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Domestic flourishing

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Brazilian companies are increasingly looking to domestic debt markets as investors show greater interest, tenors extend and government-backed debt financing gets more expensive. Denise Bedell reports.

The local debt capital markets in Brazil have grown rapidly in the past two years, coming to almost rival its neighbour Mexico both in terms of issuance size and maturities. It is now open to a wider array of issuers from further down the credit spectrum, and provides Brazilian firms with primary recourse to local debt, rather than looking to dollar-based funding in the Eurobond markets.

A number of factors have contributed to the swift expansion of Brazil's local markets, not least the rapid recovery and strong economic growth that Brazil has enjoyed over the past couple of years – in marked contrast to many developed economies. Brazil's economy recovered much faster and stronger than anticipated in the second half of 2009 and throughout 2010.

In the last quarter of 2009 GDP grew 5%, according to Alfredo Coutino, director at Moody's Economy.com. "GDP expanded at an average rate of 7.5% in 2010," he said. Coutino puts GDP growth at a more moderate 5% for 2011 and 5.7% for 2012.

With strong growth, increasing trade and solid domestic demand, companies in Brazil are looking for debt to fund growth, and both local and international investors are increasingly keen to add real-denominated debt to their portfolios.

In addition, debt financing from the Brazilian development bank BNDES, which traditionally directed very cheap funding to the corporate market, is getting harder and more expensive, pushing companies to the local public debt markets. Domestic companies' financing needs have grown, particularly with massive infrastructure projects planned over the coming years. And the government needs to cut back on its spending to maintain macro-economic stability.

However, BNDES will clearly continue to be an important funding source for the foreseeable future, said Jose Carlos de Faria, analyst at Deutsche Bank in Sao Paulo. "Although Minister Guido Mantega claimed that Treasury loans to the BNDES could be cut by as much as 50% in 2011, he did not provide details," he said. "We doubt that the new administration would be willing to reduce an important source of financing for infrastructure investments so quickly." The government recently announced an offer of up to R20bn in subsidised BNDES loans for a high-speed train project between Rio de Janeiro and Sao Paulo.

Helping hand

In order to help push development of the local debt markets, Brazilian policymakers have expanded an existing tax exemption on domestic infrastructure investment to foreign investors, in particular investors in long-term local corporate bonds. The exemption includes investment in toll roads and other infrastructure projects, all utility companies – especially energy companies – and construction companies.

In addition, the Brazilian securities commission enacted a rule over a year ago to make it easier for companies to launch a public offering. Rule 476 – which is somewhat similar to a 144a procedure in the US and speeds up and eases public launches, with some restrictions – were first used in 2009. Since then a number of companies have launched issues using this procedure.

These changes have affected the type of company that is now accessing the market, and what tenors and deal size that can be launched. "Although there has been a big concentration in the utility sector, there is now a substantial change happening in the market – especially as the country now has a lot of infrastructure investments to make in order to support growth," said Antonio Olivera, head of local debt capital markets at HSBC Brazil. "For example, with the World Cup and the Olympics, Brazil has to build infrastructure to receive these events."

Toll Road Autovias, for example, came to the domestic markets with a R405m debenture due in 2015 through bookrunners Banco Itau and Banco BTG Pactual early in 2010. The Vianorte toll road outside Sao Paulo – owned Spanish firm OHL – came to market with a R400m deal in March last year through bookrunner Banco Itau. The deal has a maturity of 2015.

Transactions are also starting to have longer maturities in comparison with the past. "Now we see market transactions with 10-year, or even 15-year maturities," said Eduardo Soares, corporate and securities partner with Tauil & Chequer Advogados in Brazil. "This is not the majority of transactions, but we have already had a few."

This is being driven by increasing appetite from both local and international investors. Katia Bouazza, head of global capital markets, Latin America at HSBC, said: "In the past Brazil, although active, looked primarily like a bank market given the banks' hold levels. But this past year, it really became a fully-fledged market with third-party distribution. Distribution to pension funds and investors is a big development in Brazil."

In the past, getting access to long term funding was a challenge for corporates in Brazil. The Brazilian government itself is still paying double digit rates on its own borrowings, making corporate bonds of less appeal to investors. In fact, Brazil offers among the highest returns on debt in the world's 20 biggest economies after adjusting for inflation, according to Thomson Reuters.

It is tough convincing portfolio managers getting double digit returns for what is, for all practical purposes, a risk-free return in the form of government debt, to take on the extra work and risk associated with corporate bonds, for a minimal additional return. It is quite a different situation from the US where investors are lucky to get 3.5% from government bonds, and are therefore keen to find a higher return.

The local market in Mexico is more developed in terms of structures, while longer tenors are available, said Olivera. But "Brazil became investment grade a few years ago, whereas Mexico has been investment grade for many years," he said. "This makes a big difference because the perception of international investors changes diametrically when a country becomes investment grade."

Brazilian companies are taking advantage of that changed perception, and the drive for yield, to fund themselves in the local real-denominated markets.

Building a secondary market

One of the factors inhibiting the further development of domestic debt markets, in Brazil and Latin America generally, is the dearth of a secondary market. When investors purchase domestic debt they are likely to be stuck with it until maturity. This limits liquidity and effectively caps both issuance volumes and maturities on real-denominated paper.

The government is working to change that. "A lot was done already but I think in the near future we will have a lot of attention from the regulatory authority on developing a secondary market," said Soares.

Another development which could help open up the local debt markets to further issuance is the development of the global depositary note structure – a debt equivalent to the equity-based global depositary receipt or American depositary receipt product. "A few banks are promoting these as a way to allow US investors to buy a dollar-denominated instrument based on a local currency offering," said Marc Rossell, Partner at law firm Chadbourne & Parke.

The search for yield is clearly driving interest in the product. "The yield that one can get on a bond in the US market is significantly reduced because of the activities of the central bank in the US to stimulate the economy," said Filippe Goossens, senior vice president at Moody's Investors Service.

As a result, investors are looking further afield for yield. Because of the historical risk profile of emerging markets – such as Brazil and Mexico – corporate issuers here must offer a much higher yield for a comparable credit rating than companies in developed market, thus attracting investors hungry for yield. The GDN structure opens a new avenue for investors to access higher-yielding Latin American paper in a dollar-denominated, registered structure.