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Profiting From Prudence

Despite a recent drop in profits amid the country's economic slowdown, Brazilian banks are poised for long-term growth.

By Antonio Guerrero

Amid a turbulent global market, Brazil's banking and financial sector is proving remarkably resilient. A stringent regulatory environment, strong domestic demand and a banking consolidation drive have contributed to the sector's relatively positive outlook. However, consolidation has unleashed a battle for market share, and the situation may even push some Brazilian banking giants to explore cross-border investment opportunities.

While the country's central bank says Brazil's 50 largest banks posted a 38% year-on-year decline in first-quarter 2009 profits, to $3.94 billion, it also says the banks are in better shape than before the crisis began. While the central bank requires banks to maintain a Basel index of 11%, which measures a bank's capital adequacy against its risk profile, the actual figure was 15.5% at end-2008.

A mega-merger between Banco Itaú and Unibanco, to create the country's largest private bank, has pushed rivals to seek mergers of their own in a bid to keep market share. The newly created Itaú Unibanco is still in an acquisitions mode and has indicated its interest in taking over small and mid-size Brazilian banks to further grow its business. With a 20% market share, Itaú Unibanco executives are aware that antitrust authorities are not likely to allow the bank to complete any large-size acquisitions.

Banco Bradesco, which lost its status as the country's largest private bank as a result of the Itaú Unibanco merger, has been struggling for market share since falling to the number two position. It is now seeking growth through an expanded credit card portfolio, for which it recently acquired Banco Ibi, Brazil's fifth-largest branded credit card issuer, for $720 million. Banco Ibi is the consumer finance arm of C&A, one of Brazil's largest clothing retailers.

Though Banco Ibi also offers insurance, personal loans and savings accounts, Bradesco was enticed by the bank's exclusivity in financing C&A customer purchases. The Banco Ibi deal marks Bradesco's largest acquisition since buying Agora, a local independent broker, in 2008. Banco Ibi had more than 30 million credit card accounts last year, when it posted nearly $5 billion in revenues. The acquisition now doubles Bradesco's credit card portfolio to more than 65 million.

Room for Growth

"Arguably, notwithstanding the recent Itaú Unibanco merger, which created a Brazilian banking giant, there should still be a lot of room for growth in the Brazilian banking market, particularly when considering the low level of banking penetration in the country and Brazil's huge financing needs," says Marcello Hallake, a partner at the New York law firm of Thompson & Knight, who specializes in cross-border mergers and acquisitions.

According to Rubens Sardenberg, chief economist at Febraban, the Brazilian banking federation, recent consolidation is the final phase of a long-term strategy to restructure and strengthen the sector. He recalls that over the past decade consolidation led to the disappearance of several banks that could no longer operate within a stable macroeconomic environment that included low inflation. "The recent consolidation move can be seen as the final step in this process and seems to be more related to a tactical strategy of the main players to increase their competitiveness through scale, cost reductions and a more robust capital base," says Sardenberg.

Hallake argues that the domination of the market by large local banks has been a positive factor. "Clearly, at a time when US and European banks have been so hard hit by the world's financial crisis, it has been beneficial to have relatively little exposure to foreign banks and to be able to rely on a strong domestic market, where four of the five largest banks are Brazilian-owned, not counting the role of the large state-owned banks," he says.

Hallake contends, though, that the system's greatest strengths are also its biggest limitations. Brazilian banks have weathered the crisis because of "their lack of exposure to subprime mortgages and off-balance sheet financing, as well as the banks' conservative practices and tighter regulations," he says. "These positive results are also part of the reason why Brazil has such a low mortgage penetration-only 2%-3% of GDP, as opposed to about 70% in the US-and so little much-needed financing is available to small businesses, start-ups and new ventures."

Sardenberg agrees the sector's concentration among large locally owned banks presents both a challenge and an opportunity. "It is an opportunity if we consider that Brazil has large, solid and capitalized banks, which tend to emerge from the current crisis in a stronger position compared to institutions in [other] emerging and developed economies," he says. He feels that solid and well-managed banks will be better positioned to face competition from foreign players at home and to expand their presence abroad.

"On the other hand, it poses a challenge, as we could expect a scenario of strong competition among the large players," adds Sardenberg. "Markets with significant capital demand tend to have fewer players, and that does not mean less competition." He contends the key challenge for the sector is to preserve its solid profile and capital base amid lower economic growth.

The government released first-quarter 2009 GDP figures in June that confirmed the country is in recession, with the economy shrinking 0.8% from the same time a year earlier. That followed the previous quarter's 3.6% decline. "We believe that the worst is now behind us," finance minister Guido

Mantega said after the release. "We are returning to normal levels and, by the end of this year, anticipate we can be returning to positive GDP." After a robust 5.1% expansion last year, this year's growth is expected to come in at -0.7%. Mantega predicts 4% growth for next year.

Government Banks Provide Stability

Hallake credits some of the sector's stability to the influence of state-owned banks. "The government banks have taken a larger role in the economy in the recent year as a result of tighter liquidity in the financial system and the closure of the capital markets after the IPO boom of recent years," he says. "BNDES, the country's development bank, has approximately $60 billion available for financings this year; this is many multiples of what the Inter-American Development Bank spends every year across the continent." In June BNDES raised $1 billion on international debt markets to support its lending program.

Over the past 12 months BNDES has increased lending to make up for some banks' more conservative lending programs. BNDES loans rose to $44 billion, 22% above the same 12-month period a year ago. Government banks increased their share of total credit to 37.7% in April, from 37.5% in March. The government is working to create an export-import bank to support the trade sector, while authorities also plan to respond to lower credit lines from major commodities traders by boosting farm lending to $54 billion in 2009-2010.

Credit remains strong despite the economic slowdown. Credit volume for the Brazilian financial system totaled $593 billion in April, equal to 42.6% of GDP, up from 42.5% in March and 35.8% a year earlier. After a 31.1% credit portfolio expansion last year, a Febraban survey predicts credit will grow by a still-healthy 14.2% this year. Consumer credit portfolios are expected to grow by 13.7%, and corporate loans by 14.6%.

Brazilian banks are likely to begin looking abroad for growth opportunities. "Brazilian banks will explore investment opportunities mainly in Latin America, where Itaú and Bradesco will likely be regional consolidators," says Dimitri Abudi, partner at IGC Partners in São Paulo, a Brazilian member of the IMAP global organization of M&A advisers.

Hallake agrees that Latin America will present the most appealing markets for Brazilian banks. "It is quite possible that some of the larger Brazilian banks will be tempted to acquire banks outside of the country, particularly in other Latin American countries, where there appears to be the most synergies in terms of similar existing banking practices and culture," he says.

"In general, they [Brazilian banks] are solid institutions, but only a few banks are prepared to operate outside Brazil," notes Guilherme Bujas, sales director for the financial services industry at SAP Brazil. "Many large banks will focus on the domestic market for growth." BNDES has already opened a London office from which to spearhead its European and international expansion, while assisting Brazilian investors in acquiring European businesses and establishing joint ventures.

Febraban's Sardenberg feels the cross-border expansion drive will be a slow one, given strong opportunities still available at home, and will be limited to the country's largest banks with capital, technology and expertise to compete internationally. "I believe that acquisitions abroad will occur at a gradual pace, given that the domestic market in Brazil offers plenty of opportunities for investments," says Sardenberg. "Some domestic sectors, such as civil construction and infrastructure, will probably register high levels of growth in the next few years. That growth will certainly generate some fantastic local opportunities for the banking system."

An international expansion drive may require banks to adapt their corporate cultures and staffing. "Brazilian banks are relatively new to the globalization or multi-country presence of running banks abroad, particularly as it pertains to compliance and local HR regulations," says former banker Dennis Nason, CEO of the Miami-based executive search firm of Nason & Nason. "In addition, within their own institutions there is normally a need to seek executives that are capable to establish governance structures that expand beyond Brazil, incorporating their global network," he adds.

Meanwhile, market analysts remain divided over the sector's prospects. In late May Bank of America deemed Brazilian banking sector shares attractive and raised its recommendation on Itaú Unibanco shares to "buy" from "neutral," while affirming its "buy" recommendation for Banco do Brasil. Deutsche Bank, on the other hand, still feels Brazilian banking sector profits may drop by 13% this year amid deteriorating asset quality and slower loan growth.

Jorg Friedemann, a Standard & Poor's analyst in São Paulo, issued a note to clients saying that indicators point to "an inflection in economic growth prospects" for Brazil and that "if it is true that the worst is behind, the banking sector should benefit, given its strong correlation with domestic activity." For Friedemann, the discounted valuation for Brazilian large-cap banks presents a buy opportunity not to be missed.