

BRAZIL'S FORTUNES

Brazil's burgeoning middle class is pushing for stronger corporate governance to protect its investment interests.

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Jim O'Neill, head of global economics, commodities and strategy research for Goldman Sachs, coined the term BRIC in 2001. With it, he drew the world's attention to Brazil, Russia, India and China and their eye-popping economic potential. These countries have delivered, Brazil included. It is South America's largest economy, and Brazil's 2010 gross domestic product growth reached 7.5%. Although Brazil struggled more than the other BRIC countries during the recent economic slowdown, its recovery is outperforming many industrialized nations, including the United States.

But Brazil still lags the United States and other developed countries in a key area — corporate

decisions in the interests of local economic growth, these decisions often rattle investors, sap profits and drive down stock prices.

Ironically, the counterforce to these trends is the very group many government actions are meant to bolster — the burgeoning middle class. Its investment savvy and expectations are on the rise and forcing the BM&FBOVESPA to respond.

A REVERSAL OF FORTUNE

In the late 1990s, Brazilian President Fernando Henrique Cardoso launched economic reforms to stabilize the Brazilian economy. The Real Plan eliminated the country's staggering hyperinflation, which reached more than 2,500% in 1993. The government also began privatizing state-owned companies to leverage the power of a market economy.

Cardoso's successors, however, Presidents Luiz Inácio Lula da Silva and Dilma Rousseff, have been reversing this trend. The Brazilian Development Bank now has significant investments in more than 150 Brazilian companies. The government is a major shareholder in many, and its actions lay bare the governance issues.

Petrobras arguably is the poster child. It is Brazil's largest energy company and the fourth largest oil

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governance at its stock market, the BM&FBOVESPA. For example, only 23 of the 500-plus listed companies trade more than 50% of their shares on the exchange. One important reason is that over the past 10 years, the Brazilian government has increased its investments and control in many publicly traded companies. Although its goal is to influence business



and gas company in the world. The government holds a 56% stake along with golden share rights. Petrobras's share price peaked at more than \$70 in 2008. By September 2011, shares were trading around \$25.

Many analysts attribute fluctuations in Petrobras's share price to government intrusions that have had a decidedly negative impact on profitability. Most oil drilling in Brazil, for example, is offshore, and Petrobras is a world leader. Oil rigs are a major investment, costing up to \$1 billion each. When Petrobras decided to build new rigs, it sought bids from companies in South Korea and Singapore, major centers of shipbuilding and offshore industrial equipment. Bids from these companies were almost 50% lower than those from Brazilian firms. Yet the government insisted that Petrobras "buy local" to support job creation and economic growth. Ironically, such actions are eating away at middle-class investment wealth. In 2000 the government allowed — and encouraged — individual investors to purchase Petrobras stock with funds from their government-run retirement accounts. Routinely, individuals are forced to place these moneys in a government fund that yields less than a typical savings account. However, for some, their Petrobras investments have been worse.

Companhia Vale do Rio Doce also was a victim of government intrusion. CVRD is the largest mining company

in the Americas and the largest iron ore miner in the world. From 2001 to 2010, shares in CVRD produced a total return of 38%, which, according to CVRD, was the highest among its peers. In early 2011, its stock was trading around \$35 per share. By the end of August 2011, the price had fallen to about \$28 per share.

Roger Agnelli, the highly regarded former CEO of CVRD, ran afoul of



President Lula. Agnelli had led the company's impressive growth during his 10-year tenure. Toward the end, however, he decided not to buy local and awarded major shipbuilding contracts to a Korean firm that bid 40% less than its Brazilian competitors. Lula publicly denounced Agnelli, and Lula's

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successor, President Rousseff, ousted him. Investor concerns about the company's future soared.

A REVIVAL OF FORTUNE

Although the Brazilian government intends to bolster the economy, its agenda will confront the implacable force of the middle class it has helped create — and that class's expectation that business decisions be made in the interests of shareholders.

There is a growing investment mentality in Brazil's middle class that wasn't there 10 years ago. Where once discussions of investments were rare, it now is a common topic at social gatherings. From 1999 to 2009, 31 million people entered the Brazilian middle class, bringing the total to 95 million (52% of the population). These individuals have disposable income and are investing in the stock market.

The BM&FBOVESPA is making efforts to improve corporate governance practices. In 1995, the Brazilian Institute of Corporate Governance was established. Its mission is to raise awareness of corporate governance standards and disseminate best practices. In 2000 the BM&FBOVESPA launched its New Market. This listing segment includes companies that voluntarily implement corporate governance standards beyond those the law requires. One of the goals is to broaden the market of individual investors by requiring that public share offerings use mechanisms that favor capital dispersion and broader retail access.

Brazil still has a long way to go with its stock market. But as Brazil moves toward better governance standards, companies will create greater value for their shareholders. Harvard Business School professor Paul A. Gompers proved the point in landmark research published in 2003. He created a governance index as a proxy for shareholder rights at 1,500 large U.S.-based companies. He found that companies with stronger shareholder rights had higher firm value and sales growth. These companies also had lower capital expenditures and made fewer acquisitions.

In the 1970s and '80s, it was common to describe Brazil as a sleeping giant. The giant is now awake. With improved corporate governance, its companies will see even greater growth. Stay tuned. ■

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