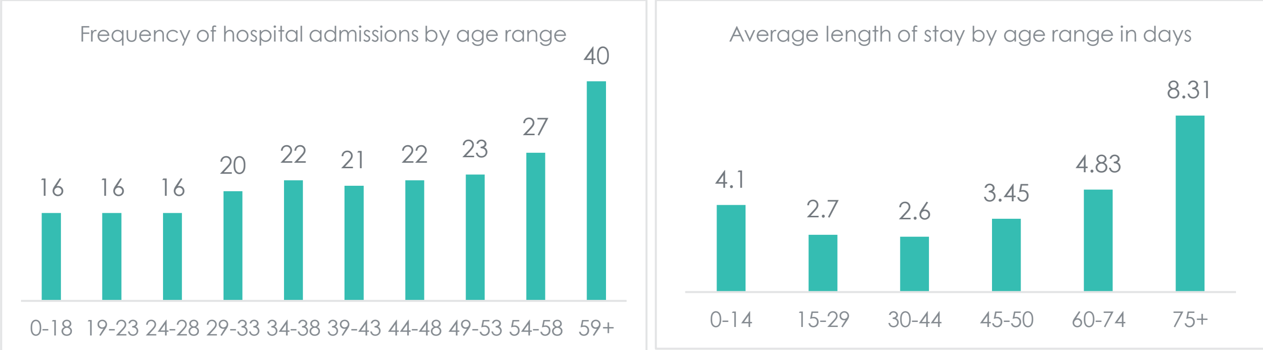
Exhibit 8: Brazil is rapidly aging (Source: JP Morgan, World Bank, RD)



This is important because there is a clear correlation between age of patients and healthcare usage. As Exhibit 9 shows, patients over the age of sixty are admitted to hospital more frequently and, on average, stay in hospital longer than other age cohorts. Consequently, healthcare expenditure for the elderly is much higher than the population average.

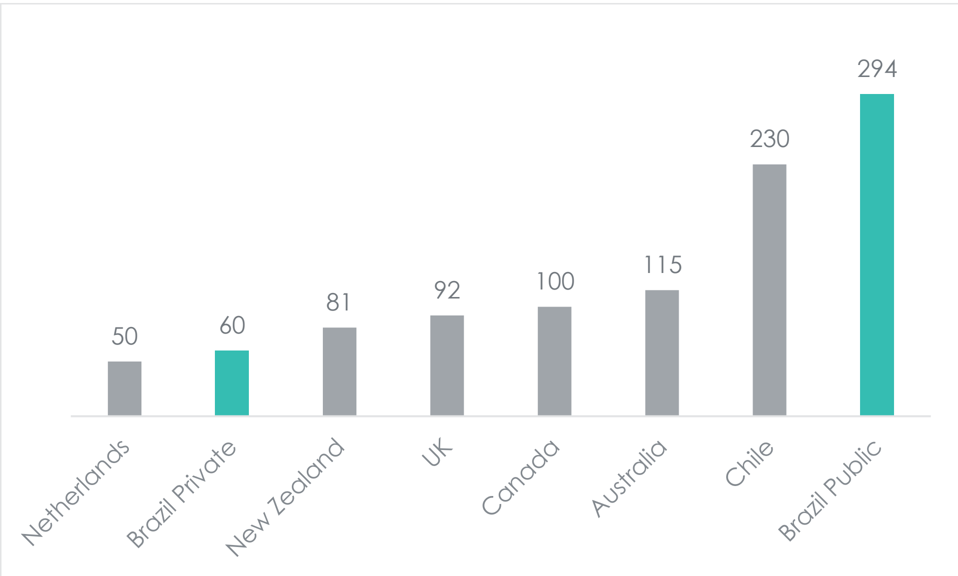
Exhibit 9: Aging population = Greater healthcare expenditure (Source: JP Morgan, ANAHP)

The elderly are admitted into hospitals more frequently… …and stay in the hospital for longer



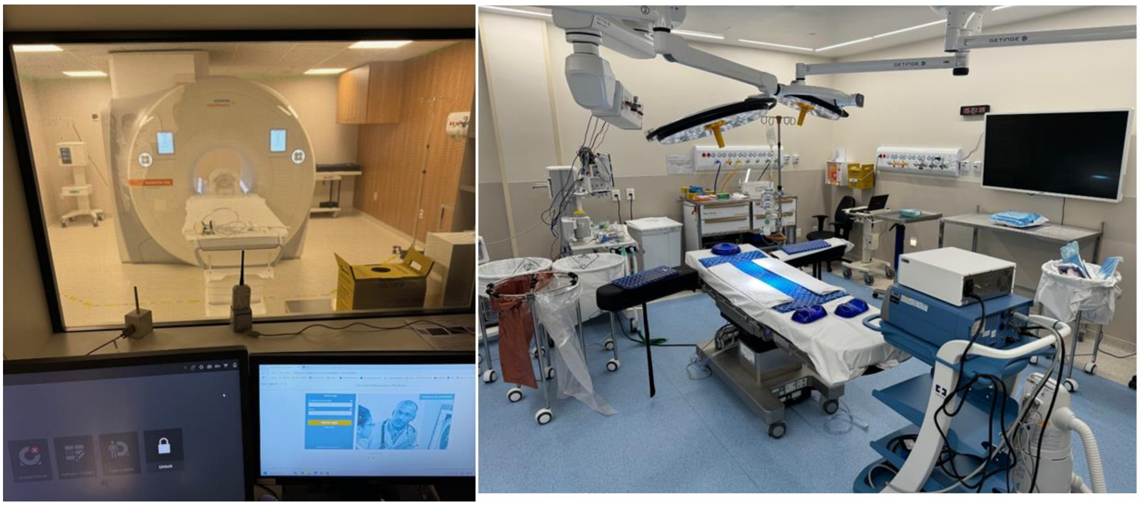
The second important point is the unsustainable public finance situation in Brazil. This will inevitably result in continued supportive policies for private sector providers in Brazil's healthcare industry, so that they can take pressure off the struggling and underfunded public sector. In hospitals, the private sector significantly outperforms public hospitals in key metrics such as surgical mortality rate and infection rates. Further, as shown in Exhibit 10, in addition to superior standards of care, the Brazilian private healthcare system has much shorter waiting times for key procedures than the public system.

Exhibit 10: Wait time for hip replacement surgery, selected countries (Source: OECD iLibrary & Rede D'Or data, Northcape Analysis)



Rede D'Or, the leading private operator of hospitals in Brazil, is the key beneficiary of the above trends and is a member of Northcape's EM Approved List. Despite sustainable double digit growth opportunities (organic EBITDA grew 30% p.a. between 2009 and 2023), it is the cheapest listed hospital operator globally, trading on just 6x forward EV/EBITDA and 13x forward earnings. Northcape visited several Rede hospitals in São Paolo (see Exhibit 11) and was impressed with the company's vision of world class hospital care delivered at competitive prices.

Exhibit 11: Inside a Rede D'Or Hospital (Source: author photographs)



Another high-quality Brazilian healthcare operator which Northcape identified for inclusion on our Approved List is Raia Drogasil, the leading pharmacy chain in the country. As with Rede, we did several site visits whilst in Brazil and noted the dramatic difference between Raia stores and those of its competitors.

As the leading operator in a fragmented industry, Raia has a competitive advantage in logistics. Product is delivered daily to 93% of Raia stores across the country, with restocking totally automated and generated from data from the stores' point of sales (POS) systems. Fast, efficient logistics means that in-store inventory per item can be lower, allowing a wider range of items (SKUs). Northcape was amazed at the depth of the selection of the stores we visited; it certainly felt better than a typical Australian pharmacy (Exhibit 12).

Exhibit 12: Inside a typical Raia Drogasil store (Source: author photograph)

Much like Rede, Raia offers strong growth, which is not fully reflected in the current valuation, even when Brazil's sovereign risks are properly considered. The company's national market share is only 16% and management aims to add at least a further 300 stores a year.

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